

# epi International Letter to Investors

December 2009

Dear Investors

The problems of Dubai are already well known. It would have required a decade's residence on another planet not to have noticed the half finished developments, the huge redundancies in the State owned investment arms and GREs and the collapse of residential and commercial property prices.

Strangely enough therefore, it's surprising, that markets went haywire after the Dubai Government's request for a rescheduling of payment terms on part of its borrowings. People and markets always assumed that Dubai's debts would be covered by Abu Dhabi although for those of us on the ground, it didn't necessarily ring true. What really alarmed everyone is the sleight of hand that suddenly took the debt of both Nakheel and Dubai World out of the presumed safety net of a Sovereign Guarantee.

Our view is that these events do not mark the start of a new round of problems. This is all part of the continuing fallout from profligacy and the legacy of past financial excess. At the heart lies a failed exercise in commercial-property speculation and a massive over reaching of ambition, without the requisite operational controls or corporate governance to manage the situation. Of course at its centre lies the endless willingness of global lenders to provide financing for these lofty ideas but I doubt anyone need shed a tear for banks who failed to study the precise asset backing for their loans.

Sometimes it's important to have something against which our local crisis can be measured. On behalf of Royal Bank of Scotland, UK taxpayers are guaranteeing loans worth a staggering total of \$274 billion – more than ten times the loans being rescheduled by Dubai World subsidiaries Nakheel and Limitless. When UK bad debt is included the total grows to \$460 billion or around 25 per cent of British GDP.

The knock-on effects of default or debt rescheduling in the wider economies should thus be fairly limited. Dubai makes up less than 0.1% of the global economy and the UAE just 0.4% of outstanding global cross-border lending. This realisation together with the thought that the crisis might just actually be bullish for world markets given the need now to keep monetary policy loose, will probably bring investors to their senses.

Of course, restructuring is a very plausible scenario. We would like to think that the people handling the situation are attempting a turnkey solution, that is, one that will last rather than a short term fix. It's certainly not new to international markets and certainly Dubai is not alone in either severe downgrades to its credit worthiness or in the mess in which it allowed itself to fall. What is inexcusable is the manner

in which the announcement was handled and the continued whitewashing and opacity of commentary from spokesmen who would be expected to say more.

Dubai's bet is that creditors have no choice but to sign up to a restructuring that has yet to be worked out. One group of bondholders insist they can reject it and may force Dubai World into default. That would take all creditors into a legal system that has few precedents to call upon and is hardly impartial, leaving them in the end with nothing. In the long run, it's likely creditors will have little option but to agree to a restructuring, in which case life will go on. It is in everyone's interests to settle upon a path as quickly as possible in order to curtail any further damage to Dubai's credibility in the capital markets and thus its ability to raise funds in future.

Whilst the news may well hold some more sobering lessons for those governments elsewhere who are indulging in fiscal extravagance and huge leverage, what does it mean for markets in Dubai, the UAE and for investors within the EPI Group?

Firstly, Abu Dhabi cannot afford to be indifferent to Dubai's woes, as problems will inevitably spill over to its own banks and investors. Any immediate or potential damage to the banking system, however, will be contained by the UAE Central Bank's explicit support to any bank in the federation and to subsidiaries of foreign banks. It remains to be seen to what extent the banks ultimately suffer from impairment losses and write downs. In the long run, the colossal revenue from the hydrocarbon industry and the capital's more muted aims and prudent approach will guarantee stability and long term infrastructure developments should allow Abu Dhabi to continue on its strategic path.

In Dubai, an already moribund property market will probably tank further although immediately prior to the default, interest was picking up across the board as prices fell to levels at which international institutions could once again make sense of doing business here. The relative popularity and high costs of Abu Dhabi may also help Dubai due to the huge number of commuters now finding it cheaper to live here. It's unclear whether or not embittered banks will respond by withdrawing from the DIFC and if that is the case then one of the stronger areas of Dubai will suffer and our investments with it. It does though remain only a threat as banks have a tendency to follow the money and that still exists in the region in abundance.

Local stock markets are being hammered, with the maximum 10% limit down point on many stocks reached early so it's hard to know the precise damage to come, particularly given the large sell orders sitting on broker books. For those looking for a low point then two things need to happen: first, the scale and rescheduling of Dubai's debts needs to be agreed; secondly, global stock markets need to correct to a level commensurate with the poor economic outlook.

At that stage it will be a matter of deciding between the two emirates and individual stocks. Abu Dhabi might still be seen as the safer bet and as having suffered unduly because of its association with Dubai. It might then be a chance to buy the best stocks at great discounts. At this point, EPI International Syndicates have no direct exposure to UAE capital markets although I am a firm believer there will be hugely attractive opportunities in the weeks ahead.

The crisis will have no obvious impact on the Australian developments. Further information and updates on those will reach investors before the end of December.

Until the fog clears over what Dubai is going to do, it's impossible to make diagnostic statements regarding UAE PP1. It undoubtedly makes the likelihood of any immediate recovery in Dubai property prices inconceivable and yet there is clear evidence of higher than usual activity in the lettings market. On the serviced office side of EPI International, we are extremely busy and some of those tenants are looking to move out into the Marina corridor. There are regular viewings in our Reef Tower floors, which are not yet translating into tenants. Sheikh Ahmed's serviced office business over several floors there, however, is full.

It's clear that businesses are viewing the fall in prices as encouragement to venture back into the market. Whether or not this latest round of problems brings that to a halt is too early to say with certainty but on initial evidence, I would say not. It is going to take time to clarify where this may leave the existing holdings but the excess liquidity can be deployed in a combination of capital market purchases and mezzanine financing that provide a tremendous opportunity to capitalise on the problems. Given the tremendous uncertainty and fear in the market, which makes risk assessment impossible at the time of writing, I would not think that wholly sensible this side of Christmas. UAE PPII in tandem with UAE PPI is making small purchases in residential apartments in Abu Dhabi that we believe will weather the storm well.

The vital ingredient is confidence in the UAE's future, which we have. Dubai's debt problems have the potential to destabilise all that has gone before and present a barrier to significant future growth. Ultimately though it will force it to concentrate on what it did so well before; provide a cheap, commercially efficient hub to the vast marketplace on its doorstep and further afield. The fact that many of its assets are trading enormously profitably and many business sectors are expanding rapidly is evidence that the city's operations will hardly dry up. For some segments, next year is going to be terribly hard, which may force the rulers to adopt a more commercially positive approach either through relaxation of the residency laws and business ownership rules and with labour transfer and costs.

I see no collateral damage to Abu Dhabi's position and it is unlikely to bring any alteration in their growth aspirations.

With regards

Stephen Corley

Managing Director

**epi** International

**Equity Management, Property Syndication & Investment Strategies**

Team @ **epi** International