After the oil

Clarissa Dann takes a look at MENA's two-speed growth rates and what opportunities diversification from hydrocarbons is offering trade financiers

When the United Arab Emirates (UAE) moved up from fifth to fourth place in the 'trading across borders' category of the World Bank's Doing Business Report for 2013,[1] this was just one indicator of the region's increasingly dominant position as a preferred global trade and logistics hub. Free trade zones allowing 100% foreign ownership and zero taxes (subject to certain caveats), along with automated efficient customs clearing services have all helped attract foreign investors.

Another was Dubai's landslide win over Brazil, Russia and Turkey in November 2013 of its World Expo 2020 bid. Held every five years, the 2015 event takes place in Milan. Dubai authorities have said the Expo is estimated to earn the country US$23bn with costs for the six-month event at US$8.4bn. And government spending on infrastructure, which is already underway, is likely to top US$6.5bn.

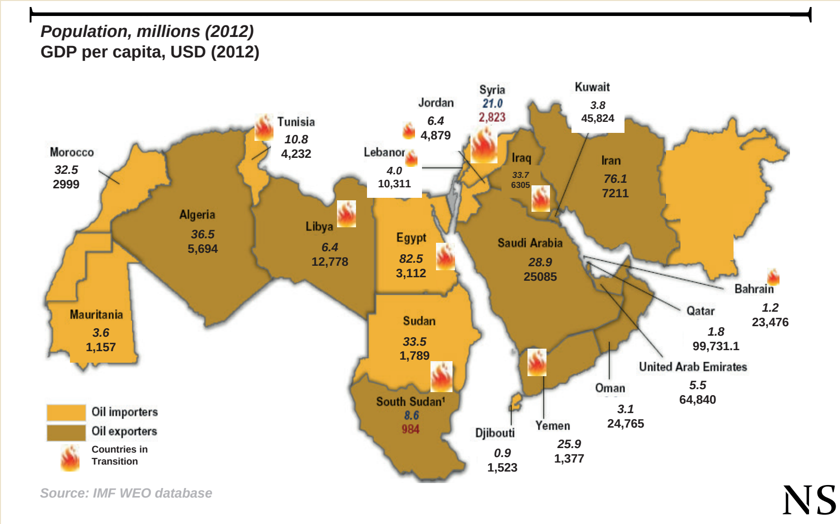
Tim Evans, HSBC's regional head of global trade and receivables finance Europe, told *TFR*: "The key drivers for trade in the Middle East will continue to be strong infrastructure spend and demographic growth. We are seeing strong contracting activity in UAE following the announcement of Expo 2020, which was a welcome confidence boost for the region."

As the wider MENA region seeks to diversify from hydrocarbons, trade in commodities, iron and steel products, fertilisers and electronic products is set to ramp up – bringing with it opportunities for trade finance.

Figure 1: UAE's projected contribution increase in merchandise exports

Source: Oxford Economics

Figure 2: MENA – wide differences in wealth resources and incomes

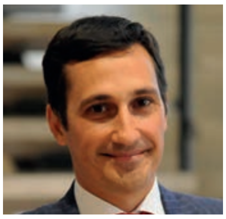


Source: IMF WEO database

but the ongoing political and economic instability implies that no new jobs were created in the past three years. This means 2.1 million additional young people out of work. So, it is not unreasonable to expect a few more Tahrir Squares!"

Overdependence on oil revenues, supported by the current high price of oil, will be detrimental to oil exporters in the medium to long-run, says Saidi. "The presence of shale gas and availability of capacity means that oil prices are likely to soften." Rising expenditure patterns in the aftermath of the Arab Spring also adds pressure. "The oil price required to breakeven on budgets in the oil exporting countries has doubled in the last five years," observed Saidi (see Figure 3).

So when it comes to policymaking, as an oil exporter, one of the priorities should be increased revenue diversification to improve fiscal stability, while as an oil importer, job creation for its youth should be the immediate concern, and a solution includes boosting trade opportunities.



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>
> MASSIMO FALCIONI, EULER HERMES GCC

However, the implementation of Basel III rules on capital requirements makes it more expensive for banks to provide trade finance and this regulatory development, coupled with the region's high levels of liquidity – compressing pricing – have resulted in some banks pulling back from lending to the region.

This article provides an overview of the main trends and shares some perspectives of some very different providers and customers of trade credit.

Oil importers, exporters and the GCC

Wide differences in wealth, resources and income set the MENA oil exporting countries apart from the oil importing ones (see Figure 2). And within the oil exporters, the Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE) account for more than 29% of global oil reserves and 23% of total gas reserves, enabling them to build up substantial sovereign wealth.

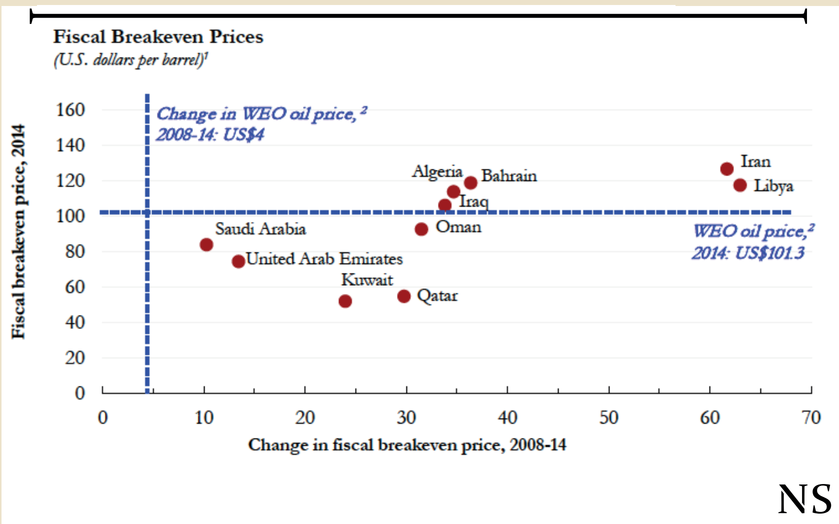
Addressing attendees at the Falcon Group's Dubai forum in March 2014,[2] Nasser Saidi explained how oil exporters have benefitted from higher oil prices, enabling them to achieve real GDP growth rate of 4% for 2014, while for the oil importers, growth is estimated at a much lower 2.9%.

Highlighting oil-importing countries' "young and fast-growing population", he stressed that growth rates of close to 6% or 7% were necessary to absorb the annual additions to those seeking work. "In Egypt, every year, around 700,000 young people are new entrants into the labour force,

Trading opportunities with the GCC

Drilling down, as it were, to the GCC, Andrew Atkinson of Euler Hermes makes the point that the hydrocarbon outputs from these countries to date when benchmark oil prices were at US$100/bbl or more, have "enabled foreign exchange reserves to remain high and, in particular, an accumulation of financial assets held in sovereign wealth funds". He estimates these at around US$2.25trn, with US$975bn held by the UAE and US$680bn by Saudi Arabia.[3]

Figure 3: High growth of government spending in oil exporters implies higher fiscal breakeven oil prices & threatens fiscal sustainability



Source: IMF Regional Economic Outlook, Nov 2013

These oil-derived reserves make it possible for the GCC countries to boost domestic demand through state spending on infrastructure and social spending. "Trade opportunities with the GCC are therefore likely to remain relatively buoyant in the forecast period, even if global conditions are not supportive," he says.

However, sovereign wealth funds do not generally take direct positions in flows of goods, but stimulate development through bonds and equities which in turn drives demand for trade and trade credit. So where is this credit coming from?

"The capital issue of the banks is not going away"

KAMEL ALZARKA, FALCON GROUP

Funding gaps and opportunities

"The capital issue of the banks is not going away," says Falcon Group chair Kamel Alzarka, whose Dubai-headquartered business has been busy structuring deals that banks cannot take the risk on. Clients range from fertiliser producers and sustainable energy companies, to computer hardware manufacturers. Alzarka, along with other providers of commodities finance, is always on the look-out for opportunities for deals that call for structuring expertise rather than the plain vanilla trade finance – particularly when the commodities in question have a certain rarity value.

Take for instance the US$40bn worth of the diamond trade which flows through Dubai – it is by introducing infrastructure like the Dubai Diamond Exchange (DDE) that fuels these kind of volumes. The DDE is part of the DMCC which was set up in 2002 by the government to establish Dubai as the global hub for commodities trade. "We have been in discussions with the DMCC for some time to see if we can finance part of this business," says Alzarka.

Dutch trade bank ABN AMRO, which has had a long relationship with the DMCC set up a representative office of its International Diamond and Jewellery Group at Almas Towers, the DDE's headquarters in 2012.

The DDE is one of many other products and services tailor-made by DMCC for the trade including its purpose-built Almas Tower (*Almas* means diamond in Arabic), the tallest business tower in the Middle East and home to the DDE, with diamond boiling and grading facilities, vaulting services and transport services on offer all under one roof.

Providing the trade with the infrastructure they need to do business efficiently in a secure environment, according to DMCC Tradeflow director Paul Boots, "is key in order to build a sustainable business and trading environment to attract these types of industries to the region". He adds: "The flow of rough diamonds through Dubai have been a great success and is a great example of this, we are also seeing a similar growth story with gold".[4] An example of this was the MoU signed by the DDE with Russia's ALROSA on 8 April 2014 (pictured) to improve cooperation between the the world's largest producer in volume terms and the UAE diamond community.

Maninder Bhandari, a former banker turned consultant based in Dubai, told *TFR*

Almas Towers, Dubai, headquarters of the Dubai Diamond Exchange

Left to right: Peter Meeus, chairman of DDE's board, Ahmed Bin Sulayem, executive chairman, DMCC, Yegor Borisov, president of the Republic of Sakha (Yakutia), Andrey Polyakov, ALROSA vice president, Gocha Levanovich Buachidze, the Russian consul general to Dubai and Northern Emirates

Source: DMCC

> **"Diamonds have been a great success and we have seen a similar success story with gold"**
>
> PAUL BOOTS, DMCC TRADEFLOW

that he is currently working on a report on the diamond financing opportunities, and that "a number of institutions want to go into this segment." While these do not include the global trade banks there is a lot of interest from the local banks and non-bank providers.

With more than 8,600 members of the DMCC Free Trade Zone and many of the small and medium-sized ones struggling to access credit, the DMCC is keen to offer them, as DMCC director Krysta Fox puts it, "the right toolkit in order to grow and succeed." A vital part of that toolkit is finance, along with trade credit insurance. The DMCC has developed insurance offerings with Euler Hermes.

A DMCC study reports that 45% of its members need "substantial funding" and that only 36% have access to funds, and of that percentage, only 33% are "fully funded by local banks". Commenting on these findings, Massimo Falcioni, CEO of Euler Hermes GCC, told delegates at an SME workshop in Dubai (May 2014): "To compete in the local, regional and global market, a company has to trade on credit. More than 60% of company assets can be reflected in its receivables and trade credit insurance (TCI), and is one of the most effective services offered to SMEs that want to trade and export."

The wider SME funding gap across the MENA region was estimated at US$210bn to US$254bn, by a World Bank/Union of Arab Banks survey of 130 MENA banks in 2011.[5] Given that this is the sector with the best prospects of creating jobs and economic growth, plugging this gap has become a matter of urgency.

With the risk profile of SMEs being unacceptable to many global banks without SME financing infrastructures, it falls to non-bank funders, trade credit insurers, and development finance institutions to find a solution. HSBC's International Growth Fund with an AED1bn pledge to UAE SMEs launched in November is a good start – as is the International Finance Corporations's commitment of almost US$3bn to MENA for 2013 – which included US$914m mobilised from other investors. Another encouraging initiative was Noor Bank's Noor Trade division, currently overseen by Bhandari. This support comprises a five-year AED5bn (US$1.36bn) Islamic banking service for UAE SMEs.

Launched in 2012 by the DMCC, the DMCC Tradeflow not acts as a central registry for commodity finance agreements, but acts as a regulator accountable for the safety of commodities finance deals against collateral. It completed its first soft commodities pledge in March 2014, signing a US$1.5m agreement between UAE-based agricultural trader, Safir Neinava and asset manager Eurofin (see note 4). Further deals of this kind are anticipated.

Bhandari observes that the DMCC has been "focussing a fair bit to develop its trade capability up and down the supply chain". Not only does this include initiatives like Tradeflow, but he believes it includes a strategy to improve the connectivity of its trading partners. This includes plans to assist its trading partners and itself to develop connectivity to the Bank Payment Obligation[6] platform. DMCC, he believes with its expertise and enthusiasm, could be a vehicle for a number of other very useful initiatives for its trading partners, which would lead to Dubai being a very important global hub for many aspects of trade.

While the physical security of the commodities and potential for higher fees in structured trade and commodities finance is attracting banks like HSBC and National Bank of Fujairah – both have set up new operations there recently – the brunt of trade finance revenues earned by global and local providers in the region, lie in the volumes of plain vanilla instruments covering the ordinary import and export movements of goods.

An LC region

Although UAE sees more open account activity, MENA as a whole, has historically been a region of letters of credit (LC) and has not followed the Swift statisics around 85%/15% open account/LC. While this had been declining before the financial crisis unfolded in 2008 followed promptly by the Arab Spring, political unrest and economic concerns dented trust levels, particularly in countries such as Tunisia, Libya, Egypt, Lebanon and Jordan. HSBC's Tim Evans points out: "Another important element in the popularity of LCs in the region, is the opportunity to leverage them to obtain pre-shipment finance for working capital."

Asoke Sen, director of global transaction services, financial institutions for the Middle East at RBS, agrees that the "use of LCs in certain sectors are slowly declining", "however, a significant part of trade is still seen in LC flows". He adds that companies are now open to adopt alternate instruments to meet their trade financing requirements. Financing of avalised bills of exchange are assuming greater significance and, to an extent, replacing LCs. This is where the bank guarantees the payment on the basis of the seller's promissory note and then further financing can be raised on this signed obligation – so another bank takes the risk on the bank and not the seller. TFR

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Clarissa Dann is the editor of *TFR*