

Chazen International Study Tour Report Oasis or Mirage in the Desert?

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**Runner-up,
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Chazen International Study Tours

Designed to enhance the classroom curriculum, Chazen International Study Tours offer students and their faculty adviser an intense, firsthand experience of the business culture of their chosen country or region. Study tours are initiated by students and organized with the help of the Jerome A. Chazen Institute of International Business. During study tours students meet with leading executives and government officials while visiting businesses, factories and cultural sites. Destinations change yearly, as study tours are student-initiated. Recent destinations include Brazil, China, Dubai, India, Japan, Mexico, Romania and South Korea.

Introduction

“Is this real?” That is what most people ask as they travel through Dubai for the first time. Most cannot believe the development that has occurred in Dubai at breakneck speeds over the last few years. The world’s tallest building, a palm-shaped man-made island in the ocean, the world’s only seven-star hotel, a ski dome in the middle of the desert and the world’s tallest water fountain—these are only a few of the things that make Dubai so special. But is there more to Dubai than just these fanciful attractions?

This winter break a group of 20 students from Columbia Business School visited the United Arab Emirates in order to answer this question. We visited public and private sector companies that operated in the following areas: finance, private equity, consulting, sovereign investment holdings and infrastructure developers, in order to see if Dubai was an oasis or a mirage in the desert.

Regardless of what one feels about the changes that have occurred in Dubai, everyone agrees that much has changed. Dubai is a very different place today than it was 10 years ago. However, there is a popular misconception that Dubai represents the Middle East. The truth is that the Middle East has many cities with their own unique culture, traditions, economics and politics. One cannot talk about Dubai as an accurate representation of the entire Middle East.

In order to answer the question as to whether Dubai was an oasis or a mirage, I decided to analyze the fundamentals of the region and of Dubai. In this regard our company visits provided deep insights as to what Dubai has achieved and the challenges it has recently faced. I have concluded that Dubai is not a mirage but is well on its way to becoming an oasis.

Services Companies

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.

Mr. Dauba-Pantanacce’s presentation indicated that Dubai has certain competitive advantages that will be difficult for its regional competitors to replicate. From airports to seaports to roads, Dubai’s transportation infrastructure, which has been built to international standards, is the best in the region. One can fly to practically any corner of the world from Dubai

nonstop. Emirates Airlines flies to destinations across the six continents. The ports at Jebel Ali have become a major transit point for international commerce shipping. Dubai's vast road network has land connections available to most cities in the Middle East, which only increases its viability as a commerce and transit hub for the entire region. The importance of this infrastructure cannot be underestimated. Even though Dubai's regional competitors are financially stronger, they are years behind in infrastructure development and as a result it will be difficult for them to match Dubai's rapid progress.

Furthermore, Dubai is also marketing itself as a destination for tourist and business travel. It has the most hotels in the region and they cater to the entire spectrum of travelers. Many companies now view Dubai as a convenient conference destination where they can bring people from all over the world. Halfway between London and Hong Kong, Dubai has the added advantage of being in the middle of the business world.

Mr. Dauba-Pantanacce also gave an overview of the Middle East region and a detailed background on the United Arab Emirates (UAE). The UAE comprises seven emirates, or city-states, of which Abu Dhabi is the biggest and wealthiest state, followed by Dubai. All the city-states of the UAE have the same defense, monetary and foreign policy but are free to have their own economic and fiscal policies. Looking at the broader region, from a business perspective the Middle East is generally accepted to consist of the six Gulf Cooperation Council states: UAE, Saudi Arabia, Qatar, Bahrain, Oman and Kuwait. These countries also have most of the oil in the world. Two notable exceptions to this list are Iraq and Iran. They are excluded due to the unstable political and security environment that severely restricts business activities in those countries. Three cities are considered to be direct competitors of Dubai: Abu Dhabi; Doha, the capital city of Qatar; and Manama, the capital city of Bahrain. However, as we learned, it is not easy to replicate the successes of Dubai.

While visiting Boston Consulting Group and McKinsey & Company, we learned that Dubai is rapidly exhausting its oil reserves and at present only about 6 percent of GDP comes from oil. As a result, the ruling family of Dubai made a decision many years ago to eliminate the reliance on petrochemical revenues and diversify the economy. Dubai was the first city in the region to do so. The government of Dubai embarked on an ambitious plan to revamp the entire economy, the results of which we can now see. The initial phase focused on the diversification of financial, transportation and logistics sectors. The second phase of the diversification is now focused on attracting manufacturing and services related companies.

Dubai has implemented a unique way to encourage sector specific growth. It has designated particular areas within the city where companies performing certain types of activities are given tax benefits and 100 percent ownership rights. For example, Dubai Media City is host to many media companies such as CNN and CNBC. Being domiciled in such specialized districts allows firms to avoid any tax liabilities to the local authorities and also allows for complete ownership by their parent companies without any local partners. These incentives have encouraged a vast number of companies to set up in Dubai.

Financial Services

We also had the opportunity to visit Goldman Sachs, Dubai International Finance Center and Zurich Financial. The head of Goldman Sachs in Dubai is Suhail Sikhtian, a graduate of Columbia Business School. During our visit to Goldman Sachs we learned that the financial markets in Dubai are still in their infancy. Products like currency swaps and derivatives have just been introduced to the market and presently remain a very small fraction of the overall financial products market. One of the key takeaways from this meeting was that if one wants to work in Dubai, or the broader Middle East region, it is crucial to start one's career in a more mature market such as New York or London, and then make a move to the region. Since the local markets are in their infancy, a candidate starting his or her career in the Middle East would not be exposed to the complex financial and business challenges that one faces while working in a more mature market. Furthermore, since Dubai is positioning itself as the next financial hub of the world, it is important to have work experience in those mature markets so that knowledge can be easily transferred.

Saad Mered, the CEO of Zurich Financial Middle East, echoed what we learned at Goldman. He agreed that the financial and insurance markets were in their early years but also stressed the huge market potential of the region. Zurich Financial's strategy is to use Dubai as a launchpad for operations in the Middle East region. Both companies saw tremendous opportunity in the broader Middle East region, due to the high per capita income (one of the highest in the world), the strategic location, the world economy's reliance on petrochemicals and the single-minded focus of regional governments to turn the region into an economic power house.

Our meeting with the Dubai International Financial Center (DIFC) helped us understand why companies are attracted by the legal, logistical and infrastructure support provided by the government. DIFC was established by the Ruler of Dubai as an independent organization whose primary responsibility is to provide financial services companies with the support necessary to

operate in Dubai. The first step in the process was to designate a “free zone” where international companies can operate with complete ownership rights, i.e. they do not need to enter into a joint venture with a local partner. Furthermore, the zone is set up so that all companies operating in that free zone have a separate judicial system based on English common law. Therefore, all business disputes are handled by an independent judicial bench that is composed of foreign judges, and this system is completely independent of the local judicial system. This judicial system applies only to business disputes and does not handle criminal matters. The DIFC also houses the Dubai Financial Services Authority (DFSA), which regulates all financial services companies based in the DIFC free zone. The DFSA is based on the Financial Services Authority (UK), the Securities and Exchange Commission (U.S.) and various other financial regulatory authorities around the world.

The fact that the DIFC allows complete ownership rights and has an independent judicial system and an independent regulatory agency, all based on international standards, gives companies the confidence to set up in Dubai and expand within the region. None of Dubai’s local competitors have such an open and extensive system of providing support to financial services companies. Some are currently in the process of setting up organizations similar to the DIFC, but most are many years behind. Dubai has taken a lead in creating an environment in which such companies can thrive. Dubai may not yet be an oasis but it certainly is the “Wall Street of the Middle East.”

Sovereign Investment Holdings, Private Equity and Infrastructure Developers

Sovereign Investment arms of regional governments play a very active role in the overall development and diversification of the regional economies. Our meeting with Mubadala, one of the investment arms of the Government of Abu Dhabi, helped us understand the role that sovereign investment firms play in the overall economy.

Mubadala has been given dual tasks: First, to diversify the economy of the Abu Dhabi, a sister emirate of Dubai, and second, to invest in projects that have a positive social impact. It is estimated that Mubadala has about \$300 billion to \$500 billion in liquidity that it can use to invest in various projects. The company is divided into various divisions such as aerospace, services and healthcare. The goal of each division is to invest in projects in their respective sectors that will achieve a positive return on investment and at the same time have a meaningful social contribution.

For example, the Healthcare Division of Mubadala is currently in the process of setting up local branches of world-class medical facilities such as the Mayo Clinic. Such facilities will enable residents to access advanced medical services thus providing a positive social impact while at the same time creating jobs in the city and generating revenues from the day-to-day operations of the medical facility.

Similarly, the Aerospace Division has instituted a flight-training academy where local students may become licensed commercial pilots. This division is also investing in an aircraft spare parts manufacturing unit with the eventual goal of becoming an original equipment manufacturer for aircrafts. These projects will generate revenues through sales of manufactured products, which will help to achieve return on investment goals. At the same time, such projects will also create hundreds if not thousands of highly paid new jobs for the local population, which will satisfy the social component of Mubadala's mission.

Our visit to Abu Dhabi Onshore Oil Company (ADCO) helped us understand where all this wealth is coming from. ADCO estimates that at current production levels and improvements in exploration and drilling techniques, Abu Dhabi has approximately 90 years of oil reserves left.

Istithmar is one of the investment arms of the Government of Dubai and has a similar dual-focus mandate. Our meeting with Istithmar was very insightful since it helped us understand the reason for Dubai's breakneck development speed. Early in the decade, the Government of Dubai realized that the Middle East lacked a financial and logistics hub. Many other cities had the resources to set up such a hub, but huge revenues from petrochemicals made such diversification unnecessary. However, Dubai was rapidly running out of oil and as a result had to quickly diversify its economy, especially before some of its neighbors implemented a similar strategy. The Middle East region has a great deal of wealth; however, there is only room for one major financial and logistics hub. Dubai had to get a head start and move rapidly so that none of its competitors could catch up. As a result, government-owned entities such as Istithmar were given the mandate to rapidly transform Dubai and diversify its economy.

Given this task, Istithmar began investing in various sectors such as transport, real estate, hospitality and services. It should be noted that one of Dubai's most successful companies, Dubai Ports World is a sister company of Istithmar. Both are controlled by the same parent conglomerate: Dubai World. However, the Government of Dubai has realized that given the current financial crisis, the rapid rate of development has to be reduced. The sovereign investment arms previously operated on a model of acquiring a diverse array of companies. This

model is now obsolete. The focus now has to shift from acquiring or setting up new companies to stabilizing and then growing the existing companies. This transformation became more urgent with the debt crisis that Dubai recently faced.

A significant amount has been written about the debt crisis of Dubai World, the parent company of Istithmar. Many leading commentators and journalist have indicated that Dubai is on the brink of financial collapse. After our trip, I can safely say that Dubai is not going to collapse. There is no fundamental problem with the actual projects and investments; the problem is merely in how they were financed. The challenge with debt repayment is that there is a mismatch in the maturities of the debt and the cash flow that the investment, bought by this debt, will generate. Short-term debt was issued to fund long-term projects that will generate positive cash flows in the future. The underlying asset or investment remains sound. Having said that, there is also a realization that some projects were simply too extravagant and went beyond what was necessary to accomplish the primary goal of diversifying Dubai's economy. An example of this is the world's tallest building, the Burj Khalifa, which was recently inaugurated. Even though many cities would like to hold the title of having the world's tallest building, that distinction alone does not add to the competitive advantages of doing business in any particular city. This is a hard lesson that Dubai has learned. But these are the mistakes that are now being corrected and most sovereign investment arms are going through massive restructuring.

The vast transportation infrastructure that Dubai provides is one of the city's biggest competitive advantages. Dubai Port World is a government-run entity that is responsible for developing and managing the port at Jebel Ali, which is now one of the busiest and biggest ports in the world. During our visit to the port we received a detailed overview of the port's operations and DP World's growth strategy. Dubai's strategic location, midway between East Asia and Europe, makes it a valuable transit point for goods moving across the world. Furthermore, the port's capacity to handle vessels of large tonnage combined with Dubai's vast road network allows the Jebel Ali port to serve as the gateway to the Middle East. Many countries in the region that do not have such a modern port have their goods shipped through Dubai. This serves to enhance Dubai's position as the infrastructure and logistics capital of the region.

It is also because of reliance on Dubai's infrastructure that Dubai's neighbors are willing to provide financial assistance to Dubai. They are dependent on Dubai for their own logistical and financial needs and as a result cannot afford for Dubai's government run entities to experience financial distress, which would affect private companies based in Dubai. Almost all international companies based in the Middle East are headquartered in Dubai and most of their staff is also

based in the city. As a result, if Dubai was to experience financial distress, these companies would suffer, resulting in a rippling effect throughout the region. As long as the regions' fundamentals remain strong, which they will due to petro-dollars, Dubai's importance within the region will continue to grow.

We also visited Abraaj Capital, the biggest private equity group in the Middle East. Our presenter, Seifallah Zoghbie, has spent the last six years with Abraaj and has traveled extensively throughout the region. Mr. Zoghbie explained to us that Abraaj sees major potential in the local markets but also acknowledged that there was a lack of qualified business professionals in the region. As a private equity group that focuses on acquiring companies and then turning them around, the firm felt that there is tremendous potential in the local markets. This was primarily due to the high per capita income and a dearth of quality companies that provide various services and products to consumers.

Abraaj has successfully acquired numerous companies, turned them around and then profitably exited the investments. The firm chooses to focus on the broader Middle East region because it believes that there is so much potential that it can successfully fulfill its investors' mandates without expanding beyond the region. Mr. Zoghbie also mentioned that the infrastructure, legal and logistical support that Dubai provided was unparalleled in the region. It is important to note that Abraaj Capital is located in the DIFC free zone and as a result enjoys all the benefits and protection offered to companies based there.

Conclusion

Dubai faces challenges but the fundamentals remain strong. It is the only place in the region where one can easily set up an independent business and still enjoy all the necessary legal, logistical and financial support. It is also physically well positioned as the gateway to one of the wealthiest regions of the world. The city has spent billions of dollars in infrastructure development, introduced both business and social reforms and created a culture where people from around the world are accepted and diversity is valued. These are Dubai's competitive advantages and they create a fundamental base that is strong and can endure challenges along the way. Dubai is neither an oasis nor a mirage but it is well on its way to becoming the oasis of the Middle East.