

Chazen International Study Tour Report

Dubai's Bid for Sustainable Prosperity: Capitalizing on Growth in the Indian Ocean Basin

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Introduction

Dubai has long been a major commercial hub for the Indian Ocean basin, a region that stretches from the Persian Gulf to Southeast Asia and includes East Africa. As such, the city-state's prosperity has always been rooted in its ability to attract human and economic capital from all over this part of the world. The 2010 Chazen Dubai Study Tour made clear that Dubai's economic future more than ever hinges on its continued hub status for transportation, logistics and finance in the Indian Ocean basin. Increasingly, the emirate's fate will be tied less to that of its Arab Gulf neighbors and more to its relationships with other large actors on the world stage, especially India. As the source of much of Dubai's talent, trade and even culture, India will play an ever-larger role in Dubai's prosperity.

Throughout the 18th and 19th centuries, Dubai served as a transit point for goods and merchants from South Asia, Persia, East Africa, central Arabia and Mesopotamia, its free-port environment protected and promoted by the ruling Maktoum family. Oil concessions were signed in the 1930s and Dubai began building a modern city in the 1950s.¹ The Maktoums' strategy has been to retain the free-port model, and the building of modern Dubai saw the rise of tax-free Special Economic Zones and a state-of-the-art port facility. Sheikh Mohammed, the current ruler, has stated that his vision for Dubai is a modern version of 10th-century Cordoba, a center of Arab enlightenment, although the modern city is often assumed to follow the mold of Las Vegas.² In reality, of course, the result is somewhere between the two. Based on the Chazen study tour's observations, many of the professionals in Dubai are focused on investing, trade and advisory services for the hydrocarbon-rich Gulf Cooperation Council (GCC) countries that form the Arab Gulf—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE). While many of the flashy real estate projects do exude a Vegas approach, these have been pulled back during the current recession, leaving the economic core of professional services.

When the UAE federation was formed in 1971, Dubai was overshadowed by neighbor Abu Dhabi and its far greater oil and gas reserves. Long the most liberal emirate, Dubai was determined to become the finance and trade hub of the Middle East by building superior physical infrastructure, maintaining a light regulatory touch that would attract businesses and liberalizing social policy to make the city a destination for skilled expatriate workers. Dubai's social

¹ See, for example, Davidson, Christopher M. *Dubai: The Vulnerability of Success*. Columbia University Press: New York, 2008, pp. 67–91.

² Worth, Robert F., and Heather Timmons, "Debt Crisis Tests Dubai's Ruler." *New York Times*, 3 Dec. 2009.

liberalization has caused tension with its more conservative neighbors, especially as the ever-splashier lifestyle projects of the 2000s garnered extensive media attention.

The global availability of credit during the mid-2000s, capital flight from Iran under the Ahmadinejad presidency and investment from oil-rich neighbors who felt unwelcome in the West after the September 11th attacks created an environment hospitable to leverage for even the most dubious of real estate projects. As occurs with many emerging markets debt crises, Dubai faced a fundamental maturity mismatch between liabilities and assets. The emirate's loans were primarily of three to seven years in duration, but were funding projects that were part of a multigenerational development strategy. The government-owned real estate company Nakheel's projects were among the most speculative and least able to support debt-servicing from cash flows. During the global credit crisis of 2007 and 2008, Nakheel and other entities were unable to roll over their debt, leading to Dubai's November 24, 2009, debt standstill request that rocked global debt markets. Whether and how Dubai will recover remains uncertain, but the city retains the advantages that have made it the business center of the Gulf and one of the busiest trade hubs in the world. However, the bail-out of Nakheel's corporate parent by Abu Dhabi casts a shadow over Dubai's ability to continue to attract foreign talent and to draw trade and finance from Iran.³

Dubai's Three Pronged Strategy

One of the first companies that we visited was Standard Chartered. Here the commercial bank's senior economist, Philippe Dauba-Pantanacce, gave us a detailed overview of the region. He pointed out that Dubai is not representative of the entire Middle East. In fact, the region's many states each have their own competitive advantages and challenges. I will first focus on Dubai and then discuss some of the other city-states.

Trade and Logistics

From pearling in the 19th and early 20th centuries to smuggling gold into closed 1950s India, Dubai's advantage has always lain in its status as the trade hub for the greater region. Along with oil revenue, the port's business as a center for transshipment of goods between Asia, Africa and

³ Data were obtained from the CIA World Factbook. Although there are no reliable data for investment flows, Iran represented over 5 percent of UAE exports in 2008. Most of those would have come from or through Dubai, which is the only emirate with a substantial trading relationship with Iran, for political reasons.

Europe⁴ provided the seed funding in the 1950s onward to build the modern city we saw in our January visit.

Dubai is the busiest port in the Indian Ocean basin after Singapore, far surpassing other ports not only in the Persian Gulf but also in East Africa and South Asia. We visited Dubai Ports World and toured their impressive facility. Their strategic plan calls for an increase in shipping volumes from 46.8 million 20-foot equivalent units (TEUs) in 2009 to 97 million TEUs by 2017. Despite its size, the port only employs roughly 4,000 people. If this is the economic driver of Dubai, one is left wondering why the emirate has built a city with a real estate capacity for a population of two million.

Standard Chartered's chief Middle East/North Africa (MENA) economist explained that Dubai's port services a region with a population of two billion. The vast bulk of this, though, is India's 1.3 billion. Consider the Arab Gulf's tiny population of about 40 million and the low trade-intensity of the GCC countries' economies, and it becomes apparent that as long as Dubai remains primarily a trade hub, its prosperity will be tied to the rise of India, given that trade in goods is dependent primarily on population and GDP size. In general, Dubai's trading partners are largely to be found in Asia. India is currently the second-largest source of the UAE's imports, after China, and the country's fourth-largest export market, after Japan, South Korea and Thailand. India accounts for 10 percent of the UAE's imports and 5 percent of its exports.⁵ Furthermore, given that so many small and medium enterprises (SMEs)—which often operate below the level of official scrutiny—are Indian-owned, the official numbers probably underreport a lot of the actual Dubai-India trade. As the country with the largest population and fastest growth in the basin, India will undoubtedly grow in stature in Dubai's trade figures.

Finance

The Chazen study tour visited several institutions with an inside view of Dubai's efforts to become the financial center of the Gulf. While this initiative is fraught with challenges, the emirate is years ahead in establishing the legal infrastructure and attracting the requisite talent necessary to fulfill this vision. The Dubai International Financial Center (DIFC) is both a physical space and a legal entity that gives foreign companies 100 percent ownership rules, a tax-

⁴ Transshipment is the activity of unloading goods and reloading them on different ships, mostly from larger oceanic tankers to smaller regional ships—similar to an airline hub-and-spoke system that moves passengers between nonmajor airports through connecting flights at hub cities.

⁵ Data were obtained from the CIA World Factbook and the IMF. Data were not available on a per-emirate basis, but as Dubai is by far the trade leader within the UAE, the proportions presented here are likely to be close to the corresponding figures for Dubai.

free charter, and access to a modern court and dispute-resolution system. However, wealthy neighbors Qatar, Abu Dhabi and Saudi Arabia are all also striving to build the region's preeminent financial center, and it is unclear how many centers the tiny region can support. Banks that left Bahrain for Dubai found that Dubai offered fewer legal protections.⁶ And, with Abu Dhabi reasserting control in the wake of the bail-out, Dubai may be forced to adopt Abu Dhabi's more combative posture toward Iran, reducing the flow of Iranian capital.

Our visit to Goldman Sachs illustrated the boom-bust cycle the city-state has witnessed in recent years. Goldman opened its Dubai office in 2003 and rapidly built its headcount to 93. As of our visit, they were down to 75. The office performs a full suite of corporate financial services, but leads with private banking and acknowledges that its lack of balance sheet precludes it from a lot of deals, indicating there is not yet a deep market for traditional M&A and underwriting activities in the Gulf.⁷

Similarly, while listed equity markets do exist, they are thinly populated and traded. Just before our group's arrival, Dubai Ports World, the company Goldman identified as the only equity to trade in significant volume on Nasdaq Dubai, announced that it was partially listing on the London Stock Exchange in a bid to boost its shares' liquidity.⁸ A perusal of the Dubai Financial Market's Web site⁹ reveals that only 135 companies trade on its exchange, and on a recent day the average bid-ask spread was 35 percent of the closing price, revealing a wide margin of difference in valuation between buyers and sellers, an indication of shallowness and illiquidity. Nonetheless, all commentators we visited—from DIFC's own staff to Goldman, Standard Chartered, MENA private equity firm Abraaj and insurer Zurich Financial—agreed that Dubai had a tremendous head start in the region when it came to the legal framework, exchange infrastructure and ability to attract expatriate talent necessary to be the region's financial hub.

Despite all these advantages, investors have still found Dubai lacking in transparency. Dubai World bondholders believed the conglomerate was backed by an implicit state guarantee, but have discovered this is not the case. Perhaps the biggest question now is how robust the demand for financial services will be after the collapse of the local real estate bubble. Given comments from our presentations, financing activities have stabilized, but the outlook is uncertain.

⁶ Interview with Professor Lawrence Potter of Columbia University School of International and Public Affairs and deputy director of Gulf2000 Project at Columbia University.

⁷ Competitor investment banks with large consumer banking operations—unlike Goldman—often drum up advisory business by using their ability to lend billions to high-profile projects to get the institution's foot in the door.

⁸ Kerr, Simeon, "Nasdaq Dubai Blow as DP World Looks to London," *Financial Times*, 6 Jan. 2010.

⁹ <http://www2.dfm.ae/>

Tourism

The Standard Chartered economist informed us that Dubai and Abu Dhabi's airports were the only ones in the world to increase passenger traffic in 2009. Even during the boom years, luxury hotel prices were a bargain relative to the capitals of Europe and Asia. One pithy investor quipped that the region is called the Middle East "because it's in the middle," making it a convenient location for meetings of Western and Asian executives. Our group can attest to the quality of service in hotels and restaurants, and the temperate January weather was a welcome reprieve from New York.

Nonetheless, the real estate binge of the 2000s has clearly left the city with overcapacity. We estimated our top-end business hotel to be about half full during a week that falls in Dubai's peak season. While many high-profile projects have been reined in, those already under construction are so multitudinous that the skyline remains replete with half-built towers. Our arrival one week after the unveiling of the hastily renamed Burj Khalifa—now the world's tallest building, named after Sheikh Khalifa of Abu Dhabi, who has bailed out Dubai several times in the last six months but most spectacularly with a \$10 billion loan after the Nakheel stand-still request—highlighted the pipeline of high-profile projects still in the works. A Boston Consulting Group consultant we met estimated that real estate supply has outpaced demand by four years. An employee of Dubai Holding, one of the state-owned holding companies, acknowledged that while the capacity of commercial real estate is in line with residential, there is significant total overcapacity in the city. Moreover, Dubai's new reliance on Abu Dhabi for short-term financing may allow the more conservative emirate to insist on slowing the pace of social liberalization, which would have a negative impact on tourism and real estate.

The Next Frontier for Modern Dubai

Notwithstanding Dubai's recent troubles, the city-state's economic foundation of trade and finance remains solid. Its greatest challenge in the coming years will be to grow into the size of the physical city it has built and—if it really wants to be the Hong Kong and Singapore of the Gulf—develop a truly cosmopolitan city where expatriates will want to live on a long-term basis and where they will feel welcome by the authorities to do so. Since the crisis, many expatriates have found themselves in jail for defaulting on car and home-mortgage loans.

Most expatriates we met have been in Dubai since no earlier than 2006, and most planned to leave relatively soon. Furthermore, it is virtually impossible to obtain a residence visa except by

employment. Even retirees who own property cannot technically stay unless they own a business. There is no nascent art scene, an uneven ratio of male-to-female expats, and little true immigrant culture except for the poorly integrated South Asian community. For a city-state with a native population of roughly 400,000, it will be difficult to build a 21st-century hub without legalizing long-term immigrants. Fortunately for Dubai, it has a long history of openness and accepting foreigners its Gulf neighbors would not. Many prominent families are in fact descended from 19th- and 20th-century Persian merchant émigré families.¹⁰ Today, the government of Dubai is addressing many of its shortcomings in order to make it a more pleasant place to live. We met an employee of the Ministry of Arts and Culture who is attempting to build a native art culture. Neighbor Abu Dhabi is engaged in several high-profile arts initiatives, including building a local branch of the Louvre.

In building a cosmopolitan Dubai, the city will once again look across the Gulf to India. A McKinsey consultant told us that if there is an indigenous entrepreneurial community within Dubai, it is to be found in the South Asian community. India and Pakistan provide 60 percent of Dubai's labor force—from construction workers to investment bankers—and one Indian business owner told me that Indians own many of the roughly 40,000 SMEs in the city. These families have lived in Dubai for decades and have a sense of permanence that the Western expatriates currently do not. The employee of Dubai Holding—an Indian expatriate and soon to be Columbia Business School student—told me that one industry the government is eyeing for the next decade is outsourcing, capitalizing on a skilled labor force, ubiquitous fluency in English and top-flight infrastructure. In this endeavor, Dubai will certainly want to study the success India has enjoyed and adapt it to its own comparative advantages.

Conclusion

In contrast to its portrayal in the media, Dubai's boom in the 2000s was a natural continuity of its historical success, built on openness and trade. As the Standard Chartered economist pointed out, wild as some of the real estate projects may have been, they were prerequisites for generating publicity and attracting skilled international talent. The McKinsey consultant compared Dubai's overinvestment in real estate and infrastructure to American overinvestment in rail during the turn of the last century: It may have precipitated a financial crisis, but it left the country with excess capacity in transportation that spurred further economic growth. Dubai will

¹⁰ Davidson, pp. 67–91.

certainly need to be innovative, create new industries and attract a more varied array of people if it expects to fill its glut of office and apartment towers, but at the least it will likely remain successful in its bid to be the trade, logistics and finance hub of the Gulf. From that position, with competent leadership and a little bit of luck, it can continue to capitalize on its advantages to ride the wave of economic growth spreading throughout the Indian Ocean basin to a new era of prosperity.