"These are global problems and they require global solutions. The Saudis and other countries in the Gulf states are very important. They are the countries with great revenues and oil wealth"

Gordon Brown, UK Prime Minister

DOWJONES

FINANCIAL NEWS REPORT

November 2008

PA PHOTOS

Credit crunch increases Gulf's influence in corridors of power

The region has suffered from the financial crisis but it might reap some benefits too, writes Ben Wright

It is no longer a question of whether the credit crunch will hit the financial markets of the Middle East, but how bad and lasting the impact will be now that it has.

The crisis has all but paralysed interbank lending across the region, caused stock markets to crash – by as much as 50% in the case of the Dubai Financial Market – prompted sovereign wealth funds and central banks to intervene, and, since July, halved the value of crude oil, upon which much of the region's wealth is based.

At the end of last month, the Kuwaiti central bank was forced to save the country's Gulf Bank following steep losses from derivatives trading. The Kuwaiti Government also decided to guarantee all bank deposits, a precaution that has been taken by most other countries in the region, and there are rumours that other Middle Eastern banks have received cash injections via the back door.

There is an air of uncertainty in the region's aspiring financial hubs. The most common answer to any question is resigned but honest: "I don't know." As one Dubai-based banker said: "Everything that I am telling you now was true, as far as I could tell, in September. I don't know whether it is true now."

In the past few years, the banks, fund managers and financial centres of the region have striven to increase their influence across global markets. They are now experiencing the downside of that ambition. Georges Makhoul, managing director and president for Middle East and North Africa at Morgan Stanley, said: "You cannot operate in isolation. If you want to become the crossroads of world trade then you cannot remain immune to global issues."

However, there are also indications – some of them faint and hopeful, others more concrete – that the credit crisis may prove to be a double-edged sword for the region. It can no longer be considered a haven immune from the rest of the world's difficulties, but that does not necessarily mean that the Middle East will not benefit from the crisis, at least in the medium term.

A trip by Gordon Brown, the UK Prime Minister, to the region at the beginning of this month demonstrated that the credit crisis is increasing the Middle East's political clout. The large stakes in Barclays taken by sovereign wealth funds based in Abu Dhabi and Qatar the week before Brown's visit illustrate why he made the trip – the budgetary surpluses and oil riches amassed by sovereign wealth funds as a result of the prolonged bull run in global commodity prices mean that these countries hold the last remaining pools of liquidity in a global financial system that is running dry.

Most of the countries in the Middle East have saved money in the fat years and are now being asked to share the benefits of their good luck and forward planning in the lean years. Ali al Shihabi, founder and chief executive of Rasmala, a regional investment bank, said: "Globally there is a shortage of credit, but this region has supply and will act as net lenders to the global system."

Brown has urged the oil-rich Gulf states – and China – to come up with hundreds of billions of dollars to aid struggling countries. If they do so, there will be strings attached. China and the Gulf states are demanding seats at the International Monetary Fund and the World Bank tables. Both organisations are currently dominated by the US and Europe.

As well as developing their political clout, Middle Eastern governments are also looking to accelerate the development of their financial muscle. Nasser al Shaali, chief executive of the Dubai International Financial Centre, believes local markets need to build capital to fund their growth rather than rely heavily on international funding. He said: "These markets need to take the opportunity to step up to the plate – they need to develop their own capital markets so that they can take control of their destiny."

Nasser Saïdi, chief economist of the DIFC and a former Lebanese Minister of Economy, thinks the credit crunch will also enable Middle Eastern financial institutions to steal market share from western rivals. He said: "We are witnessing a period of Schumpeterian "creative destruction" in the world financial markets. The destruction is occurring in New York, London and many other European capitals among the banks and other financial institutions. The creation will come to and from the growing markets in the Middle East and Asia. Ultimately, I don't think the credit crunch will have a huge impact on the region."

Turn to page 3

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From page 1

Saïdi said the banking system was strong and sound, benefiting from high economic growth rates achieved in the region. Banks have high profitability and low vulnerability to the various risk and stress factors that have led to the demise of institutions in the US, the UK and Europe.

He, like many other market participants, believes this resilience is at least partly down to the growth of Islamic finance, which accounts for some 20% of bank assets in the UAE, 25% in Bahrain and 50% in Saudi Arabia. Saïdi said: "The mode of operation in Islamic finance is different from conventional banking – account holders share in profits and risks, there is equity risk-sharing. Disclosure and transparency therefore have to be higher because banks are more accountable."

What is more, this culture of prudence is reflected by the region's central banks, which have been extremely diligent in applying Basel I, especially capital adequacy rules. The average ratio of a bank's capital as a percentage of its risk-weighted assets across the UAE is in excess of 12% compared to the 8% required by Basel. Few banks have invested in sub-investment grade assets.

The image of those western banks that did invest in assets that turned out to be toxic has taken a battering. Rasmala's Al Shihabi said: "There was a mystique to some of the largest international financial brands that regional firms were up against. But that has now been punctured, there is a more level playing field." He argues that local operators were less sophisticated and less complex than some of the large international firms. A year ago this would have been a criticism, now it is a unique selling point along with the liquidity they can tap.

Al Shihabi added: "Local players, for example, never got into proprietary trading and not many were that leveraged. There have been some large losses among regional players but that is the exception rather than the rule. On the whole, profitability has been impacted but we are still profitable."

Ashley Painter, a partner at law firm Clyde & Co, said: "We are entering an era of financial regulation and of how people raise money. Islamic finance is based on real assets so its role in global finance could be significantly strengthened. The key is how it is applied in practice."

If the regional financial institutions can get it right and the balance of power begins to tilt slightly from western to eastern financial markets, there is likely to be, if not a reverse brain drain, at least a reverse brain trickle. Bankers from the area who have trained and worked abroad may sense that now is a good opportunity to head home. Western bankers who are reluctant to twiddle their thumbs indefinitely will want to be where there is at least some action.

This migration has started to happen, according to market participants. One investment banker at a local brokerage firm said: "The speed with which people have gone from demanding $5m to work in Dubai for an Arab firm to being prepared to work for food would be funny if it weren't so sad."

Many of the negative impacts of the crisis have a silver lining when viewed from the Middle East's unique perspective, though this should not detract from the short-term difficulties that the region is likely to face. It is also likely to put the lid on some of the more flamboyant aspects of the region's development before it has had a chance to develop into the irrational exuberance that so affected western financial markets.

REUTERS

Friends in need: UK Prime Minister Gordon Brown on his recent Gulf visit

Al Shihabi: more level playing field

Saïdi: praise for the banking sector

Al Shihabi said: "This is a chance to take stock and tame some of the excesses in the market. Of course people are anxious but this may well act as a healthy timeout."

The most obvious issue facing the region is the sharp fall in crude oil prices. But market participants point out that government budgets are based on oil prices being far lower than they are now – estimates vary from between $25 to $45 a barrel. As long as prices stay above this level, regional economies will remain in surplus. The reduction in prices has also tamed inflation and reduced the amount of speculative money betting on currency revaluation.

Hashem Montasser, head of asset management at EFG Hermes, said: "The fall in the price of oil is a good thing – it will keep governments disciplined and it keeps inflation under wraps. The vital infrastructure projects will continue (certainly as long as crude oil stays about $50), but some of the non-vital projects may be shelved. Oil at $120 creates large surpluses but it is a bit of a mixed blessing."

While currency revaluation may have slipped down the agenda, the authorities in the region have worked in concert to stave off the worst effects of the credit crisis. This is particularly crucial in the UAE. There had been speculation over whether Abu Dhabi, the country's capital and largest emirate, would, in a pinch, come to the aid of Dubai, its brasher and more leveraged neighbour. As it has turned out, the credit crisis, so far at least, appears to have cemented the relationship.

Morgan Stanley's Makhoul said: "The reaction to the crisis has definitely solidified the federal system of the UAE. There was a degree of doubt about how the relationship between Dubai and Abu Dhabi would be tested but that has now been taken out of the equation."

In theory, there would have been less danger in allowing a UAE bank to go to the wall than elsewhere in the world. The banks are not interconnected like in London and New York so there wouldn't have been the domino effect. Letting one fail might have taught the others some valuable lessons without unravelling the system, according to market participants.

However, the psychological effect would have been hard to predict. One investment banker said: "They are trying to create something very fast here and I think they calculated that anything that badly shook confidence might have damaged their plans beyond repair."

But if the relationships within the UAE have been strengthened, those of the wider region could still benefit from closer ties.

Nasser al Shaali, chief executive of the DIFC, said: "The region needs greater co-operation. It has been unfortunate that central banks of the Gulf Co-operation Countries have not met to ensure that they are aligning their work on managing the crisis." Al Shaali said that if discrepancies emerge between how the different central banks handle things, it can only lead to greater problems. He added: "We want foreign direct investment but we also want stability in our capital markets – the UAE is beginning to learn how to balance those two things."

The balance of the relationship between Abu Dhabi and Dubai is shaped by the larger emirate's greater oil wealth and the smaller emirate's attempts to diversify its economy through huge property and infrastructure developments. The commodity bubble may have burst but the property bubble continues to look dangerously inflated.

Again, if it were to burst, the effects would be painful for companies and individuals but could have medium-term benefits. For one thing the bubble is quite localised, concentrated heavily on Dubai's real estate market. It has also been the only investments show in town for several years.

There has therefore been little incentive for investors to put their money in equity or bond funds that might earn single-digit, or at best double-digit, returns when they could be earning triple-digit returns from property investments.

John McGaw, chief executive of Killik & Co in the Middle East and Asia, said: "Fund managers of all stripes have been competing against the property market in Dubai and now that music appears to be grinding to a halt."

Ziad Makkawi, chairman and chief executive of Algebra Capital, a local fund management firm, said: "The financial crisis might be good for the fund management industry in the region. People have been managing their own money up until now: this may cause them to reconsider the wisdom of that approach."

The fact that the correction to the regional markets was the product of a global crisis means that it occurred earlier than it might otherwise have done had it been operating in isolation. Some of the excesses and leverage in the market have thus been corrected before they grew out of control.

The Middle East will feel a great deal of pain from its closer ties to a globalised economy and the inherent financial interdependencies, but financial market participants will hope that pain can ultimately aid the region's financial education and development.

Contents

Bankers predict good times ahead 4
Islamic banking community confident it can weather the credit crisis storm

Islamic finance needs consensus 6
Western banks are confused about what is permissable

Deals drought hits Mena region 8
Private equity in the Middle East and Africa is long on capital but short on opportunity

Banks pledge to hold firm 10
Expansion is pressing ahead despite deals being put on hold

Top accounts feel the squeeze 11
Western-style relationship banking has arrived as competition intensifies

Law firms look beyond Dubai 12
International firms flock to the region in search of a larger fee pool

Property boom under threat 14
Investors fear Dubai may become a victim of its own success

Makkawi banks on fixed income 15
Dubai-based Algebra has emerged from the pack by pushing boundaries

Gulf's reputation under scrutiny 16
A series of scandals could dent the desert city state's image abroad

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Islamic finance likely to win out in

Poll respondents are confident about the future, writes Yasmine Chinwala

While it may be too early to call the winners from the credit crisis, the Islamic finance community resoundingly believes their products will come out on top.

Eighty-three per cent of respondents to a Financial News survey of more than 40 participants in the Islamic finance industry said they believed that, in the long run, they would benefit from the fallout of the credit crisis.

Nasser Saïdi, chief economist at the Dubai International Financial Centre, said: "There are facets of the financial system in the Middle East that the rest of the world can learn from in the wake of the credit crisis and that creates huge opportunities for Islamic finance."

That does not mean the outlook is rosy – far from it. More than half of those surveyed said revenues have slumped in the past year, a fifth suffering drops of more than 5%.

Only 18% said revenues had increased, and a quarter said revenue for Islamic products had remained constant throughout the credit crisis.

Yet no one expects the market to contract. Only 5% expect a growth rate of less than 5% a year over the next 10 years, and most are far more bullish – nearly a third expect annual growth of between 5% and 10%, nearly two fifths expect growth between 10% and 15% and more than 15% growth every year.

There are approximately 500 sharia-compliant funds in the world, 153 of which were launched this year, according to data from Eurekahedge and accountant Ernst & Young. The number is expected to grow to almost 1,000 by 2010.

Demand driving that growth is largely expected to come from the Middle East and Africa. Saudi Arabia and Malaysia are the two largest markets for Islamic asset management, but investment strategies reflect the two ends of the evolutionary spectrum – Malaysia is more mature and strategies are closer to those found in the conventional mutual fund industry, while Saudi Arabia remains focused on equities, according to analysis from Ernst & Young.

More than half of Financial News' respondents said interest from institutional investors and sovereign wealth funds was increasing. Pension funds in the Gulf Cooperation Council countries have assets of more than $46bn (€35.2bn), all of which are potentially sharia sensitive. Sovereign wealth funds in the GCC and the Far East hold assets of about $1.3 trillion, according to Ernst & Young estimates. While wealth funds are not generally predisposed towards Islamic products, most adopt an ethical investment strategy.

Islamic financiers polled by Financial News hope to take advantage of the market dislocation created by the credit crisis. High expectations of greater transparency and regulatory oversight increase the attraction of Islamic financing products to a broader investor audience, helped by a shift towards ethical investing.

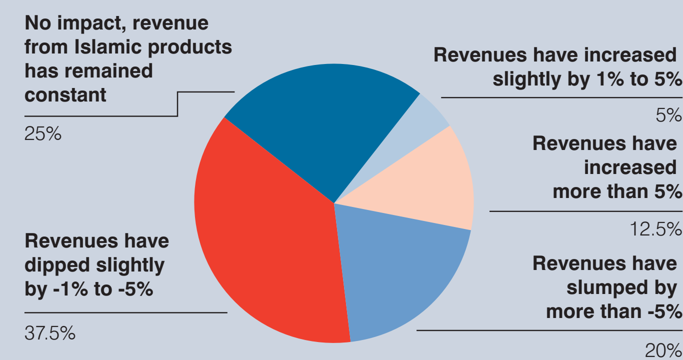
Saïdi said: "The whole mode of operation in Islamic finance is different from conventional banking – account holders share in profits and risks. There is equity risk-sharing. Disclosure and transparency therefore have to be higher because banks are more accountable."

In terms of products, demand for bond funds is expected to increase the fastest over the next 10 years, followed by equity funds, private equity, balance funds and insurance products.

Total issuance of sukuk – Islamic bonds which offer coupon profits instead of coupon interest – stood at about $14bn in the eight months to the end of August, down from about $23bn during the same period in 2007, according to rating agency Standard & Poor's. S&P credit analyst Mohamed Damak attributed this lower level of issuance to the worsened conditions in the global markets, resulting in lower investor interest in buying the paper and the related widening of credit spreads. However, S&P expects sukuk issuance will top $20bn this year given the good pipeline. Issuance is rapidly approaching the symbolic $100bn mark and is likely to surpass that next year. Damak said: "The sukuk market has established itself as a niche in the international capital markets and is on its way to becoming more than that."

As a geographical centre for Islamic finance, the Middle East was considered the natural focal point for the industry by 42% of the respondents. Close to half believe it will be spread evenly across western, Middle East and Asia-Pacific financial markets and this could rise further as the Middle East faces increasing compe-

Do you think the credit crisis has affected the Islamic finance industry in the past year?



Source: Financial News

Africa targeted by Middle East finance industry

Continent is home to second-largest Muslim population, writes Duncan Kerr

The potential for growth in Islamic finance in Africa, especially in the Muslim-dominated countries of the North, is huge.

Islamic-compliant transactions in Africa totalled $18bn (€14bn) at the end of last year, but rating agency Moody's Investors Service has estimated the region's potential to be close to $235bn, about half Moody's estimate of the gross domestic product of Africa's Muslim countries.

With Africa's economies growing fast, largely because of the boom in the commodities sector, and with the second-largest Muslim population in the world, the fundamental elements for growth in Islamic finance are in place.

Anouar Hassoune, senior credit officer at Moody's, said average per capita GDP on the continent was a low $1,137 last year, but the absolute size of its economic production reached $469bn.

Hassoune said: "This is not insignificant, as it is on a par with the combined GDP of Saudi Arabia and the United Arab Emirates, two of the dominant economies of the Muslim world."

One of the areas of growth is expected to be in project finance and Islamic bonds, or sukuks, which will support the financing of massive infrastructure projects across the continent.

Michael Saleh Gassner, division head for product development in the Islamic banking group at Bank Al Jazira, said: "To finance these processes, Islamic financial institutions should open up their minds. There are tremendous opportunities in setting up Islamic financial institutions for retail and microfinance, creating new investment funds for listed stock companies and allowing existing portfolios to diversify more efficiently.

"Likewise, big opportunities exist for private equity, venture capital and real estate, especially for infrastructure needs – a business proposition underscored by the needs of raw material buyers, such as China."

However, at this stage, the Islamic finance industry is still very concentrated in Africa, with more than half its assets located in Sudan. Egypt ranks second, but with a lower share of about a fifth, according to Moody's.

Islamic banking tends to fare better in countries with established banking systems, such as South Africa and Kenya. South Africa's only Islamic bank, Albaraka, was set up in 1989. Last year the Kenyan authorities licensed two Islamic banks, Gulf African Bank and First Community Bank, both backed by Gulf investment.

Hassoune said: "Provided that the continent continues to grow at its current pace, which is the fastest in decades, incremental wealth creation will make it easier for the Islamic financial services sector, including Islamic commercial banking but also sharia-compliant insurance, investment and microfinance, to develop."

Access to international wholesale markets will support growth too. While the outlook has darkened as a result of the credit crisis, a breakthrough for African Islamic finance came last November when Berber Cement Company, a Sudanese cement firm, sold $130m of sukuk bonds – the first corporate issue of its kind from the continent.

Bahrain-based investment advisory firm Liquidity Management Centre acted as mandated arranger for the deal. Ahmed Abbas, the chief executive of LMC, said following the Berber sukuk issue, that his company was keen to extend its offering beyond the Gulf Cooperation Council countries to "support infrastructure projects in the broader Middle East and North Africa region".

Sukuk issuance is arguably the most promising area of growth for Islamic finance in Africa, though it remains limited in size. In a study published in September, rating agency Standard & Poor's said only Gambia has issued about 30 or so sukuks through its central bank, for a total of about $4m, although it sees a lot of potential for this market.

Mohamed Damak, a credit analyst at S&P said several entities based on the continent have said they will issue sukuks, including the Housing and Development Bank in Egypt, which is looking to raise about 200m Egyptian pounds (€28m) for real estate financing.

Islamic finance bankers also report that Senegalese and Kenyan governments are assessing the merits and viability of issuing sukuks.

Apart from sukuk issuance, Islamic-compliant project financing transactions have emerged in some countries, providing an example of how Middle Eastern capital is finding its way into Africa.

Damak said: "We have seen a few examples of projects in Tunisia and Morocco launched by Gulf Finance House, which is an investment bank based in Bahrain. In Tunisia, for example, there is a project to develop an offshore financial centre.

"Islamic finance in general and the sukuk market in particular, could act as a bridge between Africa, where there is an immense need for financing, and the Gulf countries which have a wealth of financing resources due to their strong oil-based economies."

the long run

CORBIS

Chasing the pack: the rate of sharia-compliant fund launches is accelerating

tition from other financial centres.

Respondents agree that the variety of opinions about which products are sharia compliant and the lack of people qualified to make that judgment creates capacity issues. This also raises questions over the assessment of Islamic products to ensure they continue to abide by their founding precepts. Industry insiders worry that once investment vehicles are classed as sharia compliant they can invest in whatever they like without fear of scrutiny.

One Gulf-based lawyer said: "A lot of Islamic finance products suffer from a lack of transparency. It is often about dressing interest up as some other form of return and there is no monitoring of these vehicles. Something can be Islamic at launch but no one is checking whether it stays that way. Compliance is a real sleeper issue."

Lessons for the west as region's banks escape credit crunch

Maha Khan Phillips

Nobody can blame Islamic banks for feeling complacent. While conventional banks are dealing with estimated losses of more than $400bn (€312bn) from the credit crunch, Islamic banks have remained buffered from big losses. Supporters say there are lessons to be learnt, while others say it was luck.

There are many reasons why Islamic banks have remained relatively unscathed. But the main one is that Islamic institutions are more traditional in their approach to banking.

Rodney Wilson, professor at Durham University and chairman of the academic committee of the Institution of Islamic Banking and Insurance in the UK, said: "Islamic banks tend to follow classic banking models. The financing that they do comes from their deposits, and they are not leveraged up and borrowing from the wholesale markets. Therefore they are less exposed."

Broadly speaking, sharia law prohibits usury, making it difficult to incorporate debt, interest or leveraged products. It also prohibits investments in alcohol, gambling, tobacco, weapons or pork-related products. As a result of shying away from debt, Islamic finance is asset based, rather than asset backed.

Tahir Jawed, managing partner of law firm Maples and Calder in Dubai, said: "Any borrower has to have an asset base to borrow against. That in itself is a healthy thing in light of current market conditions, and the structure protects you against sub-prime and overleveraging."

Islamic banks also have an extra layer of governance through their sharia boards, which must approve all big decisions about products or transactions. Practitioners say this second layer of scrutiny provides a level of comfort. Others argue it is a cumbersome process, which would not work for traditional banks, where profit, rather than moral imperative, is the primary concern.

Wohid Islam, legal counsel for the Qatar Investment Authority, said that in the west, Islamic banks are subject to the same laws as traditional ones, but have chosen to adhere to laws more strictly. "They are governed by the same regulatory authority which regulates conventional banks, except in the case of risk management, where sharia-compliant institutions comply with additional requirements under different regimes."

Talent war puts focus on employment law

Claire Smith

The stream of financial institutions setting up in the Middle East to take advantage of favourable market conditions and the resultant demand for staff has created a need for employment and remuneration policies that take into account Islamic law.

While most Middle Eastern employment legislation mirrors that of western countries such as the US and the UK, businesses can enhance their recruitment potential in a competitive market by making employment policies more sharia-friendly for the benefit of Muslim workers, according to employment lawyers.

Problems can arise when companies are setting up schemes for bonuses, profit-sharing or equity incentives. Islamic law requires certainty in such relationships, and schemes will need to be designed with that in mind if Muslims are to participate.

Monique Fry, a partner at the London office of law firm Norton Rose, said: "There is strong competition for talent in the Middle East, and until recently incentives have primarily been structured as cash bonuses. Those have to be drafted with a degree of certainty, because they are basically a contractual relationship, and they need to be certain to avoid conflict arising."

It requires businesses to have transparent scorecards to determine bonuses, based on publicly available documentation rather than behind-the-scenes compensation committee decisions.

Fry said equity incentive schemes are popular because of the fierce competition for talent. Investment banks often offer employees the opportunity to invest in the bank's products in the same way that consumers do, and as many of those products are sharia-compliant, that presents no issues. But, she said: "When you are talking about share options in the company itself, you need to think about certainty, and sharia's prohibition of forward contracts where both parties are contractually committing to delivering their part of the contract in future."

A typical share option arrangement might see the employer agreeing to give shares in the future in return for the employee agreeing to pay a certain exercise price. That kind of contract is forbidden by Islamic law.

Fry said: "Instead, an employer has to say that they promise to provide the shares, but the employee does not have to make any promises on the exercise price. It is a one-sided promise, but in reality the employee won't get the shares unless he or she pays for them, so the commercial outcome is the same."

Occupational pension schemes can also present problems for Muslim employees if they are investing in companies that sell alcohol or are otherwise non-compliant with Islamic law. Many of the funds that employers invest in for share options, pension schemes and bonuses are interest-only, which is against Islamic law.

Employers in the Middle East are not obliged to offer sharia alternatives to Muslim employees, with the onus being on the individuals to opt out of schemes that they deem to be incompatible with their faith.

But Mohammed Farrukh Raza, managing director of Islamic Finance Advisory & Assurance Services, said that could present problems in future. He advises companies on sharia compliance, and said: "We have come across a lot of situations where people have opted out of pension schemes or health insurance because they don't conform to their faith, and they are then left in a disadvantaged position. They have accepted it because they have no choice."

He said no challenge had gone to court, but it could do: "This is becoming a growing concern for a number of organisations. They have started looking at it seriously, and there are many seeking advice about coming up with solutions that will be acceptable for Muslim employees so that they are not disadvantaged."

On a day-to-day basis, employers in the Middle East need to be aware that Muslim employees are required to pray five times a day and have the right to refuse to handle alcohol or pork products. Dress code could also be an issue, particularly for Muslim women who choose to wear the hijab or headscarf at all times.

Yasir Hassan, an employment lawyer in the Dubai office of law firm Denton Wilde Sapte, said: "When a woman employee signs the employment contract, if there is clear indication that she is not expected to wear the hijab, she will be required to abide by the dress code of her employer, in the case of air hostesses, for example. If she agreed to abide by a dress code that was not the hijab, she can't then say she decided to wear it. She may lose her job."

If there are only certain circumstances where she is not allowed to wear the hijab, and she has not agreed to that, then the employer will not be able to enforce such a requirement.

When it comes to alcohol, employers should not have alcohol on the premises. But sharia law originates from a combination of three sources: the Muslim holy book the Qur'an, the Hadith, which is the sayings and conduct of the prophet Mohammed, and fatwas, which are the teachings of Islamic scholars. Hence the exact rules are not set in stone.

Western banks are confused about what activities are permissible, writes Maha Khan Phillips

Search is on for consensus in Islamic finance

Like any religion, Islam is complex and multi-faceted, and so it is no surprise that approaches to Islamic banking have traditionally varied in different parts of the world. Although attempts at industry standardisation are being initiated by associations such as the Accounting and Auditing Organization for Islamic Financial Institutions, the industry is divided about how far consensus should go.

Rushdi Siddiqui, director of the Dow Jones Islamic Market Index Group, said: "You have to put standardisation into perspective. Practically speaking, the Islamic finance industry only really caught the imagination of investors and started to develop five years ago. It's very difficult for something that's only five years old to have standards etched in stone. It would stifle growth and development."

In an attempt at industry standardisation, the Accounting and Auditing Organisation for Islamic Financial Institutions launched a programme to help financial groups market their products by certifying that financial contracts between the institutions and their clients comply with AAOIFI standards.

Western banks developing Islamic products say they are often left confused about what is permissible, because it varies from country to country and scholar to scholar. Malaysia, for example, is considered to have the most liberal approach, permitting the securitisation of Islamic mortgages, something that is far less common in the Middle East, where there are stricter attitudes to trading debt.

Tahir Jawed, managing partner of law firm Maples and Calder in Dubai, said: "The general view is that Malaysia is a bit more liberal, because certain types of cashflows can be securitised. But they haven't quite integrated with the rest of the world. The Middle East approach seems to be more linked to the London market, because there is no point producing something in London which won't sell in the Middle East."

However, there are signs of integration. Cagamas, a Malaysian firm that issues securitised Islamic mortgages, plans to expand into the Gulf Cooperation Council, comprising Saudi Arabia, United Arab Emirates, Bahrain, Qatar, Kuwait and Oman. Western banks are also expanding their operations in the region.

Malaysia continues to be the biggest domestic market for Islamic finances, with ringgit-denominated sukuk, or Islamic bonds, issued last year amounting to $64.4bn (€50.4bn), or 66% of global outstanding issuance as at December 31 2007, according to rating agency Moody's Investors Service. In the Middle East, Islamic banking assets have grown three times faster than conventional banking assets over the past five years, according to the Halal Journal, a Malaysia-based publishing group that focuses on issues of compliance with Muslim law.

One hedge fund of funds manager, whose company was poised to launch an Islamic hedge fund in the Middle East and was forced to back out after the project was vetoed by an Islamic scholar, said: "We were given the OK by one scholar only to have another one turn round at the marketing stage and say what we were doing was not permissible, even though other managers had exactly the same structures and were offering products. We are left with no knowledge of where we stand."

Some believe it is a problem for scholars. Jawed said: "Sharia scholars have been studying sharia law for their whole lives, and are now advising without having a legal or financial background. Part of the problem is how things are presented to the adviser. Banks have a vested interest in getting things approved, and a lot of these structures are extremely technical and difficult to understand."

Rodney Wilson, a professor at Durham University and chairman of the academic committee of the Institution of Islamic Banking and Insurance in the UK, believes scholars must be educated. "Sharia boards may not understand what is happening. They must be trained, and I think there is recognition of that, with more emphasis being placed on training and education."

Dow Jones' Siddiqui argues that scholars are proactive when they launch products that divide the Islamic community. He said: "Certain scholars sign off on a controversial product because they want to see a particular industry grow and develop. Then, as it gains traction, a scholar will say, enough time has passed now that we can make it more compliant." He said the dearth of scholars in the industry was more of a challenge than having an inconsistent approach.

Hedge funds are one example of where inconsistency is a problem. Many scholars believe there is no room for them in Islamic finance, while others make allowances, provided they are structured correctly. Richard Phillipson, a principal at London-based consultants Investit, said: "If you can make a sharia hedge fund, then anything is possible."

He cites the example of Barclays Capital, which has worked with Sharia Capital, a US-based Islamic financial services company, to provide a prime brokerage platform that will enable managers to operate as usual while still being sharia-compliant. The market has not taken off yet, and sharia-compliant hedge funds are estimated to be worth no more than $5bn, according to Oracle Investment Management. Phillipson said: "The market has yet to be convinced."

Buyout firms must adapt to sharia legal framework

Catherine Craig

The body of Islamic jurisprudence known as sharia law commands attention from private equity investors operating in the Middle East, North Africa and certain parts of Asia.

Under sharia principles, certain concepts of western financial models are prohibited to varying degrees according to scholarly teaching.

According to Al-Harith Sinclair, partner and Islamic finance specialist at law firm DLA Piper, among these are the payment of interest, or "riba", investment in "haram" industries such as gambling and alcohol, and contractual uncertainty or "gharar". All this is underpinned by the principles of transparency and trust.

Sinclair said: "One of the stories about Islam coming to Asia tells of the date vendors who set up their market stalls with total honesty, never hiding the rotten fruit among the good. According to the story this led people in the region to convert to Islam."

However, these fundamental principles may be enforced to varying degrees of strictness subject to the opinions of specialist Islamic scholars who advise on sharia's interpretation in everyday life.

Sinclair said: "Private equity as a concept is probably one of the closest western financial models to the Islamic idea of sharing both profit and loss. Despite this the structuring and running of private equity funds and the acquisitions they make are impacted by adopting Islamic compliance."

He said investors marketing a fund in the region should decide which Islamic audience they are selling to. He added: "Malaysia, for example, wants to be seen as modern and progressive in developing Islamic financial products and has embraced innovative products. Saudi Arabia on the other hand is much more traditional."

Private equity funds which undertake to operate in compliance with sharia principles may need to check whether portfolio companies' operations are Islamic and to restructure their capital and management accordingly.

One crucial area of compliance for buyout firms is the use of debt, which, as an interest-bearing instrument in its western form, is not permissible. Neil Miller, head of Islamic finance at law firm Norton Rose, said: "While there are ways of funding asset-based deals with Islamic debt, as this offers some security, it is much trickier to do a deal where you're buying a business that does not include tangible assets. The other thing is you can't generally buy a company if it is considered to be over-geared. If a company is borrowing more than 30% of its tangible net worth, as a rule it will not pass that screen."

An essential key to resolving these layers of complexity is the appointment of a sharia committee, or Islamic supervisory board, which moderates investments on behalf of the fund and its investors.

This board, which should usually consist of a minimum of three recognised scholars, will issue a "sharia

Turn to page 8

HOLD EVERYTHING DEAR

An investment dispatch on preserving capital and creating wealth on a firmer footing in the Middle East*

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Optimistically, one can view the current crisis as cyclical and anticipate it will play out like the last downturn in 2002 to 2003.

The pessimistic view is that the current crisis is systemic in nature and threatens the global financial infrastructure. It took adecade to recover from the last systemic meltdown - the Great Depression of the 1930s.

In the Middle East, we tend to take a middle path.

The current crisis may not be just cyclical but at the same time need not be systemic. This would still mean the existence of liquidity problems, depreciation of asset values, a period of extended slowdown and a shift of power from the developed world to emerging markets. While this may characterize the global markets, the Middle East (especially the Gulf) may be more resilient due to its oil resources.

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* Inspired by the book " Hold Everything Dear: Dispatches on Survival and Resistance" by John Berger

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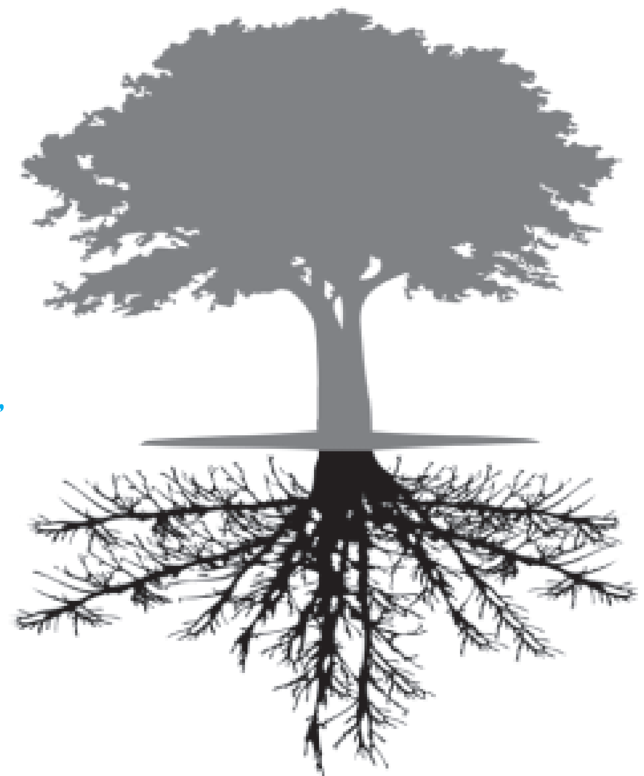

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Investors' enthusiasm for the Mena region hampered by deals drought

Private equity in the Middle East and North Africa is long on capital but short on opportunity, writes Catherine Craig

Investors in private equity buffeted by the financial maelstrom are increasingly fixing their gaze on the Middle East and North Africa. But appearances can be misleading.

On first appraisal, growth in infrastructure, driven mainly by oil production, has been spectacular in the Mena region, which the World Bank defines as the area spanning Morocco in North Africa to Iran in south-west Asia.

In July, consultancy McKinsey said in a survey, which included India and Pakistan, that the region's public equity markets had grown by 41% on average year on year between 2004 and this year.

Saudi Arabia's stock exchange, the Tadawul, was fourth in the world by market proceeds after New York, Hong Kong and London last year and this, with a global market share of 7%, according to data provider Thomson Reuters.

Non-infrastructure focused private equity funds raised for the region since 2003 total $18bn (€14.4bn), according to research company Private Equity Intelligence, and Bahrain-based finance house Investcorp estimates capital deployed in the region increased from $6bn in 2007 to $9bn last year.

Despite this, the investor community is divided over whether the Mena region can stand alone as a source of private equity returns, or whether a broader scope is required to align investment discipline with economics.

One director at an international investment house based in the region said: "I think the region is cash-long and deal-short – if you take a look at the fundraising statistics there is money available for many more deals than have been implemented."

Neven Hendricks, head of financial advisory services in the Middle East at accountant Deloitte's Dubai offices, said: "Aside from oil, the economies of the Mena region have primarily been built on family-owned businesses which take a lot of convincing to sell to private equity.

"I think, in the main, this will change over the next three to five years. Expansion capital will come from private equity houses and stock market listings but the prospect of sourcing deals and creating stellar returns is far more difficult here than in the west today."

According to McKinsey, 90% of non-oil related GDP in the Menasa region (which includes South Asia) is driven by family-owned businesses. But advisers believe this represents a very small portion of its economy.

One lawyer advising on deals in the region, who asked not to be named, said: "There just isn't the buyout mentality here as there is not really an indigenous middle class of people yet to drive private equity and M&A in the region.

"Most successful businesses to have developed beyond the oil boom over the past 50 years are family-run and want to stay that way."

But Gary Long, president and chief operating officer at Investcorp, which has $17bn in invested assets under management in the US and Europe, said the region held great promise, with the group having raised its first fund focused on the six Gulf states, at $1.1bn last year.

Though based in the Gulf since 1982 and investing on behalf of Gulf institutions and high net worth individuals, Investcorp only made its first investment in the region this year.

Top 10 funds raised focusing on the Middle East

Manager	$ million
Abraaj Capital	2,000
Global Investment House	1,000
Global Investment House	550
Argent Financial Group International	500
Dubai International Capital	300
Korea Technology Investment Corp	300
Macquarie Funds Management Group	*1,000
Amwal AlKhaleej	267
Amwal AlKhaleej	267
Ithmar Capital	250

Source: Preqin

** UAE dirhams*

Long said: "Several years ago our clients started to ask whether we would use our platform to invest in the Mena region. We spent time getting comfortable with the attractiveness of economic conditions and saw that clients' allocation of investments was shifting to their own markets. We believe there are particularly good opportunities for investment firms with insider status. We have 1,400 clients providing us with a rich source of deals and referrals." Long said it was a myth that buyouts were not possible in the Middle East. He said: "This is both a buyout and buy-in market. Of all the deals done over the past five years, I would estimate 30% to 40% have been for controlling stakes."

But he said operational improvement in the region would take precedence over financial engineering or general market growth as global economies adjusted. Hendricks said returns on exits in the region had been above 50% but he expected this to adjust as growth slowed.

The Mena region has not escaped financial downturn. Saudi's Tadawul All-Share index has lost 40% of its value over the past year and a report by the World Bank said it expects inflation to be a big concern as food prices increase.

Growth has also been slowing over the past three years, placing greater emphasis on investors' ability to drive value in their investments. Annual growth in GDP, a measure of national productivity, fell from 3.9% in 2006 to 3.8% last year, according to the World Bank, which said the region had the slowest rate of economic growth of any emerging market in 2006.

As a percentage of mergers and acquisitions activity in the region, private equity has a long way to go before it occupies the prominent role it has developed in the west. Figures from Thomson Reuters show private equity represented 4.2% of M&A for the year to October 15, compared with 8.1% in Europe, even under the pressure of a financial downturn.

Long said: "Private equity has a lot of growth potential in the region. Private equity funds as a percentage of GDP in the US and UK represent 3% to 4% while in Mena this is more like 0.4%."

But independent research suggests the capital raised by private equity funds targeting Mena may already outweigh the opportunities available. Thomson Reuters records 110 deals in the region valued at a combined $6.8bn since 2003 compared with Preqin's $18bn in funds raised over the same period.

One adviser said large, established investors in the region operated under a broader investment mandate to mitigate the paucity of deals. The lawyer said: "A lot of funds which have set up Dubai-registered offices focus on much more accessible markets in India, for example, where it's easy to find technology companies looking for capital."

Dubai-based Abraaj Capital, the largest private equity investor dedicated to the region and managing $5bn in funds, invests across Menasa, which includes India, Pakistan and Turkey under some definitions.

The group's largest investment to date is in Turkey, with the acquisition of a stake in healthcare services firm Acibadem for up to $585m, according to Abraaj's website. Its second-largest investment is a stake in the Karachi Electric Supply Company, for more than $350m.

Buyout firms must adapt to sharia legal framework

From page 6

fatwa" or opinion, to investors on whether an investment is compliant or not, and whether it requires a process of "purification" to make it so.

Miller said there were about 250 practising scholars worldwide who advise 350 Islamic financial institutions while only about two dozen of these were well known to the global investor community.

But while there are possibilities for structuring Islamic debt to mirror the leveraged buyout model, these are not always ideal in scholars' eyes. Miller said: "One type of Islamic debt used in these situations is a commodity-based 'murabahah', a 'cost-plus financing' technique, where a bank will buy a commodity as principal from a broker then sell it to its customer on deferred terms.

"The customer requires cash and will immediately sell the commodity in a technique known as 'tawarruq' ('to turn into silver'). The customer ends up with an obligation to pay the bank over time, usually based on the asset value plus a premium to Libor. The technique can be used by investors when there is no alternative way to structure an acquisition, but it is not generally favoured by the majority of Islamic scholars. The real issue for Islamic banks will be to devise more sharia-compliant techniques to support buyout activity."

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Banks promise to hold their nerve as

Expansion is pressing ahead despite deals put on hold, writes David Rothnie

Feeling the pressure: banks expanded in anticipation of bulging pipeline

The Middle East was every investment banker's idea of a haven from the global financial crisis, but last month they found it had arrived on their doorstep.

First oil prices – the bedrock of the region's stellar economic growth – slid towards $70 a barrel, then about $54bn (€42bn) of foreign deposits fled the banking system, prompting the Government in the United Arab Emirates to offer a guarantee on all bank deposits and savings. A week later, it hit investment banking business when regulators in Qatar and Saudi Arabia postponed initial public offerings.

The edict issued by the Qatar Financial Markets Authority forced Vodafone, Europe's largest mobile phone company, to delay the planned flotation of Vodafone Qatar. The company and HSBC, which is lead arranger, are awaiting approval on a revised timetable as they scramble to complete the deal or risk breaching the terms on which it purchased its mobile phone licence.

Declan Hegarty, co-head of global banking for HSBC in the Middle East and North Africa, said: "There has been a slowdown in activity but there is still a decent pipeline of deals: the watchword is versatility. It is important to be able to run floats on local markets – Dubai Financial Market, Abu Dhabi Securities Exchange, Dubai International Financial Exchange – as well as global depositary receipt programmes in London."

The global financial crisis may have blunted risk appetites elsewhere, but in the Middle East, the seizure in the region's equity capital markets has done nothing to discourage banks from pressing ahead with the second phase of their regional expansion by offering equity research sales and trading to local companies so they can offer full post-flotation care to their clients.

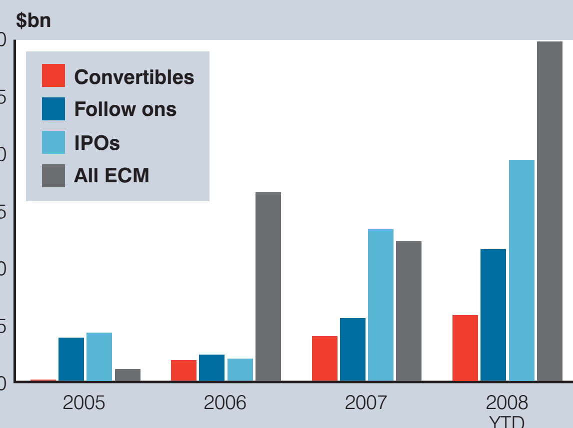
Days after the Qatari watchdog blocked the Vodafone offering, John Thain, chairman and chief executive of Merrill Lynch, restated the bank's commitment to expanding its presence in Dubai and the Gulf region. Fares Noujaim, president of Mena at Merrill Lynch, said: "The Middle East will continue to be a high-growth area and a long-term commitment is important for when the market turns around."

At the same time, UBS issued its first piece of equity research in the region, after establishing an equity research team and six-person sales and trading operation in July as part of its plan to double the size of its Middle East operation. Earlier in the month, Deutsche Bank launched its sales and trading and equity capital markets operation in the region with the recruitment of Ahmed Beydoun from UBS. Deutsche also relocated Carl Hayes, head of equity sales trading in Mena, and Alex Ells, head of trading in Mena, from London to Dubai.

Per Larsson, chief executive of Middle East and North Africa for UBS, said: "The Middle East is not immune to the turmoil and turbulent markets, which means there will be a shortage of big equity capital markets deals in the short term, but there are a number of companies in the region preparing to go public and demand will grow as local stock exchanges develop and the equity capital markets open up."

Investment banking revenues rocketed in the Middle East between 2006 and 2007, admittedly from a low base, and equity capital markets volumes in the region are at record -

Middle East ECM issuance



Source: Dealogic

The top bankers being redeployed to the region

Investment banks have been redeploying staff to bolster their Middle East operations for more than a year, *writes David Rothnie*.

Cynics regard the moves as attempts to impress clients by sending over big hitters and to unload excess capacity following the credit crunch. This cynicism is heightened by the fact banks will not disclose how many staff they have relocated.

To dispel some of the mystery, Financial News has compiled a list of bankers regarded as among the best in their field. The list does not include local bankers or those that relocated more than a year ago.

Makram Azar, Kohlberg, Kravis Roberts
Less than a week after Lehman Brothers' European and Middle East operations went into administration, Azar jumped from being the bank's Dubai-based head of sovereign wealth funds and chairman of media investment banking to set up the Middle East operation of KKR. After an 18-year career at Lehman Brothers, Azar faces the challenge of building KKR's business in the region during a downturn.

Mukhtar Hussain, HSBC
HSBC took redeployment of talent by its rivals seriously enough to send Hussain back to Dubai in May to take on the roles of global chief executive of HSBC Amanah, HSBC's Islamic finance operation, and to be chief executive of global banking and markets in the Middle East and North Africa region. Hussain, who joined HSBC in London in 1982, is the perfect redeployment candidate, having been first posted to Dubai in 1993 to set up HSBC's investment banking business.

Christopher Laing, Deutsche Bank
As co-head of equity capital markets for central and eastern Europe, Middle East and Africa, Laing moved to Dubai in August after finding himself travelling to the Middle East on a weekly basis. Laing joined Deutsche Bank in 1995 and has worked in equity capital market positions in Sydney, Hong Kong, New York and London.

David Law, Morgan Stanley
Law's appointment as chairman of investment banking for Middle East and North Africa in February was seen as both a statement of intent by Morgan Stanley and a sign of the times. Previously head of financial sponsors for Morgan Stanley International, he was the bank's most senior private equity coverage banker outside the US.

Philip Lynch, Nomura
Lynch can never be accused of staying in the comfort zone. While at Lehman Brothers, Lynch established a reputation for versatility, running equity capital markets, fixed income and equities before choosing to move to Dubai to run Lehman Brothers' business in May. A no-nonsense operator, Lynch has little time for titles, despite having to change his business card more than most.

Christopher Niehaus, UBS
UBS's South African investment banking business has been a hotbed of talent for many years, with stars such as Ken Costa and Alex Wilmot-Sitwell passing through. Niehaus was running UBS's South African investment banking business before relocating from Johannesburg to Dubai in April to become joint head of investment banking for Middle East and North Africa earlier this year.

Fares Noujaim, Merrill Lynch
Noujaim joined Merrill Lynch in June from Bear Stearns to run the bank's global coverage of sovereign wealth funds across its investment banking, trading and wealth management businesses.

George Pavey, Credit Suisse
Pavey moved to Dubai in August as head of real estate equity capital markets for Europe, Middle East and Africa, and co-head of Emea emerging markets equity capital markets. He rejoined Credit Suisse in October 2007 from HSBC where he was a managing director and co-head of global capital markets in the Asia Pacific region for two and a half years.

Alberto Verme, Citigroup
In May, Citigroup became the first investment bank to relocate a global function to the Middle East, with the deployment of its global co-head of investment banking to Dubai.

Alasdair Warren, Goldman Sachs
Warren's decision to swap running UK investment banking in London for a berth running the bank's financing business in Dubai was the first of many overseas redeployments by Goldman Sachs, which for all of its dominance in investment banking, had lagged its rivals in the Middle East.

stakes rise

levels following a strong first half. Total equity capital markets issuance hit $30bn by the end of last month, compared with $20bn for the whole of last year, according to Dealogic, an investment banking data provider.

Initial public offerings are on course to beat last year's record, but after a strong first half, volumes have started to tail off and bankers agree that revenue growth is slower than they predicted. Bankers have been forced to lower their expectations and hope their employers do not start cutting back as they enter a crucial phase of their expansion plans. Larsson said: "Even if we see slower growth in the Middle East than previously expected, the region remains a fast-growing market."

However, slower growth could threaten the some banks's models, particularly those that are about to make big redundancies in time for the end of the financial year. Hegarty said: "We're not seeing any evidence of retrenchment, but next year some banks may start to trim because the fee pot will not resemble the projections that the original business case was based on. So it is important to have cushions of income and a good rounded product mix."

Banks face a dilemma in the Middle East. On one hand, they must start to show revenue growth and profitability, while on the other, they must invest in people and infrastructure to create a full-service offering, not only to capture clients and revenues, but as a display of commitment.

Bankers hope turmoil in the credit markets will provide a boost to equity capital markets. Larsson said: "The debt market has been the venue of choice for Middle Eastern companies, but with current market conditions they are increasingly looking at raising equity as an alternative form of fundraising."

Focus shifts to corporate clients

David Rothnie

Western-style relationship banking has arrived in the Middle East as competition for lucrative corporate accounts intensifies while sovereign wealth funds and private equity investors call a temporary pause on foreign investment.

Although banks are eager to display their commitment to covering sovereign wealth funds, the battle for fees has moved to the corporate heartland of the Middle East.

In August, the nine banks that arranged a $5.6bn (€4.3bn) offering for the Investment Corporation of Dubai did so on a "pay-to-play" basis, whereby they agreed to lend on the condition that they secured additional fee-based work. This approach is becoming more common and sources said banks committed to bond issues by DP World in May and Taqa in August on a similar basis.

Bankers say the pay-to-play strategy comes as corporates review existing banking and advisory relationships following the global financial crisis and consolidation within the investment banking industry.

This shake-up is evident in the advisory rankings for Middle East M&A, which is topped by Japanese bank Nomura following its acquisition of Lehman Brothers operations in the region. Bank of America is second, and that is before its planned merger with Merrill Lynch is taken into account. Last year, Goldman Sachs was the top adviser, and Morgan Stanley was fifth this year. Goldman Sachs is sixth while Morgan Stanley does not feature in the top 10. This shift is only partly explained by lenders gaining market share at the expense of firms offering only advice or underwriting.

It is also because different companies are active in any given year, and the trick is for banks to ensure they cover companies that provide the most lucrative source of fees are they seek to expand in the region.

Last year, corporates were the source of 90% of the record $445m fees paid out for M&A deals in the Middle East. For the first 10 months of this year, fees have dropped on the back of a sharp fall in M&A activity, but strategic buyers and sellers still account for 93% of the fee pool.

Bankers predict a wave of acquisitions by Middle East companies, which have big growth plans, and they believe the international focus on expansion will favour global investment banks.

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Law firms explore beyond Dubai

International firms flock to the region in search of a larger fee pool, writes Claire Smith

GETTY IMAGES

Making tracks: legal practices are increasing their footprint in the region

International law firms are expanding in the Middle East as fees in the west shrink in the wake of the credit crisis. Lawyers are seeking to capture dealflow from sovereign-backed entities doing outbound work and to advise foreign investment banks and investors.

As well as putting increased resources in place, the legal industry has this year broadened its horizons away from the traditional financial hub of Dubai in the United Arab Emirates.

Last month, the New York-headquartered international law firm Dewey & LeBoeuf became the latest to announce expansion. The firm, which already operates from offices in Dubai and Riyadh in Saudi Arabia, has outlined plans to open in Doha in Qatar and Abu Dhabi. The new outposts will be staffed by people redeployed from the firm's offices throughout the world and by staff hired in the region.

Steve Davis, Dewey & LeBoeuf's chairman, said: "Dubai is a major centre for finance and capital markets work, but Abu Dhabi is very important for energy and projects work. We felt there was a different market focus there, and a sense that if you are going to be working with clients you really need to be on the ground."

He said Qatar was emerging as a hydrocarbon and energy centre and, as a result, several of the firm's clients were setting up regional headquarters in the city. He said: "We felt it was a significantly distinct market and we really needed to have something there."

Other law firms have reached similar conclusions. US-based Latham & Watkins has expanded considerably in recent years, but until early this year it had no presence in the Gulf. It announced plans in February to open offices in Dubai, Abu Dhabi and Doha.

Bill Voge, member of Latham & Watkins' executive committee responsible for the Middle East, said: "Our initial thought was to go into the region and have one office, and it became clear to us that Dubai was the most logical place to have a regional base. But in Abu Dhabi we are already representing some sovereign wealth funds on investments in North America and elsewhere, and those clients and the Government in Abu Dhabi were saying we needed to have an office there if we wanted to keep on doing work for those clients. Then our clients in Qatar said, 'We assume you are coming to Doha', and we realised we needed to be there too."

Latham & Watkins' clients include the Qatar Investment Authority, the Saudi Electricity Company and the Executive Privatisation Committee of the Government of Jordan. Voge said the next decision would be whether to expand into Saudi Arabia.

It is a story being repeated elsewhere. White & Case has had an office in Riyadh since 1991 through an association with a Saudi law firm – the only way in which foreign legal firms can set up shop in the country. The firm has been representing the world's largest oil company, Saudi Aramco, since the early 1950s, but decided 18 months ago that the Gulf region held even more potential, and opened in Abu Dhabi.

Mohammed Al-Sheikh, executive partner of White & Case's Saudi operations, said: "We have a huge client base in the region. Clients demand lawyers to be close to them – the days of lawyers flying in and out from London and New York are gone."

The economic boom in the region is creating huge opportunities for law firms in all practice areas. Capital markets activity is high, and mergers and acquisitions teams are busy as regional companies look to expand domestically and internationally. Project finance and real estate deals abound as the Gulf states seek to build essential infrastructure and diversify their economies away from their finite oil resources.

London-based law firm Denton Wilde Sapte has been active in the Gulf for more than 40 years, and with 23 partners and 124 fee-earners is one of the biggest international firms on the ground. It has offices in Cairo, Dubai, Abu Dhabi and Muscat in Oman, and is expanding in the region. Last year it opened in Riyadh, Doha and Amman in Jordan, and expanded into Kuwait this year.

Neil Cuthbert, the firm's Dubai-based Middle East managing partner, said: "The legal work here has definitely got much more sophisticated. When I first came here eight years ago you didn't have so many mega-instructions, and now the market has moved on. Dubai is hectic – it's developing a lot of its economy and resources, and Dubai companies are buying up assets all over the world."

Islamic finance is one area that has taken off, with financial institutions moving to offer sharia-compliant products as local investors fund the economic activity in the region.

Al-Sheikh said: "Islamic finance has exploded in the past few years, and White & Case has been doing a lot of that. The last non-Islamic finance deal we did was probably two and a half years ago; now everything is Islamic."

While the established firms continue to prosper, newcomers are arriving in an attempt to share the riches. London-based law firm Lovells opened in Dubai last year. Shibeer Ahmed, the firm's Dubai managing partner, said: "We were behind our competitors, so we needed to find a way of setting up an office that meant we would have client relationships from day one. We were looking to hire people with strong relationships with banking clients, and that means both international banks and regional banks in the Gulf."

Lovells hired three partners from Denton Wilde Sapte, led by Islamic finance specialist Rahail Ali, and now acts for clients including Standard Chartered, HSBC, Barclays Capital, Dubai Islamic Bank and Deutsche Bank in the region.

For all law firms, there is no doubt that the credit crunch is hitting business in the US and Europe, and for the internationalists, the Middle East appears to offer the greatest growth opportunities. Davis at Dewey & LeBoeuf said: "It seemed to us collectively in the firm that if we were going to do any near-term expansion, this was the place to do it."

It is a view being echoed in law firm boardrooms the world over.

Imported intermediary community faces local hurdles

One criticism levelled at the Mena region's financial community is that it lacks the sophistication required to execute complex M&A and buyout deals, *writes Oliver Smiddy.*

Robert Wages, head of private equity at sovereign wealth fund Abu Dhabi Investment Company, said: "Things do take longer here. The legal framework is not as conducive to private equity deals, and documentation can be more cumbersome than in Europe or the US."

Fred Sicre, executive director of Abraaj Capital, said it was unjust to single out the Gulf. He said: "Wherever you look in the world there's room for regulatory reform. But there's a momentum here, an aspiration, particularly in Dubai, to be best in class. The regulatory framework is high on the agenda, but some countries move faster than others. It's certainly not impacting our ability to do deals."

The advisory community has been piling into the Gulf in recent years, a process which is bringing about a change in the level of sophistication. Sicre said: "There is increasing sophistication, and it's a fast-changing environment. Even a few years ago, you would have found it hard to find an acquisition finance team here. Now many of the big institutions have set up here."

Despite the influx, many fear there is a surfeit of intermediaries in a market where their services have not traditionally been in demand.

Nick Bryans, managing partner of Ashurst's Dubai office, said: "Deals are generally less complex than those in Europe or the US – primarily because many are not leveraged and so there's not quite the same level of rocket science required as with a complicated, cross-border deal in Europe, for example. Many advisers are able to compete on price for mandates rather than on the services they provide or the experience they can bring to the process."

Nick Garland, a partner at Linklaters' Dubai office, added: "Private equity sellers don't give warranties to a buyer as they don't want their fund to have any lingering liabilities. So a business has to be pretty transparent if you're not going to give warranties and representations. You don't see many cases where a firm has flipped an asset, with Abraaj's Egyptian Fertilizer being the exception. There is, however, a drive towards greater transparency, with internal reporting and internal documentation growing more rigorous."

Investcorp president Gary Long said deals in the Gulf were transacted to a less demanding time frame. "In the west, auctions dominate and a seller is typically under pressure to sell quickly. Here, the due diligence process has unique challenges, but it does allow the parties to work to a less challenging time scale."

Top law firms

Claire Smith profiles the practices that are scooping the biggest mandates in the region

Allen & Overy

Offices: Dubai, Abu Dhabi, Riyadh
Lawyers in region: 100+
Regional head: Simon Roderick, Middle East managing partner
Key partners: Pervez Akhtar (corporate), Bimal Desai (finance), Ian Ingram-Johnson (project finance), Ibrahim Mubaydeen (finance)
Launch: 1970s
Clients: Abu Dhabi National Energy Company, Emirates Islamic Bank, Emirates Bank, Depa, ArcelorMittal

Allen & Overy has increased its Middle Eastern presence with the relocation of 20 partners and associates. Relocated corporate partners include Andrew Schoorlemmer and Chris Thornes from London to Dubai, Johannes Bruski from Frankfurt to Riyadh, and Tom Levine from London to Abu Dhabi.

Its principal practices in the region are capital markets, banking and mergers and acquisitions, with recent deals including advising the Abu Dhabi National Energy Company on a $1.5bn (€1.2bn) senior note issuance and a 4.15bn UAE dirhams (€880m) convertible bond.

Al Tamimi & Company

Offices: Dubai, Abu Dhabi, Sharjah, Baghdad, Doha
Lawyers in region: 145
Regional head: Essam Al Tamimi, founder and senior partner
Key partners: Hassan Arab (banking, intellectual property), Husam Hourani (banking), Yazan Saoudi (insurance), Edward Sunna (real estate), Gary Watts (corporate)
Launch: 1989
Clients: Dubai Bank, HSBC, Standard Chartered, DP World, Mubadala Development Company, Deyaar Development

Al Tamimi is one of the biggest law firms in the Middle East. It covers dispute resolution, aviation, banking and finance, construction, corporate and commercial, private client, intellectual property, IT, insurance, real estate, technology, media and telecoms work. Landmark deals include advising Dubai Bank on converting from a conventional institution into an Islamic bank, as well as working for HSBC and Standard Chartered.

Clifford Chance

Offices: Dubai, Abu Dhabi, Riyadh
Lawyers in region: 100
Regional head: Graham Lovett, Gulf managing partner
Partners: Robin Abraham (banking), Debashis Dey (Islamic finance), Simon Clinton (corporate), Iain Hunter (corporate)
Launch: 1975
Clients: Dubai Financial Group, DP World, Future Pipe Industries, Istithmar World Capital, Mubadala, Abu Dhabi Investment Council, Abraaj Capital, the Carlyle Group, Morgan Stanley, Investment Corporation of Dubai

Clifford Chance opened in Dubai in 1975 and has a practice covering corporate M&A; banking, finance and projects; debt capital markets and structured products; real estate and construction; and dispute resolution. The firm opened its second UAE office in Abu Dhabi in August and has 10 lawyers on the ground. In Saudi Arabia it has a 10-year co-operation agreement with Riyadh's leading legal practice, Al-Jadaan & Partners.

Recent highlights include work for Dubai Financial Group on a $600m investment in Bank Muscat of Oman.

Denton Wilde Sapte

Offices: Abu Dhabi, Amman, Cairo, Doha, Dubai, Kuwait, Muscat, Riyadh
Lawyers in region: 125
Regional head: Neil Cuthbert, Middle East managing partner
Partners: Neil Cuthbert (banking), Ibrahim Elsadig (corporate), Owain Jones (banking), Vincent Mulvey (banking), Neil Nicholson (corporate)
Launch: 1964
Clients: Mena Infrastructure Fund, AB Capital, Planet Pharmacies, Vodafone, Dubai World, Sumitomo Chemicals, National Electric Company of Jordan, Total, BP, Abu Dhabi Commercial Bank

Denton Wilde Sapte has one of the most established Middle Eastern practices of any European law firm. It opened three additional offices last year – in Riyadh, Doha and Amman – and another in Kuwait opened in January. It recently advised the Mena Infrastructure Fund on its $500m acquisition of a minority stake in Egypt's Alexandria International Container Terminals.

Linklaters

Middle East offices: Dubai
Lawyers in region: 38
Regional head: Ewan Cameron, senior partner of the Middle East
Partners: James Martin (banking), Sarosh Mewawalla (finance), Richard O'Callaghan (capital markets), Luma Saqqaf (Islamic finance)
Launch: 2005
Clients: DP World, DIFC Investments, Dubai Holdings, Emirates NBD, Citigroup, Barclays Capital, Borse Dubai

Linklaters opened in Dubai three years ago to focus on mergers and acquisitions, private equity, capital markets and and real estate.

In the past year it has advised Emirates Bank on its $12bn merger with National Bank of Dubai, creating one of the largest banking groups in the Middle East, and advised Deutsche Bank, Merrill Lynch, Millennium Finance Corporation and Shuaa Capital on the flotation of DP World on the DIFX.

Bank Sarasin-Alpen voted Best Private Bank in the Middle East for the 2nd year in succession.

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Property boom could be riding for a fall

Some fear that Dubai may become victim of its own success, writes Darren Lazarus

State-backed developer Nakheel last month unveiled one of Dubai's most ambitious schemes – the Nakheel Harbour & Tower, which will include a kilometre-high building. The inner-city harbour development will cover an area of more than 270 hectares and house more than 55,000 people. It is just the latest iconic project for the developer behind the man-made Palm Islands along the waterfront.

Nakheel does not stand alone in its belief that the Middle East will fare better than the rest of the world from the fallout of the sub-prime crisis that has ravaged residential and commercial property prices.

A majority of respondents to a Jones Lang LaSalle survey of 350 local developers and investors – interviewed soon after the collapse of US investment bank Lehman Brothers in September – said they believed the Middle East "will outperform all other regions" in the next two years.

Vinay Bedi, a UK director of developer DEC Dubai, said this optimism was because the financial crisis was less relevant to Dubai because the emirate will only truly "be ready in three to four years' time".

Certainly, if past performance is to go by, investors have much to justify their optimism. Dubai's love affair with construction has sparked one of the biggest investment stories in the past decade. In Colliers International's house price index, residential property soared by 42% in the first quarter of this year and by 16% in the second quarter. The commercial sector offered double-digit growth of 27% in average asset value and 37% growth in rent in the second quarter compared with the end of last year. Part of the reason for this is supply and demand. Dubai has a total of 22 million sq ft of office stock in the city, but a vacancy rate of only 3%.

As a result, the emirate is pressing on with one of the largest construction experiments in living memory. In the past 12 months alone, four million sq ft of office space has been built, and a further 30 million sq ft of accommodation is under construction. According to Colliers, the total value of real estate projects in Dubai over the next 10 years is estimated at more than $230bn (€180bn).

State-backed developers are leading the charge – having rapidly transformed themselves from little-known local companies into global property groups with some of the largest and most exciting projects.

Emaar, the Dubai-listed developer, in which the Government holds 32%, is building Burj Dubai, billed as the world's tallest tower. And Dubai Properties, whose projects include the 80 million sq ft Business Bay, is set to almost double its real estate investment to 1 trillion dirhams (€212bn) within the next five years from 565bn dirhams now.

However, as the market is still in its relative infancy, there are concerns that each developer is competing to build the same product. Colliers warns of the focus by many developers on high-end products – 40% of the 140,000 residential units to be completed by the end of 2010 are in luxury developments. Don Bradley, real estate agent Knight Frank's Middle East chief executive who has worked in the UAE for 26 years, said developers in the area are concerned about the global downturn.

He said: "The Middle East used to be counter-cyclical as global recessions were previously linked to the increase in oil prices, so it wasn't bad here when it was elsewhere. But this is the first time that I'm aware of the market being more aligned to the global economy."

Some developers and bankers have been worried by the speed of the development, fearing that the dream to build a modern western city on the edge of the Arabian desert has been motivated by government aspiration, rather than commercial sensibility.

According to Jones Lang LaSalle research, if all announced development was realised, up to 90 million sq ft of office space would be built over the next five years, increasing Dubai's office space fivefold.

But Matthew Hammond, head of agency for Jones Lang LaSalle's Mena office, believes the financial crisis will act as a brake on the development pipeline and will bring a dose of realism to the market.

He said: "The credit crunch has shown that the development pipeline may have been too ambitious. The clear lack of readily available funds for development is likely to cause some development plans to be put on hold and delayed and there will be more phasing of the major projects."

The pricking of the Dubai property bubble will also cause rents to fall. Hammond said: "It has become a victim of its own success. Rents have climbed to levels that are unsustainable in the longer term – comparable with the levels seen in London's West End – making Dubai look an expensive city in which to grow. What's happened during the last year – with the spike in rents particularly driven by the investment banking sector – will be dampened."

Dubai
Offices Average rent $1,050 per m2
Average sales price $11,730 per m2
Yield: 8.1%
Residential Average rent $420 per m2
Average sales price $5,420 per m2
Yield 7.7%

Abu Dhabi
Offices Average rent $720 per m2
Average sales price $8,600 per m2
Yield 8.4%
Residential Average rent $450 per m2
Average sales price $6,500 per m2
Yield 6.9%

Riyadh
Offices Average rent $310 per m2
Average sales price $4,000 per m2
Yield 7.7%
Residential Average rent $60 per m2
Average sales price $655 per m2
Yield 9.2%

Doha
Offices Average rent $660 per m2
Average sales price $5,350 per m2
Yield 12.3%
Residential Average rent $285 per m2
Average sales price $4,670 per m2
Yield 8.0%

Source: Colliers International, Mena Real Estate Overview, Fourth Quarter, 2008

Western investors head east, attracted by liquidity and

Institutions are finding it easier to access the region, writes Elizabeth Pfeuti

With economies benefiting from oil revenues and historically cautious monetary policies, Gulf countries have not felt the dearth of liquidity as keenly as markets worst hit by the credit crunch. The region also does not have the pension drain on its finances, because almost half of its population is under 35.

While European and US investors tied themselves in knots by allocating to structured credit, securitised real estate debt and futures, domestic investors in the Middle East benefited from sticking to simpler, unleveraged access to tangible products.

The region has not escaped unscathed. In mid-October, the United Arab Emirates Government injected 25bn dirhams (€5.3bn) into national banks to shore up liquidity, but this is far from the levels needed in the western banking sector.

Nasser Saïdi, chief economist at the Dubai International Finance Centre, said: "We saw very little securitisation in the Middle East and the credit portfolios here were good enough for investors to not have to venture outside of the region where the real problems are. Markets here are strongly capitalised and have been able to withstand the shocks we have felt so far."

In the region, the liquidity injections have largely been seen as a stimulus rather than a bailout package as governments have retained most of their surplus built through oil sales.

Imran Ahmed, managing director of Mashreq Asset Management in Dubai, said: "The region is not entirely immune and has felt the ripples from the severe financial crisis elsewhere. Still, banks are mostly insulated as they remain well-capitalised and, broadly speaking, have limited exposure to exotic financial instruments."

Oil prices reached record highs of nearly $150 a barrel in July but dropped to under $60 by the end of October. Ahmed said governments in the region based financial and budgetary projections on oil prices of between $30 and $40 a barrel.

He said: "The region still has a capital surplus including that accumulated in their various sovereign wealth funds and this means growth and reinvestment in infrastructure is moving at a reasonable pace."

Historically, western investors have not shown much interest in the region, citing limitations on foreign ownership and uncertainty over governance and regulation, but this is changing through a combination of sophisticated local markets, investment in infrastructure and technology, and foreign investors' search for sources of liquidity in the credit crunch.

Figures from Lipper Feri have shown in the first six months of the year €1.1bn ($1.4bn) was moved into equity funds based in the Middle East and North Africa region – an increase on €871.3m and €140.4m moved there in the preceding two years. By comparison, €84.6bn was pulled out of equity funds worldwide.

At the most recent count, Lipper Feri found 21 regional funds open to international investors, with €3bn under management and predictions from the Gulf Cooperation Council are that this will quickly rise in volume. In the region, most agree that in 2006 almost all investment was sourced locally, but by 2008 this had become a 50/50 split with external investors.

There has been greater co-operation between GCC countries, with the local population now permitted to use any of them as a home for their savings and investments. While many of the different states maintain different levels of access, the region has drawn a global audience with attractive growth potential and the benefit of rich oil reserves.

Qatar now allows free access to companies listed on its stock exchange with a cap of 25% foreign ownership and international mutual funds have been allowed to invest in GCC nations for a couple of years. Saudi and Dubai are less open, but have been working with international agencies on ways to bring more international money to their markets without removing all regulation.

Some astute asset managers in the region realised there was a growing interest in their patch and have responded with products aimed at international investors.

Financial services group Mashreq, based in Dubai, has launched the Arab Tigers Fund, investing in stocks across the Mena region, but domiciled in Dublin. Similarly, Gulf Capital, an Abu Dhabi-based alternative investment house focused on private equity, structures its funds destined for the western market in the US to appeal to international investors.

One of the first ways into these markets has been through equity swap ventures. These vehicles have opened the region to international interest through agreements between Morgan Stanley partners in the area. For markets such as Saudi Arabia that contribute a large amount to the region's economy yet remain largely untapped by foreign investors, this has been seen as the most practical measured first step for both sides. Craig Niven, head of Emea equities, Morgan Stanley,

Burj Dubai: rents in the emirate are climbing as high as the buildings

improving markets

based in London and closely involved with the Saudi swap this summer, said: "The Capital Market Authority, the Saudi equivalent of the FSA, was looking at how to open up their markets further after allowing local neighbours access a few years earlier.

"They wanted a way that was beneficial for both their country and potential investors without making the process too onerous by capping or applying bans on certain stocks, for example."

Equity swaps were not a new phenomenon – such transactions have been successfully executed in India. Niven said the Morgan Stanley Saudi swap allows investors to buy any share listed on the Saudi exchange and reap performance benefits, while not accruing voting rights that normally accompany the purchase.

The swap must be fully funded and both parties must be aware of the counterparty with whom they are entering into the sale. The purchaser cannot transfer ownership and any holding over 5% has to be disclosed, which is the normal disclosure law in Saudi Arabia.

Niven said this swap had helped clear the way for fund managers who could now invest and offer clients a single stock instead of a mutual fund structure. He did not confirm the bank had any more in the immediate pipeline, but said the Saudi authorities wanted to evaluate how the venture had affected the economy before committing to more. It is likely other GCC countries will find this an attractive method of bringing in foreign capital instead of having to amend existing regulation.

This slow, methodical approach has been typical. Despite heavy regulation, the area continues to grow using local resources and young people as assets to its future.

Karim El Solh, chief investment officer of Gulf Capital, said the region should not be seen as an investment utopia: "We too are suffering bank financing struggles. It is not as easy as it was to get loans and they are often given at a higher rate than we were used to. Our margins have been eroded a little, but the banks have received cash injection and this state is just temporary. By 2009 we will be back on track."

Makkawi sees fixed income in Algebra's future formula

The Dubai-based firm has emerged from the pack by pushing boundaries, writes Ben Wright

Most Gulf countries are classified as frontier rather than emerging markets – although the UAE, Qatar and Kuwait are being reviewed for an upgrade by index provider MSCI – and their fund management industries have developed a reputation commensurate with that label.

Firms have sprung up in recent years to take advantage of the fast-developing financial markets. The regional head of fund management at a western firm said: "There are the makings of an asset management bubble in the Middle East. There are a lot of unsophisticated companies setting up that have no idea what they are doing."

Algebra Capital – which received its licence to operate in the Dubai Financial Centre in November 2006 and did not become operational until May last year – is one of only a few firms to have emerged from beneath such blanket generalisations.

For one thing, Ziad Makkawi, the firm's chairman and chief executive, has more than 20 years of banking experience. He founded Algebra after serving as chief executive of Dubai Bank for two years. Before that he was executive managing director of Shuaa Capital, where he met many of the people that make up Algebra's team – the Arabic word Al-Jabr, from which algebra is derived, means "reunion".

Makkawi joined Shuaa after founding Middle East Capital Group, the first regionally focused investment bank, in Lebanon in the 1990s. He started his career at JP Morgan in New York and Elf Trading in Switzerland. Makkawi said: "I've launched two investment banks in the Middle East and I deliberately chose to avoid investment banking and concentrate on asset management this time."

Makkawi said there are very few western fund managers operating in the region and those that are have not yet committed enough resources. "We are a small firm but we are focused and we have more people on the ground analysing the debt and equity of regional companies than any international firm," he said. In general, local firms have the edge on their international rivals which saw a greater opportunity in offering investment banking than asset management. He said: "Why they came to that decision is a mystery to me – I have always thought that the biggest opportunity in this region is on the asset management side – but it is good for us."

Last September, Franklin Templeton bought a 25% stake in Algebra, which has benefited not only from the international firm's global reach and brand recognition but also the endorsement of the investment.

Makkawi said that, in the past year-and-a-half to two years, local firms have benefited from institutional investors shifting their money out of large international emerging market fund managers and into small on-the-ground operations, which he believes is part of the growing trend of specialisation in the asset management industry.

The equity markets of the Gulf Cooperation Council have taken a beating in the past few months but fund management executives said global investors have bought into the diversification benefits of an exposure to the region. Makkawi believes there are opportunities not just in managing local equity funds but also fixed-income products.

He said that, without fully functioning debt capital markets, the region cannot achieve sustained economic growth or adopt an independent monetary policy. Similarly, he thinks it will be almost impossible to fund the volume of projects planned for the region purely through equity issuance and bank loans. Makkawi said: "We see great potential and we want to position ourselves as experts in that market for when it is realised."

Currently 85% of the $750m (€580m) that Algebra manages is invested in equities and Makkawi would like that proportion to shrink to 50% with an equal amount invested in fixed income.

He conceded that the credit crunch has made it harder to forecast when this will happen but remains convinced fixed-income management has a future. He said: "When we launched the business we thought we would get there in a couple of years. It is hard now to predict anything – we don't know what is going to happen next week. But I still think that fixed income will get its day in the sun."

It is a view that not everyone in the region shares. Another fund management chief executive described the fixed-income market as "embryonic" at best and said there was no established sovereign bond market on which to base functioning debt capital markets.

Makkawi: asset management focus

One senior Dubai-based investment banker said it would be even harder for the fixed-income market to develop in the Gulf while the credit market has taken a step back in the west.

On the other hand, Nasser Saïdi, chief economist at the Dubai International Financial Centre and a former Lebanese minister of economy, believes the credit crunch could kick-start the regional debt capital markets. He said the fact that regional banks have been hurt by their reliance on international wholesale funding will cause them to seek more diversified, and indeed localised sources of liquidity. He said: "The interbank credit market is global and has shut down across the board. I think this will result in the development of more local means of funding – money market and bond funds for example."

The time-scale for such development remains unclear and Algebra is therefore left with the cost of nurturing its fixed-income capability until appetite grows. In the meantime, Makkawi is confident that the credit crunch has created investment opportunities in the equity markets. Fund flows suggest that foreign investors have – and, to a certain extent, still are – exiting the market. As elsewhere, equities with decent fundamentals have been badly hit as hedge funds became forced sellers to cover redemptions and margin calls. Makkawi said: "The baby has gone out with the bathwater.

"This creates good opportunities for us – lots of companies are trading below book. The markets are looking very cheap. Of course, that is not to say that they might not get cheaper.

"There are a number of leveraged local investors and there will be weakness for a while. But from a valuations point of view, we feel like kids in a candy shop."

Gulf grows between Dubai and investors

A series of scandals could dent the desert city state's image abroad, writes Dominic Elliott

Investors in Dubai are starting to feel the pinch as stock markets in the emirate, which initially weathered the global credit crunch, are taking a battering, financial stability totters and corruption scandals proliferate.

The Borse Dubai-owned Dubai Financial Market, the larger of Dubai's two stock markets, has fallen by as much as 45% since July. The United Arab Emirates Government has injected $33bn (€26bn) in emerging bank lending to stabilise the market.

Of all the concerns about investment in the city-state's financial markets, corruption is the elephant in the room. In the past seven months almost 30 people in Dubai have been questioned by police in connection with probes into financial corruption.

Investigations have centred on individuals who in many cases have had multiple roles at different companies, with more than 10 firms or subsidiaries associated with the scandals as the dragnet widens.

The property and financial sectors, which are at the heart of the credit crisis globally, have accounted for almost all the cases in the region.

Dubai real estate has flourished as the Middle East has enjoyed an economic boom in recent years, triggered by rising oil prices.

However, many Dubai residents believe the property market is overinflated. The real estate sector has been a focus for the corruption scandals as authorities fingered mortgage lender Tamweel and construction company Sama Dubai, palm islands developer Nakheel and Deyaar Development.

Emad Mostaque, co-manager at asset manager Pictet's targeted fund for the Middle East and North Africa, said: "The massive rise in real estate prices has encouraged corruption. Bubbles breed greed."

The financial sector has also been probed through a scandal at investment bank Shuaa Capital and the arrests of employees at Dubai Islamic Bank, which owns 41% of property firm Deyaar.

Sharia finance, which bans speculation and the charging of interest, also carries the risk of manipulation. As sharia interpretations are subjective and vary from one institution to the next, it is hard to quantify actual demand and supply, according to a research report into the Middle East by media relations company Penrose Financial.

Sheikh Mohammed Bin Rashid Al Maktoum, the Emirate's ruler, took the unprecedented step in August of warning: "There will be no tolerance shown to anybody who tries to exploit their position to make illegal profits."

That did not immediately stop the rot. More arrests were made in September and October.

While the scandals have been unsettling for investors, there is an air of catharsis about the crackdown in a region where businesses remain family-dominated and webs of corporate cross-holdings are the norm.

Mostaque said: "You could argue that the timing has been relatively good – the issues have been unearthed during the credit crisis and before the majority of investment has arrived in the Middle East."

Investments in the Gulf Cooperation Council countries remain discretionary, meaning they are not included in the MSCI Emerging Markets Index. MSCI Barra has issued a white paper, whose results will be disseminated next June, and this could lead to their inclusion in the next couple of years. Mostaque said Gulf countries could potentially account for 5% to 6% of the total index.

Mostaque, who will not invest in a Dubai-based company without first meeting its management, said: "Companies that are transparent will be preferred by investors. The stock prices of the more opaque have been punished and will continue to suffer."

A lack of transparency is one of the main criticisms of Dubai, where there is a stark divide between a pledge of open markets and the practices of the murkier elements of the corporate world.

In the corruption cases discovered since April, a reluctance to provide information on the part of the companies involved until after the media broke the news has been mirrored by silence from the state on arrests and imprisonment.

This epitomises the challenges faced by the emerging city state, which is not a democracy, and sits at the heart of the Arabic world styling itself as a gateway between Asia and Europe.

Expats, including British banker Charles Ridley, have been taken in for questioning. Zack Shahin, a Lebanese national and formerly chief executive of Dubai-based Deyaar Development, was arrested and imprisoned in connection with a scandal at the property company he ran. As Shahin proclaimed his innocence from prison, reports of Lebanon's Prime Minister Fouad Siniora monitoring the situation hit the newswires.

Such events could in the long-term dent Dubai's image internationally and halt the stream of bankers searching for jobs in the emirate.

But there are signs that Dubai is embracing change. Attendees at the private equity SuperReturn conference in Dubai last month said there was a readiness to discuss issues more openly.

Mostaque said: "No falsification of balance sheets has been uncovered to date. Although no charges have been levelled yet, it seems most of what has occurred has been backhanders to secure preferential access to off-plan investments rather than Enron-style shareholder fraud."

The perception of the level of corruption in the UAE improved this year from last year, according to a ranking of business executives' views compiled by Transparency International, a Berlin-based anti-corruption watchdog.

The UAE was also not a particularly big payer of bribes relative to other countries surveyed by Transparency International in 2006, the most recent year that was surveyed. It did better than European countries such as France, Portugal and Italy.

Arwa Hassan, senior programme co-ordinator for the Middle East and North Africa at Transparency International, said Dubai's reaction to recent events showed it was serious about tackling corruption in the business sector.

However, she warned that limiting possibilities for bribery by implementing specific procedures and guidelines, improving compliance, clarifying the role of the agent and ensuring that transactions such as payments to any agents used are documented and transparent, are all essential in the fight against corruption in the private sector. However, she stressed that much more could be done to improve disclosure of economic data.

She said: "Dubai provides investors with free access to markets, is liberal and is home to a thriving and dynamic business environment. But some of the things that make the emirate so attractive for investors also carry heightened risks of corruption."

These attractions to international investors also carry other risks. Penrose Financial said its research showed that the open attitude of the Emirates generally towards western culture makes it a target for Islamic fundamentalist groups such as Al-Qaeda: "The Emirates ranks as having the highest threat level for a terrorist attack – on a par with Saudi Arabia and Yemen."

Leadership succession issues are less problematic after Saudi Arabia largely dealt with concerns last year. Iran has also stabilised.

Amid a period of relative geopolitical calm, the Dubai International Financial Centre, a tax-free trade zone for international financial institutions, is touting for more business from international companies and investors. The DIFC, located in Dubai and entirely separate from the domestic market, also continues to attract business from companies in the UAE.

It has struggled to win listings to its stock market, the Dubai International Financial Exchange, which was set up in 2006 but only offers trading in the shares of 22 companies. However, the DIFC hopes its independent regulatory system, policed by the Dubai Financial Services Authority, will attract more.

The DFSA took action in September in response to a corruption scandal involving Dubai-based investment bank Shuaa Capital. It fined Shuaa 3.5m dirhams (€742,000) and imposed other remedial actions following a detailed investigation into suspicious trading by the bank in the shares of port operator DP World on the DIFX at the end of March.

Michael Zamorski, managing director of supervision at the DFSA, told Financial News: "Companies that treat compliance in a perfunctory way may find there is a cost and their reputation will suffer. They need to ensure the board has instilled values in employees. Incentive systems need to reinforce behaviour."

The DFSA, modelled on other international regulators, requires all companies to conform to an anti-money laundering policy and also issues letters to senior executives in an attempt to inform on best practice.

As Dubai's domestic market adapts and reforms it will look to buttress its checks and balances. Zamorski said: "Once investor confidence in a firm is lost it is very hard to get back."