



Change Is In The Air

The six nations of the Gulf Cooperation Council (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE—have a common need to adjust to a changing global oil market as a result of the surge in US oil production. They will need to be less profligate in their spending and more careful about how they invest oil revenues. They will also need to continue to look toward Asia in hopes of finding sustained demand for energy and petrochemicals in emerging markets.

The recent decision by Saudi Arabia to shift its weekend to Friday and Saturday—from Thursday and Friday—is symbolic of the broad changes taking place throughout the Arab Gulf. It will bring Saudi Arabia into line with the other members of the GCC and will help strengthen economic relations within the group. The realignment could portend a move by Saudi Arabia to open its financial markets wider to foreign investors. The sparkling new King Abdullah Financial District in the Saudi capital, Riyadh, is looking for tenants. The UAE capital, Abu Dhabi, has also built a new financial center and will be competing for a role in the global marketplace.

GCC countries will still be big spenders on infrastructure projects this year, despite longer-term worries about oil prices. Metro and light-rail projects are planned or underway in Riyadh, Doha, Kuwait and Abu Dhabi. Power and water projects are on the agenda in Oman. Qatar is preparing to host the FIFA World Cup in 2022. Highways and hotels are being built throughout the GCC.

Foreign direct investment is also an important economic driver in the region. Countries such as Saudi Arabia and the UAE are attracting significant amounts of investment from abroad owing to their pro-business environments. The GCC remains a region of political and economic stability in a sea of unrest.

There are many question marks on the long-term horizon, however. Efforts to diversify economies have been less successful than many had hoped. Oil is still the key economic ingredient for most GCC countries, and they face growing threats of falling prices and new competition. Rising consumption of cheap oil within the region is another issue that needs to be addressed. Change is indeed afoot.

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Seeking A New Model

As the infrastructure boom continues, it may be time for GCC countries to reevaluate how they select and fund new projects.

“**A**bu Dhabi cannot rely solely on the auto when the population reaches three million. The city will need a multi-layered transportation network to connect the downtown core with new growth nodes and the developed islands,” reads a passage from Abu Dhabi’s 30-year plan. It goes on to discuss the need for such a transportation network, including “high-speed rail to distant destinations, a local metro rail, freight rail, a surface network of buses, street cars and light rail.” Qatar, a much smaller GCC country, has discussed the need for sizable

investments in infrastructure that “will be significant relative to the size of the economy.”

An infrastructure boom is taking place in the GCC. Most of the GCC countries have some kind of 30-year plan or vision to develop projects, as these oil-rich countries look to invest surplus funds in transport, utilities (power, water) and petrochemical infrastructure to keep pace with their rapidly growing economies and populations.

In 2012 when he was chief economist of the Dubai International Financial Centre (DIFC), Nasser Saidi estimated that developing oil export economies needed to commit 11% of their GDP to maintaining and improving their national infrastructure. Areas with the greatest need for investment, he said, were transport, particularly roads, and the electricity sector.

Historical underinvestment in infrastructure, rapidly-growing populations, the emergence of the new Silk Road trading route between the MENA region and Asia and the need to diversify beyond oil and gas are all contributing to the need for heightened investment in infrastructure. “GCC countries are looking to diversify away from carbon-based economies, and as part of that they have to become more efficient in order to compete in the global market,” says Tim Risbridger, partner and head of major projects, Middle East, at international consultancy EC Harris. “This requires investment in new transportation infrastructure—airports, ports, highways and rail.”

EC Harris’s Global Infrastructure Investment Index ranks 40 countries in terms of their attractiveness for infrastructure investment. The UAE and Qatar are featured in the top 10. Saudi Arabia, the GCC’s largest economy, is ranked 11. Given its high income per capita and government support for large-scale infrastructure projects, the GCC, says EC Harris, will become a hub for global infrastructure investment.

The infrastructure gap is not unmanageable in the UAE, Qatar or Oman, notes Dolan Hinch, director and head of infrastructure and energy, Middle East and Africa, Deutsche Bank. “Kuwait has more to do, and in Saudi Arabia the population is growing exponentially, so it needs to put in more infrastructure.”

Despite the quest to support economic diversification through infrastructure investment, Hinch says, most of the large infrastructure projects in the GCC are dominated by power, oil and gas and industries based on natural resources. Risbridger says there is currently a major focus on transportation in the region, with some facilities being built ahead of demand as a way to attract new businesses into the region.

FUNDING MECHANISMS

Unlike in Europe—where most of these projects are developed on a public-private-partnership basis—in the GCC, PPP has not really taken off yet. “Governments have tended not to choose PPP and have just written a check,” says Hinch. “Part of the reason for that is access to funds. Why borrow [at] 250bps above

Libor when you can write a check from your own balance sheet?”

Risbridger says that for PPP to be attractive to investors, there have to be reliable revenue streams. “[GCC] governments have reviewed the value of using the PPP model for highways, but it is difficult to financially justify this approach when they have direct access to cheap capital. There isn’t currently the appetite in the region for toll roads, so revenue can only be generated through operational efficiency KPI [key performance indicator] mechanisms paid for by the government, at what is often seen as a premium price.”



Saidi, Middle East economist and corporate governance advocate: Financing infrastructure projects through bonds or sukuk gives you a market test as to their viability

However, in the utilities sector, where there is revenue generation, PPP is taking hold. “There are some examples where PPP is working and has worked for a number of years now,” says Risbridger, “but in transportation it is probably some way off.” GCC governments may have the capital to finance large-scale infrastructure projects, but Hinch says they should get the experience and operating benefits (risk mitigation) of PPP and use their own capital to finance the more difficult ones (toll roads, schools hospitals).

“Nobody really asks about the feasibility of these projects,” says Saidi, adding that reaching into their pockets every time a piece of infrastructure needs financing doesn’t subject these projects to a true market test.

“Financing infrastructure projects, petrochemical, water, ports, airports through bonds or sukuk—that gives you a market test as to their viability,” Saidi believes the Middle East is at the start of a major shift in terms of how public finances are handled. “If you want to finance electricity and water, turn to the markets. I am encouraged by the UAE, where the Dubai Electricity and Water Authority used sukuk markets,” he notes.

Iqbal Khan, chief executive of Fajr Capital, an investment firm based in the DIFC, says there is a growing realization that the region’s infrastructure needs cannot be met by the public sector alone. “The development of PPPs, therefore, is leading to opportunities for the private sector to contribute towards infrastructure development to enhance the provision of services and facilities and create enduring value through synergies between public authorities and private companies.”

Mark Lemmon, CEO of Fajr Capital’s MENA Infrastructure, a private equity infrastructure investor, says there are several experienced international developers prepared to invest in companies within the GCC that are responsible for the construction, operation and ownership of key infrastructure assets such as power

and water utilities. In addition, he says development agencies, sovereign wealth funds, pension funds and other sources of capital also have an appetite for investment in infrastructure in the GCC. The strongest appetite, he says, comes from Asian countries.

The MENA Infrastructure Fund that Lemmon manages invests in the equity of companies that own either brownfield or greenfield infrastructure assets. “This capability and appetite provide a significant level of increased liquidity for this asset class,” says Lemmon. “In turn, this liquidity enhances competition from private-sector consortia for winning projects to build new infrastructure facilities in the GCC region—hence enabling governments to achieve optimal pricing for infrastructure investments procured via public-private-partnership structures.”

Hinch says export credit agencies also play a major role in infrastructure finance in the region. “The Japanese government is the single largest lender to Saudi Arabia and is mostly invested in power plants and petrochemicals,” he says. Islamic financing is also being used in some infrastructure projects. “The uniqueness of Islamic finance, which allows for conventional investors to also participate in its issuance, makes it an inclusive financing option with a broader appeal,” says Khan of Fajr Capital. “Syndicated financing and tapping into the sukuk market are two concrete steps in the path to achieving financial close.” Khan says infrastructure is also an attractive asset class for Islamic investment institutions such as Fajr Capital, which seeks to complement sizable and stable returns by creating long-term socioeconomic value.

Lemmon also expects to see an increase in equity investment in infrastructure in the region from funds and from large institutions participating directly in investment projects. But for PPP to really take off, Hinch says, a broader PPP framework that looks at risk allocations and what is expected from the development is needed. “Now, it is just an ad-hoc exercise,” he says.

But with billions slated for investment in infrastructure across the GCC, are all of these projects likely to get done? Pretty much all GCC countries are rightly reviewing the situation on an ongoing basis, says Risbridger, and are deciding which investments should be prioritized. “Just the sheer volume of what is planned can’t be done in five to 10 years. As countries grow and develop, they are having to prioritize projects to reflect changes in their population demographics and the needs of new industries. So what we are seeing is that some projects are being put back whilst others are being brought forward.”

Hinch says there is significant potential for infrastructure development in the GCC but that a different view is needed of what money to use. At the moment, he says a lot of infrastructure projects get done based on relationship lending and pricing. But if external investors are to get involved, they will want to see a return on their investment. “Some of the infrastructure projects are just a pipeline of dreams,” says Hinch. “Some won’t get done. Only those projects that make sense will get done.” ■

Stepping Up The Competition

Does the Gulf Cooperation Council need yet another international financial center? Oil-rich Abu Dhabi thinks it does.

The United Arab Emirates is about to open its second international financial center, in the capital city of Abu Dhabi, 90 minutes down the highway from Dubai, which has already established itself as the leading regional financial hub. Abu Dhabi will also compete with Qatar, Bahrain and the up-and-comer: King Abdullah Financial District in the Saudi Arabian capital of Riyadh.

The emirate aims to offer an exceedingly wide range of financial services that will put it in direct competition with Dubai. The new financial market will be tax-free for 50 years and will allow full foreign ownership of companies.

Meanwhile, Riyadh has become the headquarters of the Gulf Monetary Council and will host the GCC central bank, which aims to introduce a single GCC currency by 2015.

Earlier this year, UAE president sheikh Khalifa bin Zayed Al Nahyan, who is also ruler of the emirate of Abu Dhabi, issued a decree establishing Global Marketplace Abu Dhabi as a free zone for international financial services. According to the text of the law, the new market is being created as a link between markets in the Far East and Europe, eliminating the time gap among global financial markets from 7 AM to 11 AM, UAE time. Of course, this is the same time zone in which Dubai operates.

The new marketplace is designed to create a favorable economic environment to attract financial investments. A major concern is that the free zone on Abu Dhabi's Al Maryah Island will siphon business away from Dubai, which only recently recovered from a debt crisis in 2009, following a collapse of its property sector. Abu Dhabi bailed out Dubai at the time with \$10 billion of financing to help Dubai World, the state-owned holding company, avoid default.

"There are examples of financial centers in relatively close proximity in other countries and regions," says Giyas Gokkent, group chief economist at National Bank of Abu Dhabi. "There will inevitably be areas of overlap [between Abu Dhabi and Dubai], given that both centers intend to offer a wide range of services, but there will also likely emerge areas of differentiation," he says.

For example, asset management, currency and commodity trading could be areas of strength for Abu Dhabi, according to Gokkent, particularly given a number of sovereign wealth funds based in the capital. "A focus on asset-management activity



Gokkent, NBAD: The presence of the Abu Dhabi Investment Authority and Mubadala could be a powerful magnet to attract foreign financial institutions

would attract ancillary businesses such as brokerage, custody, administration, consultancy, audit, legal, ratings and so on."

The presence of the Abu Dhabi Investment Authority, the second-largest wealth fund in the world, and Mubadala, the state investment fund, could be a powerful magnet to attract foreign financial institutions, Gokkent says. There will also be scope to develop debt capital markets, he adds, bolstered by the substantial debt that will be issued to finance Abu Dhabi Economic Vision 2030—the long-term plan to transform the emirate's economy

away from overreliance on the oil sector and toward greater focus on knowledge-based industries.

Meanwhile, following five years of review, index provider MSCI in June upgraded the UAE (along with Qatar) from frontier markets to emerging markets status, effective May 2014.

"Greater foreign investment flows will improve liquidity and further attract investor interest," Gokkent says. "I also expect initial public offering [IPO] activity to pick up." While Saudi Arabia has the biggest stock exchange in the region, it limits foreign investors to equity swaps and exchange-traded funds.

The UAE government announced in May that it would create a separate court system and legal infrastructure for businesses operating in the new financial free zone. There will be a lower court, or court of first instance, as well as an appeals court. The system will be based on English common law, similar to the legal structure used in Dubai International Financial Center.

The infrastructure for the Global Marketplace has nearly been completed, including four new office towers. Nearly 50 multinationals, including General Electric, Deloitte, J.P. Morgan, Société Générale and Macquarie Bank already have offices on the island.

The DIFC, meanwhile, already houses more than 900 actively registered companies, including Nasdaq Dubai—one of the world's leading exchanges for sukuk. ■



Shale Oil Boom Rattles GCC Economies

As US shale oil and gas production continues to grow, it could have an impact on GCC economies over both the short and long term.

The supply shock to global energy markets created by a surge in US oil and gas production is putting a damper on economic growth in the Arab Gulf, as oil-exporting countries of the Middle East have become more reliant on high oil prices to balance profligate fiscal spending. The International Energy Agency says US shale oil will help meet most of the world's new oil needs in the next five years, and the US could become the world's largest oil producer as early as 2017, the IEA forecasts.

Real GDP growth in Saudi Arabia, the world's largest oil exporter, will slow to 4% this year from 5.1% in 2012, owing to an expected decline in oil production to support prices in the face of new supply, according to the International Monetary Fund. "Private-sector growth is expected to be strong, but oil production is likely to drop below 2012 levels, while government spending growth may slow," the IMF noted following a consultation with Saudi Arabia in July. In Kuwait the central bank expects economic growth to slow to 1.9% this year from 6.3% in 2012, also owing to lower production.

The pace of public spending in a number of Gulf Cooperation Council countries increased dramatically in the wake of the Arab

Spring uprisings in an effort to placate the populace. Despite the expected slowdown in government spending this year, continued strong investment in non-oil industries—such as petrochemicals, fertilizers, steel and aluminum—will support non-oil GDP growth in the near term, economists say. But any shocks to the oil price could have a serious impact.

James Reeve and Andrew Gilmour, senior economists at Riyadh-based Samba Financial Group, said in a recent report: "The outlook for oil prices is perhaps more uncertain than normal. Worries about conflict in the Middle East are likely to keep

GCC OIL PRODUCTION BY COUNTRY IN 2012

Country	Production (millions of barrels per day)
Saudi Arabia	11.53
United Arab Emirates	3.38
Kuwait	3.13
Qatar	1.97
Oman	0.92
Bahrain	0.05

Source: BP Statistical Review of World Energy, June 2013

markets on edge, but the shale-oil 'revolution' in North America seems set to loosen fundamentals in the medium to long term. We see [Brent] prices drifting—albeit remaining high by historical standards—to some \$98 a barrel by 2015.”

The Organization of Petroleum Exporting Countries (OPEC) expects demand for crude produced by its member countries to fall 2.6% next year, even as global oil demand is forecast to rise by 1 million barrels a day. “GCC oil production has already been cut quicker than we had expected, and real oil-sector GDP is seen declining 2% this year and unchanged in 2014,” the National Bank of Kuwait (NBK) said in a recent report. This will still leave oil output at historically high levels and be enough to finance rising government spending without draining financial reserves in most GCC countries, the bank says.

The IMF notes in its latest regional economic outlook that, given oil-exporting countries of the Middle East and North Africa region's current vulnerability to oil-revenue shocks—despite a near-term positive outlook for the regional economy—these countries are projected to start drawing on savings soon and should contain current spending. “It is important to contain hard-to-reverse spending to increase resilience to oil price declines,” the IMF says. Governments should ensure that capital spending is productive and invest in human capital, as well as implement reforms to increase economic diversification, it adds.

The expected drift lower in oil prices will affect economic activity in Saudi Arabia, the Samba economists say. “Activity has already slowed somewhat, and we expect this trend to consolidate as the government trims the pace of capital spending. Thus, we see non-oil GDP growth easing from an estimated 4.8% this year to 3.5% in 2015.” The main risk to this relatively benign outlook, according to the Samba economists, comes from the oil market: Projections of North American supply additions are still very uncertain, and there is a chance that the market will struggle to absorb the new supply, putting more downward pressure on prices.

Saudi Arabia's government spending commitments are substantial and leave little room for a reduction in the event of a sharp and sustained downturn in oil prices, the Samba economists say. However, they add, “we do not currently expect such a downturn, and it is also true that the authorities have built up substantial savings worth more than 100% of GDP.”

AT RISK

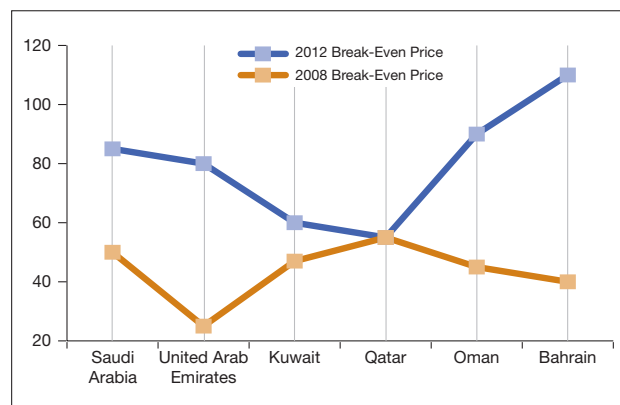
In addition, Saudi Arabia's petrochemicals industry is at risk. “The Saudi petrochemicals industry is perhaps more vulnerable than it has been for some time,” Samba's economists say. There is a clear challenge from US petrochemical plants with access to cheaper natural gas, a crucial raw material for petrochemical production, they explain. Meanwhile, China's economic growth outlook has weakened, which could affect demand for petrochemicals, they add.

Moody's Investors Service placed the debt of Bahrain on ratings watch in June for a possible downgrade, noting the country's rising debt burden and reliance on a high fiscal break-even oil price, which is estimated by the IMF at \$118.7 a barrel. The break-even price is the price needed for oil revenues to cover the cost of government spending (see chart, below). In addition to debt worries, the ongoing political and social tensions in Bahrain could ultimately weaken the country's growth prospects, according to Moody's. The United Arab Emirates and Saudi Arabia need a price of about \$85 a barrel to balance their budgets, up from about \$20 a barrel in 2003.

Neil Shearing, chief emerging markets economist at Capital Economics in London, says that although the US shale-oil boom will have an impact on the GCC mainly through the price channel, “oil prices would have to fall a long way and stay low for a long time to cause serious fiscal problems for most of the GCC countries.” Bahrain, Oman and then the UAE are the most vulnerable to a decline in oil prices, Shearing says. Saudi Arabia has strong reserves to count on: more than \$694 billion of foreign currency reserves, according to the Saudi Arabian Monetary Agency. He adds that the kingdom would have no trouble borrowing in international markets, if necessary.

Oil prices rose to the highest levels in more than a year during July, amid political upheaval in Egypt and a seasonal rise in

GCC Oil Break-Even Prices By Country (Brent Crude, \$ per barrel)



Source: Capital Economics

summer driving in the US and elsewhere, as well as growing demand for air conditioning, particularly in the Middle East and other emerging markets. Nevertheless, the trend for the next three years appears to be toward weaker prices. Capital Economics expects oil prices to drop to about \$85 a barrel by the end of 2015, putting more pressure on budgets in the GCC.

Substitution of shale gas for oil in transportation could have a long-term impact, Shearing says. In addition, the development of shale fields in Russia and China could add to supply. ■