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DRIVERS OF CHANGE

Understanding the factors shaping the UAE's approach to funding diversification

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Foreword

Maintaining economic liberalisation policies is critical to bolstering the economy's current momentum

At the outset of 2023, the economic outlook for the GCC is as bright as it has ever been for some time.

On the back of oil prices averaging more than $80 a barrel, the six states are posting their first budget surpluses in years and are projected to maintain these over the next two budget cycles at least. However, despite the improving fiscal environment, it is critical for the GCC's policymakers to maintain the economic liberalisation policies they have been pursuing over the past half-decade.

The UAE, especially, is making major strides to diversify the economy, explore new revenue-raising strategies and find efficiencies in expenditure.

Liberalising economic reforms such as the introduction of valued-added tax (VAT) in 2018, the lifting of corporate ownership restrictions, and the privatisation of state assets have added dynamism to the market and in part ensured that the nation remained relatively insulated during the pandemic.

It is clear that the government intends to continue along this path. In mid-2023 the introduction of corporation tax will provide another income stream, as will a further planned series of initial public offerings (IPOs) of government-owned companies. Innovative capital debt market issuance is another important factor. All three policies will bolster federal spending, which is playing an increasingly important role in a federation where traditionally individual emirates have followed their own independent fiscal strategies.

This report analyses the initiatives the UAE is making as it works towards its long-term goals. It assesses the advantages of the economic reforms from the perspective of both revenue diversification and expenditure rationalisation, and provides a prognosis for the market's future outlook. We hope that it provides an invaluable resource for understanding the various options and policies the government is exploring as it seeks to maintain the economy's current positive momentum.

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EXECUTIVE SUMMARY

Despite rising interest rates that threaten to stymie economic growth, UAE equity markets are still poised to outperform in regional terms.

Even with turbulence elsewhere, GCC economies including the UAE are somewhat insulated, thanks to higher oil prices, forward-looking policies, and transformation from a regional to global outlook.

Bearing this premise in mind, this research report takes a deep-dive into how an economy such as the UAE is reassessing its approach to fiscal policymaking.

The report is broadly divided into three sections, each of which delves into the various actors prompting a shift in the government's approach to financial policy-making, investment tactics and supporting tools.

Section A looks at different ways of raising finance, covering the role of sovereign wealth funds and tools such as taxation as a means to raise capital for various public projects.

Sovereign wealth funds (SWFs) are often seen as unorthodox economic actors, but they are increasingly acting like their peers (such as pension funds and real estate investment trusts) in the way they raise debt and seek to control costs. They have to adjust to the same macroeconomic trends too.

SWFs may stand out from the investment crowd in many ways, but they are still subject to the same risks as the rest of the market. As they become more integrated into global financial markets, the potential for other actors to collaborate with them should increase in a variety of ways.

One of the challenges confronting the UAE sovereign's debt strategy is the higher interest rate environment, which will continue to inhibit issuance volumes, as will robust competition from equity markets as an alternative means of funding. Rising interest rates mean maturing debt must roll over at higher rates, hiking debt service costs.

Taxation is a fundamental route for any country to generate public revenue. Compared to most parts of the world, the UAE is still a low tax jurisdiction, but the tax net is steadily expanding, including excise tax and value-added tax (VAT), with corporate tax coming into effect from June 2023.

The corporate tax move strikes an effective balance between maintaining a competitive low tax business environment and alignment with global standards. Though the tax regime will affect corporate earnings, businesses will be able to adjust to the impact through restructuring their business models – for example, changes in pricing. It may still, however, prove to be more of a burden for SMEs that operate in price-sensitive areas.

The impact of corporate taxation remains to be seen and will depend to some extent on how the process is managed and what other actions individual emirates might take.

Section B of the report covers the UAE's debt and equity prospects in the short- and long-term. The performance of UAE bonds may have dipped in line with the wider economic situation, but evidence suggests these are still doing better than other fixed income markets.

The evolution of the UAE debt capital market is – ironically – taking place at a time when the UAE's fiscal position is flush thanks to high oil prices, which has limited the requirement for sovereign debt issuance.

Equity markets in the UAE have also defied the downturns witnessed in much of the rest of the world and bond markets in the GCC have revealed much smaller declines against the wider emerging market trend.

Finally, **section C** of the report is more forward-looking in nature, analysing the effects of trends such as public-private partnerships (PPPs) and sustainability on the UAE's long-term fiscal stance.

PPP activity has provided a boost for the local finance market, with each deal requiring a bank or (more usually) a syndicate of regional and international lenders to provide the funds to develop the scheme.

Meanwhile, the integration of environmental, social and governance (ESG) factors by investors, corporates and governments has implications for both private entities

UAE outperforms expectations

The UAE is increasingly exploring different income sources to diversify its economy

Despite the challenges of recent years, the UAE has maintained its status as a globally competitive economy and an investment destination of choice.

Few would argue that the past seven years have been economically challenging for the UAE and the wider region. Sustained low oil prices from 2014 onward, combined with the 2020 pandemic, hit the GCC nations' fiscal positions hard and many fell into budget deficit for the first time in a generation.

However, the past 18 months have witnessed a significant change in their fortunes as the crude price has averaged above $80 a barrel and budget revenues returned to levels not seen in more than half a decade. This has particularly been the case in the UAE.

From an average federal budget deficit of just over 2 per cent of GDP in the period 2015-2020, according to Central Bank figures, the UAE recorded a 5.8 per cent surplus in 2021. In its October 2022 analysis, credit rating agency Fitch Ratings expects the government to post a budget surplus of 9.4 per cent of GDP in 2022, while peer Moody's anticipates the 2023 figure to cross 6.4 per cent.

"With oil prices largely expected to remain robust, the outlook for the UAE in aggregate is very strong," says Justin Alexander,

director of GCC-focused research firm Khalij Economics.

According to estimates from the International Monetary Fund (IMF), the UAE non-hydrocarbon growth is expected to be around 4 per cent in 2023.

EMIRATE-LEVEL

Assessing the UAE's economic performance can at times be challenging given that government finances are only a small portion of total revenues and expenditure by individual emirates due to the nation's federalised structure.

For example, oil-rich Abu Dhabi, the largest emirate economically, rarely discloses in-depth details of its own budgets. Fitch, which rates the capital at AA, states that it projects it to register a fiscal surplus of 19.2 per cent of GDP in 2022 up from 8 per cent the previous year, but there is no specific published data on its revenues and expenditure.

Although it does announce revenue and expenditure on an annual basis, unrated Dubai can also at times be difficult to analyse given its restricted data. In early 2022, the emirate announced expected expenditure for the year ahead of just under AED60bn against an income of AED57.6bn.

Likewise, Umm al-Quwain and Fujairah have not published any fiscal data for some years.

Alexander adds that "Dubai is likely in good shape due to the tax/fee revenue from the rebounding real estate and tourism

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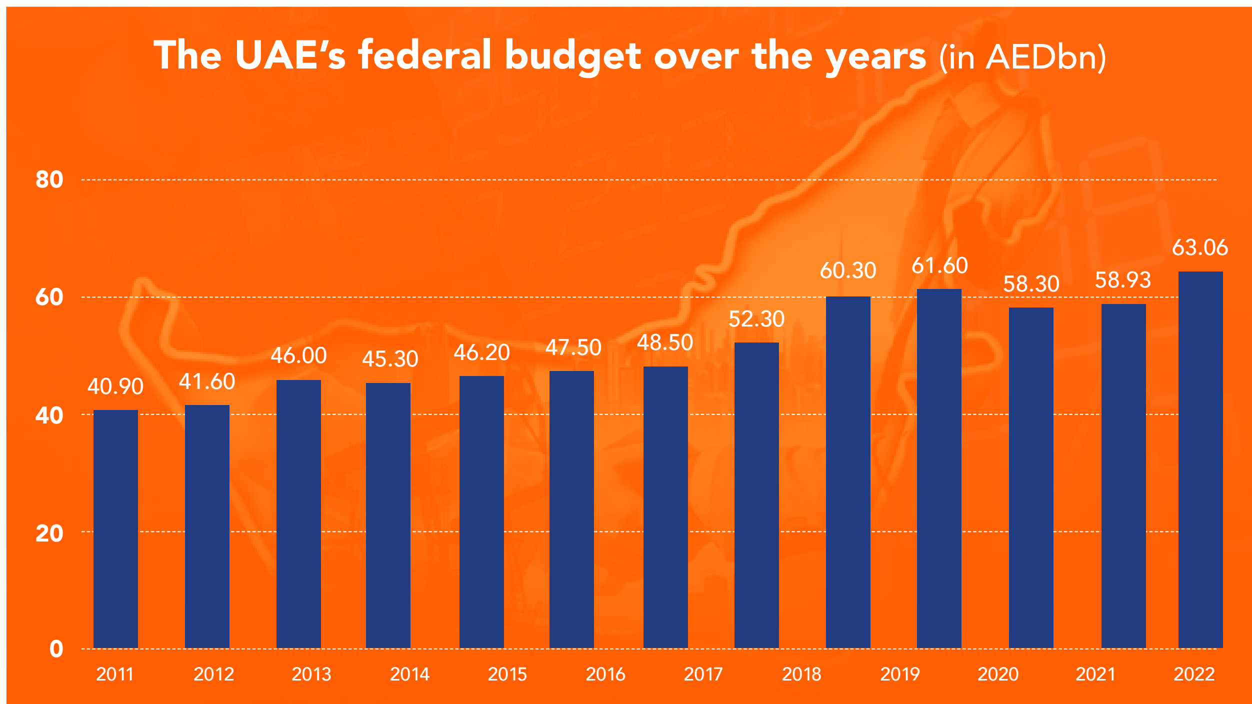


Sources: Global SWF, SWF Institute

Diversification of the UAE's GDP

Source: UAE Ministry of Economy

sectors, although it hasn't disclosed fiscal outturn data for a while and is unrated so there are no third-party forecasts".

On the other hand, Ras al-Khaimah and Sharjah are rated. The former says it expects to maintain a modest surplus of about 1 per cent of GDP in 2022, while the latter in May 2022 said it was anticipating a budget deficit of AED9.2bn equating to 7 per cent of its GDP.

In January 2023, S&P Global Ratings revised Sharjah's credit outlook from negative to stable, on the back of an updated fiscal plan and growing economic prospects. The emirate's budget for 2023 stands at AED32.2bn, geared at achieving financial sustainability and enhance the economic competitiveness of the emirate.

The distinctive economic fortunes of each emirate illustrate their different fiscal strategies and priorities. As the economies and revenues of the northern emirates are much smaller, they rely more on federal expenditure as well as funding support from Abu Dhabi. In the long-run the expectation is that there will be gradual reduction in dependence on the capital emirate's largesse and an increasing focus on federal spending. The continuing diversification of the UAE's revenues away from oil will help support this.

"The federal government itself is increasingly independent of oil revenue (via grants from Abu Dhabi) as it is growingly financed by dividends from Emirates Investment Authority – mainly from Du/Etisalat, VAT and soon corporate tax," says Alexander.

Taxation is viewed as particularly key to the UAE's economic prospects. The introduction of a 5 per cent rate of VAT in 2018 has raised some $26bn of distributed revenue at the

UAE key macroeconomic indicators

	2020	2021	2022	2023	2024
Real GDP growth (% change)	-4.8	3.8	5.1	4.2	3.9
Nominal GDP ($bn)	358.9	419.8	503.9	519.0	538.2
Inflation, average consumer prices (%)	-2.1	0.2	5.2	3.6	2.0
Current account balance (% of GDP)	5.9	11.4	14.7	12.5	9.6
Fiscal balance (% of GDP)	-5.2	2.1	7.7	4.9	4.3
Government debt (% of GDP)	39.7	34.7	30.7	29.5	29.0

Source: IMF

state level in its first four years of implementation according to the Ministry of Finance. In 2023, a corporation tax of 9 per cent will be applied for the first time on the profits of onshore companies across the emirates, and is expected to raise even greater sums for the state coffers.

Taxation is just one element of the funding diversification process to smooth out annual fiscal fluctuations and reduce reliance on oil sales. Increasingly, the issuance of sovereign bonds and sukuks (Islamic debt securities) is forming a key component of the UAE's wider macroeconomic management.

Borrowing also reflects the desire to create an effective financing mechanism for key spending needs, such as infrastructure projects. The UAE has been an active issuer of debt in recent years, both at federal and emirate levels. With greater exposure and better understanding, it has developed a sophisticated strategy for its wider debt capital market requirements.

One of the results of this came in the first half of 2022 when the federal government undertook the first sales of local currency bonds, followed in July by the sale of $3bn in dual-tranche dollar-denominated bonds.

Debt raising is far from the only funding mechanism. The past 12 months have seen a notable policy shift toward the privatisation and initial public offering (IPO) of state-owned entities. Major IPOs in 2022 such as those of Dubai Electricity & Water Authority (Dewa), the Salik road toll system and Abu Dhabi Ports (AD Ports) have raised billions of dollars for individual emirates.

“The federal government itself is increasingly independent of oil revenue (via grants from Abu Dhabi) as it is growingly financed by dividends from Emirates Investment Authority – mainly from Du/Etisalat, VAT and soon corporate tax”

Justin Alexander, director of GCC-focused research firm Khalij Economics

The IPO programme is likely to continue beyond the year-end, as the UAE has a list of investment-grade institutions that are looking to tap into a widening pool of local and regional capital, underpinned by the aim of making state-held entities more efficient and with more diverse sources of funding.

Reining in state-led expenditures

The UAE's stance is increasingly turning towards reducing its dependence on state-led finances and opting for other means to drive the economy

The UAE's long-term ambition is to curb state outlays and ensure a balanced budget.

Despite a procyclical spending approach during the 2020-21 pandemic, the focus is shifting towards restraining expenditure. That makes sense in view of the broader need to reduce the government's reliance on oil revenues and make the non-oil private sector the engine of economic growth.

Public expenditure decisions in the UAE are shaped by economic circumstances, even though oil prices remain elevated in 2022.

Take capital spending; this took a significant hit during the pandemic. While the UAE Central Bank recorded that current expenditure rose by 9.8 per cent in the first nine months of 2021, standing at AED257bn ($70bn), capital spending declined by almost 60 per cent in the same period, reaching AED13.6bn ($3.7bn).

Since then, events have shifted. Following robust oil revenues in H1 2022, the authorities chose to raise public spending.

In June, the government said it increased federal spending by AED1.23bn ($335m) in 2022, a 2 per cent rise on the original forecast, with the government projecting that the UAE's revenues in 2022 would increase by about AED374.9m ($102m) over the previous forecast. Meanwhile, the cabinet approved a budget of AED63.06bn ($17.2bn) for 2023, estimating an 11 per cent growth in revenue in this year. The evidence suggests something of a return to a more expansionary fiscal stance, reflecting both flush revenues and the need to shield UAE consumers from the impact of rising prices.

Critically, it does not mean a permanent shift to procyclical spending and to a looser fiscal stance.

Looking at emirate-level patterns, expenditure continues to be outpaced by revenues. According to Fitch Ratings, Abu Dhabi is on course to post a fiscal surplus of 19.2 per cent of GDP in 2022, after a surplus of 8 per cent in 2021, such that surging oil revenues will more than offset increased domestic spending and higher foreign aid and subsidies. Abu Dhabi's budget has never been published.

"You will not see a large increase in spending, even if all prices remain high," says Garbis Iradian, chief economist for the Middle East and North Africa (Mena) at the Washington-based Institute for International Finance. "However, the continued decline in capital spending included in the budgets

for Saudi Arabia and the UAE is being more than offset by the sharp increase in spending by the government-related entities (GREs) on major public projects, which are largely financed by the respective SWFs."

BUILDING RESILIENCE

The impetus to restrain spending reflects the UAE authorities' need to pay down debt and to deploy financial resources to build long-term resilience in the economy.

This will test the government's fiscal discipline, particularly at a time when residents in the UAE have been impacted strongly by inflation. The authorities would be advised to sustain that discipline, given the uncertainty in the global economy and the possibility that hydrocarbons income could come under pressure.

The smaller emirates continue to face fiscal challenges. Even as S&P revised Sharjah's credit outlook to stable in January this year, it states that ratings could be lowered over the next two years if the government's net debt burden rises sharply, resulting in further upward pressure on already-high government debt interest payments.

The ratings could also come under pressure if additional contingent liabilities materialise on the government's balance sheet, inflating public sector leverage.

There is also the challenge of wider impacts on the banking and other key economic sectors. According to a Ministry of Finance note issued in June 2022, fiscal spending on infrastructure and investment projects drives credit to public sector entities and private contractors and bank credit for personal lending is driven by public sector wages. This means that if this spending is cut and public sector wages come under pressure, this could, potentially, increase levels of non-performing loans held by banks.

Sectors that are dependent on household consumption, including education, healthcare and housing, may be adversely affected by lower levels of economic activity that result from lower government revenue.

For instance, in July 2022, an announcement from UAE President Sheikh Mohamed bin Zayed al-Nahyan turned the Social Welfare Programme for low-income citizens into an integrated programme worth AED28bn ($7.6bn) – double the previous allocation.

Indeed, the largest share of spending in the federal 2023 budget is allocated to social development and social benefits, with AED24.8bn ($6.75bn) or 39.3 per cent of total spending. Defence is another significant area of spending. For 2022, the UAE is estimated to have spent $22.5bn on defence, according to GlobalData research.

This still leaves scope for curbing subsidies, having made more progress than other Gulf states in adjusting domestic gasoline prices to the international market level. Over time, there will be pressure to eliminate or continue reducing water and electricity subsidies.

The government needs to show progress on these, and to wean residents off the 'cradle-to-grave' benefits that, over the long term, will prove unaffordable.

Increasingly, there is now a greater recognition of the need to examine and implement more innovative ways of raising finance.

SECTION A

RAISING FINANCE

Sovereign wealth funds drive growth

The UAE's sovereign wealth funds are being positioned at the heart of economic growth

The UAE has more sovereign wealth funds (SWFs) than most countries, with individual emirates and the federal government between them running about nine funds with combined assets of more than $1.7tn, according to data compiled by Global SWF.

The field is dominated by Abu Dhabi, whose three SWFs between them have assets under management of some $1.3tn – the most prominent of which is the $829bn Abu Dhabi Investment Authority (ADIA), the largest SWF in the Gulf region. In addition, Mubadala Investment Company has assets of $284bn and ADQ manages a further $157bn.

Dubai comes second with a further three funds, led by the $300bn Investment Corporation of Dubai (ICD) and also including the $42bn Dubai World and the $35bn Dubai Holding.

The northern emirates have fewer economic resources and, consequently, have fewer, smaller funds, including the $2bn Sharjah Asset Management and the $500m Fujairah Holding. In addition, there is a federal fund, the Emirates Investment Authority, which has assets of around $91bn.

In 2023, these SWFs – like their Middle East counterparts – are expected to emerge even stronger. According to Global SWF's 2023 annual report, Middle East "have shattered stereotypes of following hidden agendas and only hunting trophy assets and are now recognised as smart, flexible, and mature investors that can move the needle locally and overseas".

SOURCE OF FUNDS

The money these funds invest comes from a variety of sources. Historically the biggest contributor – particularly for the Abu Dhabi funds such as ADIA – has been oil and gas revenues. But other funding sources also play a role and are likely to become more significant over time, including dividends from portfolio companies, the sale of assets and the raising of debt.

When Moody's Investors Service rated ADQ for the first time – giving it a credit rating of Aa2 in June 2021 – it noted the fund's liquidity was bolstered by the dividends it received from its operating subsidiaries and investments, with Abu Dhabi National Energy Company (Taqa) being the main contributor in 2020.

Mubadala says it receives government funding from time to time, but funds its capital and investment expenditure through operating cash flow, third-party debt and asset sales. Mubadala has a long track record of raising debt. Its debt-issuing subsidiary, Mamoura Diversified Global Holding, had debts of AED132bn ($35.9bn) as of 30 June 2022, including $75bn of corporate bonds.

An increasingly interesting option for SWFs seeking to raise funds is to list shares in their portfolio companies on the stock market. The opportunity to launch initial public offerings (IPOs) is currently stronger in the Middle East than in most parts of the world. According to consultancy firm EY, the region has outperformed the global market this year. In the first nine months of 2022, there were 31 IPOs in the region – almost 300 per cent more than in the same period in 2021 – while the number of

deals across the world as a whole fell by 44 per cent.

Among the recent deals is ADQ's listing of 25 per cent of AD Ports in February 2022, raising some $1.1bn. Other major IPOs in 2022 have included the Dubai government-owned utility Dubai Electricity & Water Authority (Dewa) and toll operator Salik, both listed on the Dubai Financial Market in April and September respectively. The proceeds of the listings were $6.1bn for Dewa and $1bn for Salik.

THE VARYING ROLES OF SWFS

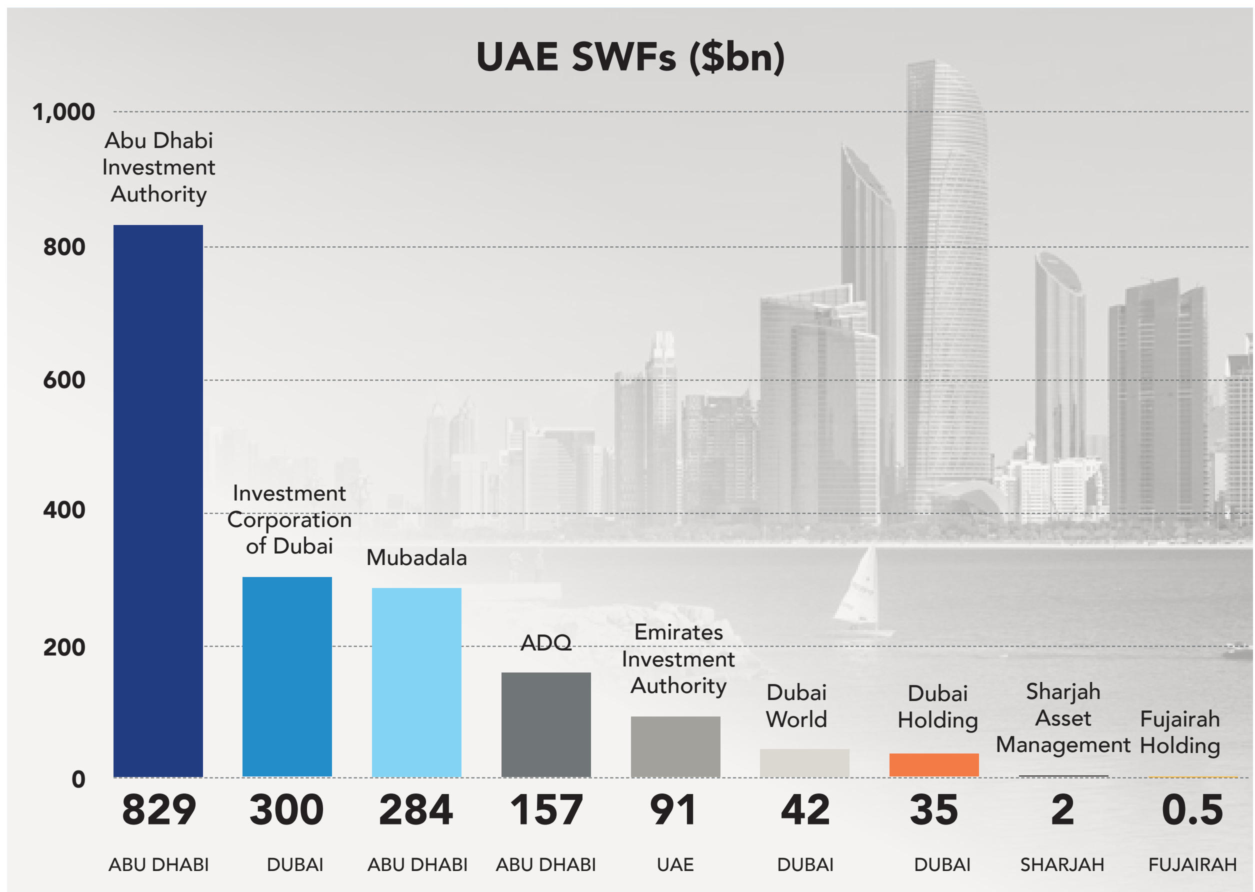
The role of SWFs also varies from case to case. The classic task for a SWF is to act as a vehicle to build up savings for tougher economic times or future generations. However, they can also be used to diversify the local economy, at times by encouraging international portfolio companies to set up operations there. Fujairah Holding, for example, has a subsidiary called Panthera Capital Investments, which acts as its investment arm, but is also tasked with attracting investors into the emirate.

Funds also often have an important role in managing strategic enterprises. The Dubai government, for example, handed important assets to ICD soon after the fund was set up in 2006, including majority stakes in National Bank of Dubai (NBD), Emirates Airline, Emirates National Oil Company and Dubai Aluminium Company. Further asset transfers followed, including Dubai Duty Free and the Dubai Airport Free Zone Authority in 2009 and FlyDubai in 2015.

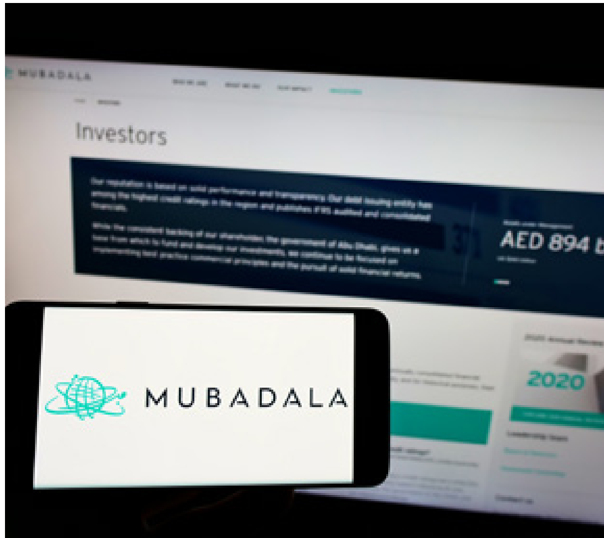
This is an ongoing trend. Over the course of 2022, the Abu Dhabi government handed ADQ a series of Etihad Aviation Group subsidiaries, including the ground handling, training and cargo services divisions, followed by the airline itself.

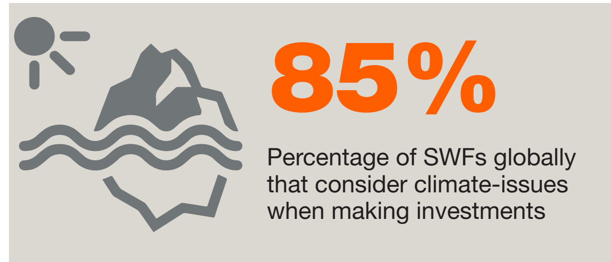
SWFs can also play a quasi-diplomatic role, investing in countries that the UAE's leaders are keen to improve ties with. For example, in May 2022 ADQ pledged to invest €4bn ($4.3bn) in Greece during a visit by Greek Prime Minister Kyriakos Mitsotakis to Abu Dhabi. "ADQ is becoming a big foreign investor," said the economist. Another analyst noted that many large SWFs are "trying to balance their international and domestic pursuits".

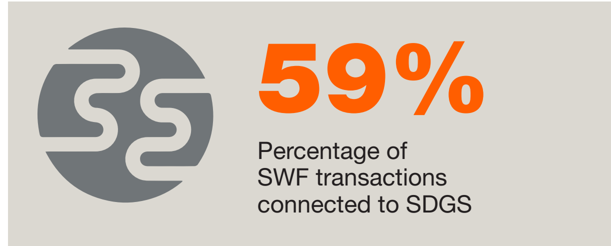
In a recent report, consultancy Bain & Company highlights that SWFs in the Middle East typically buy up with objectives



Sources: Global SWF, SWF Institute







including building local champions; investing in strategic industries of the future; and market entry into new verticals.

However, the position of SWFs is not static and there have been several instances of governments consolidating them with related businesses. In January 2017, Mubadala Development Company was merged with International Petroleum Investment Company to create Mubadala Investment Company. The following year, the Abu Dhabi Investment Council was also folded into the group.

Another example of changing SWF dynamics is ADQ. The fund started in 2018 as the Abu Dhabi Developmental Holding Company. It was rebranded in 2020 and has since taken an increasingly prominent role in the local economy. In March 2021, Global SWF estimated the fund had around $110bn in assets, but its most recent estimate – for Q3 2021 – put the figure 43 per cent higher at $157bn.

COST AND CLIMATE CONSIDERATIONS

SWFs have not been immune from wider considerations about reducing unnecessary expenses, particularly during times of low oil prices when government revenues are under greater pressure. ADIA, for example, has cut an estimated 230 jobs since 2016, leaving it with a workforce of 1,520 by December 2021, according to its most recent annual report, published in October.

Ethical considerations are also rising up the agenda. According to a 2021 survey by the International Forum of SWFs (IFSWF) and the One Planet SWF (OPSWF) network, 85 per cent of SWFs around the world now consider climate-related issues when making investments. The survey also found that, from January 2020 to September 2021, 59 per cent of all SWF transactions were connected to specific sustainable development goals (SDGs).

That is perhaps unsurprising given that SWFs often move in concert with global investment trends. According to the Centre for the Governance of Change at Spain's IE University, SWF investment activity in 2021 was "generally aligned with global mergers and acquisitions trends".

More recently, Sharjah said it intends to raise $1bn from its nine-year dollar-denominated bond, the first sustainable sovereign bond in the GCC. Proceeds from the bond will be used to finance/refinance eligible projects in line with Sharjah's Sustainable Financing Framework issued in February 2023.

SWF fortunes also tend to rise and fall in line with broader economic metrics. During the Covid-19 pandemic, many Gulf governments pulled money from their SWFs to help balance their budgets and the funds themselves often had to provide additional help to struggling portfolio companies. According to Global SWF, Gulf funds spent around $32bn bailing out airlines and other businesses in this period.

Among those affected was ICD, which saw its AED25bn profit in 2019 turn into a AED15.5bn loss in 2020. The following year, things had turned again however, with the fund reporting an annual profit of AED10.1bn. Mubadala also reported record income of AED122bn in 2021, up from AED72bn the year before.

SWFs may stand out from the investment crowd in many ways, but they are still subject to the same risks as the rest of the market. As they become more integrated into global financial markets, the potential for other actors to collaborate with them should increase in a variety of ways.

Most of the funds remain very well-capitalised, but over the longer-term more of them are likely to explore a wider variety of fund-raising avenues, including asset sales, stock market listings and debt-raising. That in turn will create opportunities for banks and others.

The tax take

The impact of changing tax policies on government budgets and the wider economy

UAE government finances have been undergoing a significant evolution over the past few years, with new taxes leading to a more diverse revenue base that is less reliant on volatile oil and gas markets.

Compared to most parts of the world, the UAE is still a low tax jurisdiction, but the tax net is steadily expanding. The most important recent changes have been the introduction of excise duty in 2017 and VAT the following year.

Excise tax was introduced across the UAE in October 2017 on a small number of goods, including carbonated drinks, energy drinks, tobacco and tobacco products. From 1 December 2019, it was expanded to vapes and sweetened drinks. Duty is 50 per cent on carbonated drinks and products with added sugar or sweeteners and 100 per cent on other products.

VAT was introduced on 1 January 2018, at 5 per cent on most goods and services. This was done at the same time in Saudi Arabia, with Bahrain following in January 2019 and Oman in April 2021.

Qatar and Kuwait are not expected to follow before 2024, if at all. VAT-registered businesses collect the tax on behalf of the government and file VAT returns with the Federal Tax Authority on a monthly or quarterly basis (depending on company size).

There are other taxes too. While there is no income tax, UAE and other GCC nationals pay a social security levy. For most of the country, this is 20 per cent of salary, split between the individual, their employer and the government, but Abu Dhabi charges 26 per cent.

Individual emirates levy municipality taxes on properties and fees for hotel guests. Dubai also charges a 4 per cent fee when land or property changes hands. A customs duty of 5 per cent is applied to imports, although it does not apply to goods from other GCC states or for imports into free trade zones.

There is currently no federal corporate tax, but at the emirate level oil and gas companies are taxed at 55 per cent and foreign banks' branches are taxed at 20 per cent. However, in January 2022, the federal government said it would start taxing most businesses from July 2023 or January 2024, depending on the financial year used by individual businesses, with a 9 per cent levy on profits over AED375,000.

The only exceptions are oil and gas companies, which will continue to be subject to emirate-level taxation, and free

zone companies, which will continue to enjoy tax free status.

Businesses also face other charges, such as a licence fee to set up – the cost of which varies depending on the location, type of business activity, company structure and other factors. However, there have been efforts to cut fees in recent years to support economic activity.

IMPACT OF TAXATION

The impact of excise duty and VAT was immediately obvious in government finances. In 2016, the consolidated accounts for the federal and emirate governments showed spending easily outpacing revenue, leading to a deficit of 2.8 per cent of GDP. The following year, the deficit was cut to 1.6 per cent and by 2018 it had become a surplus of 1.9 per cent.

That was in large part due to the new taxes. In Abu Dhabi, tax revenues rose from AED89.9bn in 2016 to AED142.4bn in 2017 and AED199.5bn in 2018.

Abu Dhabi accounts for around 80 per cent of all tax revenues across the country due to its huge oil and gas sector. Dubai also saw a sharp jump in income, with tax revenues up from AED17.4bn in 2016 to AED27bn by 2018. Across the country, tax revenues fell during the Covid-19 pandemic, with Abu Dhabi's tax take averaging just under AED160bn in 2019-21 and Dubai's figure close to AED24bn.

Even so, this was still far more than before the introduction of VAT and excise duty. The higher revenues have enabled the authorities to maintain consolidated government spending (i.e. federal and emirate) at around 30 per cent of GDP without adding to the country's debts.

The fact that excise duty and VAT were introduced in most other GCC countries at around the same time has meant there has been little impact on the UAE's competitive position – as evidenced by foreign direct investment (FDI) trends. The UAE has been the largest recipient of FDI inflows in the GCC since 2013 and inward FDI into the emirates has risen steadily since 2016, reaching $20.7bn in 2021, according to the United Nations Conference on Trade and Development.

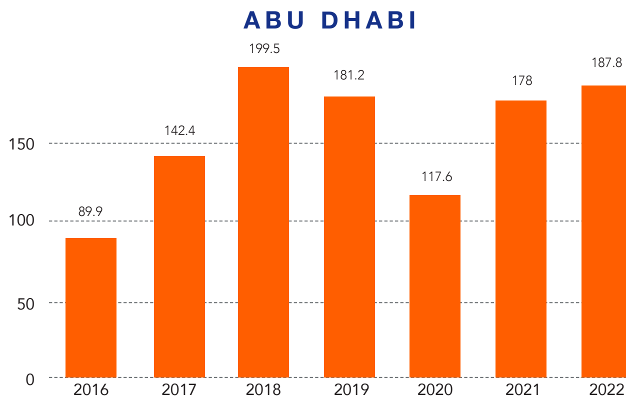
However, the new taxes did cause higher inflation, as prices rose to accommodate the new charges. Inflation rose from 1.6 per cent in 2016 to 2 per cent in 2017 and 3.1 per cent in 2018, before falling to 1.9 per cent in 2019 and dropping again to 2.1 per cent in 2020 amid the Covid-19 pandemic.

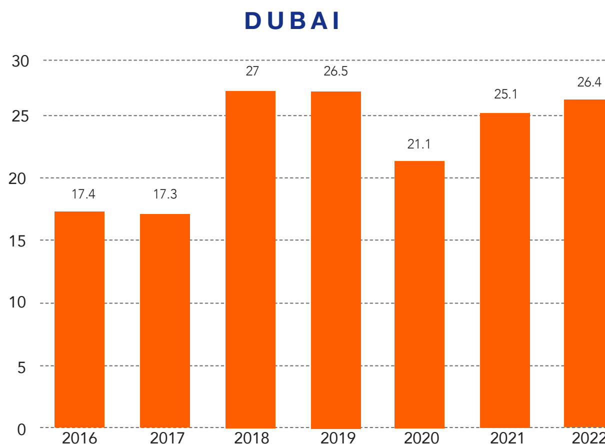
UAE taxation

	2016	2017	2018	2019	2020	2021	2022
Consolidated Government - Federal and Emirates							
Total Revenue (AEDbn)	378.5	404.4	477.6	476.5	367.9	457.8	482.5
of which, taxes (AEDbn)	116.8	166.6	240.6	228.3	151.2	216.8	229.2
Fiscal Balance (% GDP)	-2.8	-1.6	1.9	0.6	-5.1	-0.7	-0.2
Federal Government							
Total Revenue (AEDbn)	63.6	69.5	79.8	85.1	68.1	69.8	71.5
of which, taxes (AEDbn)	5.3	5.6	10.1	14.9	8.8	9.5	10.5
Fiscal Balance (% GDP)	-0.5	0.3	0.9	1.1	0.3	0.3	0.2
Abu Dhabi							
Total Revenue (AEDbn)	251.7	280.1	327.8	317.4	242.3	325.4	344.4
of which, taxes (AEDbn)	89.9	142.4	199.5	181.2	117.6	178	187.8
Fiscal Balance (% GDP)	-3.5	-3	0.7	-0.7	-5.3	0.9	1.4
Dubai							
Total Revenue (AEDbn)	63.3	57.9	69.4	67.1	51.3	56.5	59.5
of which, taxes (AEDbn)	17.4	17.3	27	26.5	21.1	25.1	26.4
Fiscal Balance (% GDP)	-1.2	-0.7	2.5	0.6	-7.8	-5	-4.3

Source: IMF; Figures for 2022 are forecasts

Revenues from tax (AEDbn)





WHAT THE FUTURE HOLDS

The impact of corporate taxation remains to be seen and will depend to some extent on how the process is managed and what other actions individual emirates might take. One analyst suggested Ras al-Khaimah, for example, might cut some of its other taxes and fees when corporate income tax is introduced, in an effort to maintain its attractiveness relative to other emirates.

That raises questions about how other emirates might react and indeed how companies will respond, both to the tax and to any incentives offered by individual emirates. Some may try to move parts of their operations into free zones, where the tax will generally not apply – offering potential work for advisers with expertise in financial, tax, legal and other areas.

The federal authorities may also be tempted to make other changes in the future, based on the experience of neighbouring countries. Saudi Arabia and Bahrain have both increased VAT levels in recent years and Oman has discussed bringing in income tax for high earners. Such developments are being keenly watched by policymakers across the region.

CASE STUDY
Saudi Arabia VAT increases

Saudi Arabia introduced VAT at 5 per cent on 1 January 2018 at the same time as the UAE, but then tripled the rate to 15 per cent on 1 July 2020 as it sought to offset the costs of the Covid-19 pandemic.

There was an immediate impact on inflation, with consumer prices rising 6.1 per cent year-on-year that July. Over 2020 as a whole, inflation was 5.3 per cent, according to the IMF.

There was, though, only a modest rise in government tax revenues – in part because of the lower levels of economic activity during the pandemic. According to the IMF, Saudi tax revenues rose from SR175bn in 2019 to SR189bn in 2020. Activity rebounded in the following year and tax revenues climbed to SR257bn, almost all of it from levies on goods and services.

Crown Prince Mohammed bin Salman said in April 2021 that the rise to 15 per cent was a “temporary decision” and would only continue for “maximum five years and then things will go back to what they were”. There has been no announcement of a reduction in the tax as yet.

SAUDI ARABIA

TAX
REVENUE

SR189bn
2020

SR257bn
2021

Corporates gear up for taxation

The full impact of the UAE's implementation of a corporate tax regime remains to be seen

The UAE government has been in active economic reform mode and there is no sign of let up in the pace of change. The announcement in January 2022 of the introduction of a federal tax on business profits is a case in point. The corporate tax will take effect on 1 June 2023, levelled at 9 per cent of business profits above AED375,000 ($102,110). It is aimed at both broadening the state's revenues base and diversifying those revenues away from oil.

The law represents a marked shift for most companies active in the UAE, who until now – energy sector and foreign bank branches aside – have no experience of paying tax. It is a decisive shift that affirms the UAE's willingness to think outside the box, and one that other Gulf states may well choose to follow.

Until now, there has been no federal corporate tax regime in the UAE. Any taxes have been imposed at emirate-level. Indeed, the hydrocarbon sector will remain subject to emirate level taxation after the introduction of federal corporate taxation.

The authorities believe the new 9 per cent corporate tax rate will not put off companies from basing themselves in the UAE for two main reasons.

First, the widespread use of free zones, of which there are more than 40, insulates many companies from tax liabilities. Second, the 9 per cent rate announced represents one of the most competitive rates globally – and crucially, within the region. These factors will insulate companies from likely adverse effects, and again reaffirms confidence in fiscal decision making.

The introduction of corporate taxation represents a means for the UAE to align with international standards, notably on tax avoidance – a long-standing thrust of policy. It also prepares the ground for compliance with the global minimum tax rate of 15 per cent, which the UAE has agreed to as part of the 2021 Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) project.

These are important for the UAE if it is to embed its wider linkages to the global economy, and to ensure that best practice is followed — something that analysts have in the past had reason to question.

GLOBAL STANDARDS

The tax move strikes an effective balance between maintaining a competitive low-tax business environment and integration with global standards. In particular, protection is afforded to the

> **“The UAE authorities have undertaken so many other changes that have created a more flexible labour market, which has compensated for the transparency typically brought about by taxation”**
>
> Garbis Iradian, chief economist for Mena, Institute of International Finance

important small and medium-sized enterprise (SME) sector by introducing – under the three-rate structure – a higher rate for large, multinational companies.

Though the tax regime will affect corporate earnings, businesses will be able to adjust to the impact through restructuring their business models – for example, changes in pricing. However, it may still prove to be more of a burden for SMEs that operate in price-sensitive areas.

Law firm Gibson Dunn notes that the UAE’s corporate tax regime is based on well-recognised and practiced international principles, making the cost and process of implementing the law relatively efficient for businesses subject to similar regimes in other jurisdictions. The law will also maintain some of the most distinct tax benefits of the UAE — for example, the tax benefits afforded to free zone registered entities.

The tax programme is also expected to bring in greater transparency in formal business processes overall, including licensing and associated fees.

“The UAE authorities have undertaken so many other changes that have created a more flexible labour market, which has compensated for the transparency typically brought about by taxation,” says Garbis Iradian, chief economist for Mena at the Washington-based Institute of International Finance.

“Moving forward, taxation will be able to provide greater clarity on the processes and stakeholders.

“And the corporate tax rate of 9 per cent is relatively low, if you compare it to corporate tax rates in advanced and emerging economies,” said Iradian.

There remains the risk that the 9 per cent rate will be increased. This is a likely scenario in the long term, given the commitment to the 15 per cent tax rate under the UAE’s OECD BEPS obligation. Much will also hinge on the broader macroeconomic backdrop.

“Over the medium term, beyond 2024, if oil prices fall below $75 a barrel, then the incentive to reform the tax system could be much higher, including raising the VAT rate from 5 per cent to over 10 per cent in the UAE, Oman and Bahrain (in Saudi Arabia it is already 15 per cent), and the introduction of VAT in Kuwait and Qatar,” says Iradian.

IMPROVING BANKABILITY

The introduction of a corporate tax regime goes further than broadening the country’s revenue base. Underlying the strategy is a need to establish more of an institutional infrastructure around the federal fiscal system. Part of that is about standardising and streamlining government spending and revenues, and creating a more transparent structure. These are all to be welcomed.

“The federal corporate income tax is less about the fiscal need, and more about streamlining and standardising different government revenue sources, because the UAE has seen a multitude of different kinds of levies and charges, and which administratively are often quite complicated and costly,” says a senior adviser to a Gulf finance ministry.

Corporate income tax is about boosting the resources available for the federal government. But, says the adviser, it is also about boosting transparency and governance at the corporate level.

“The reality is that when businesses have to pay taxes, this is the point at which they start getting serious about their accounting and auditing. And the indirect benefit of that is that they become more bankable and better able to raise money on their own. It’s a win-win process.”

SECTION B

Financial prospects

Debt and equity

Understanding how the opportunities for debt and equity are shaping out in the UAE

The question as to whether to opt for debt or equity is not clear cut.

UAE bonds have made a compelling proposition in a year of profound economic and geopolitical turbulence, exhibiting defensive characteristics that show resilience when interest rates are rising and when the fixed income market has been in sell-off mode.

Equity markets in the UAE and the wider GCC have also defied the downturns witnessed in much of the rest of the world, revealing much smaller declines against the wider emerging market trend. This stability is widely attributed to factors including the GCC's successful response to the Covid-19 pandemic and reopening of markets. The region also remains largely shielded from the effects of the Russia-Ukraine war.

Market performance — key GCC exchanges

Market	Returns YTD*
GCC	5.70%
Abu Dhabi	13.80%
Dubai	4.40%
Saudi Arabia	8.10%
Qatar	15.00%

Fixed income — performance of key 10-year bonds

Issuer	Returns YTD*
Kuwait	-7%
Saudi Arabia	-8.60%
Qatar	-7.80%
Abu Dhabi	-8.70%

GCC 10-year sovereign yields

Market	Spreads over 10-year US Treasuries	
	Current*	One year ago
Saudi Arabia	114	103
Abu Dhabi	70	69
Kuwait	55	12
Qatar	110	80

** August 2022. Source: Markaz*

Market volatility, however, has still impacted issuance, with bonds and sukuk down relative to 2021, notes bond specialist Franklin Templeton.

Despite all the headwinds, spreads are at relatively low levels, as commodity-exporting countries such as the UAE benefit from a natural buffer to high inflation through exposure to rising oil prices. Oil may be vulnerable to slowing demand, but Franklin Templeton sees Opec+ production cuts maintaining oil prices above $70 a barrel for GCC sovereign credit profiles. The recent indication of releases by the US Strategic Petroleum Reserve is also not regarded as a concern by the UAE.

With absolute yields now at levels not witnessed in two decades, and a history of 12-month forward returns from similar yield levels consistently delivering double-digit returns, valuations provide a compelling rationale, particularly for higher-quality issuers, says Franklin Templeton.

The broader universe of risk assets, such as equities or high-yield bonds, may have to face further decline in a downturn. Despite the risks, or rather because of the abundance of risk, higher-quality fixed income assets are poised to better defend portfolios and provide attractive levels of income, justifying an increase in fixed income allocations, especially to those with active mandates.

Bond markets have already moved to price significant interest rate increases in the months ahead, and analysts say the UAE should be well-supported in an environment of elevated commodity prices.

However, 2023 has opened with the looming risk of a global recession. Oil and gas prices are also at a lower level than they were in 2022, while central banks have raised their benchmark borrowing rates in line with the US Federal Reserve. The UAE Central Bank lifted its base rate for overnight deposit facility from 4.4 per cent to 4.65 per cent in February.

The issuing of equities – such as through IPOs – may not deliver to the UAE sovereign a long-term income stream, but it does help boost the market in line with wider policy priorities.

Despite the higher interest rates that might stymie the economic revival, UAE equity markets are still poised to outperform in regional terms. Moreover, the opening up of China's borders is expected to provide a boost for UAE's tourism, aviation and retail sectors.

In a time of heightened volatility and uncertainty, investors are advised to focus on diversified and long-term asset allocation, including alternatives to equities and bonds.

Performance of key 10-year bonds

Issuer, Maturity Year	YTM (%)	July Price Returns (in %)	YTD Price Returns (in %)
Kuwait Sov, 2027	3.2	1.5%	-7.0%
KSA Sov, 2029	3.5	3.6%	-8.6%
Qatar Sov, 2029	3.3	2.9%	-7.8%
Abu Dhabi Sov, 2029	3.3	3.8%	-8.7%
Aramco, 2031	3.8	4.4%	-8.7%

** August 2022. Source: Markaz*

Similar to equity markets, fixed income markets were weighed down by a confluence of factors in the third quarter of 2022. For bonds, these included stubbornly high inflation, aggressive central bank tightening, Europe's energy crisis, repeated lockdowns in China, and controversial fiscal policy decisions in the UK. The rise in bond yields this year has reached historic proportions, creating an abysmal period for fixed income investors.

The yield on the Bloomberg Global Aggregate Index has risen nearly 250 basis points over the past nine months, the steepest and largest rise in the history of the index, exceeding even 1994's epic rise. Equally unprecedented is the breadth of the drawdown. All corners of the fixed income market have been affected. For the Global Aggregate, more than a decade of returns have been completely unwound in 2022.

Transforming the UAE debt capital market

The UAE is actively taking advantage of rising demand for high-quality debt

For Emirati decisionmakers, the attraction of accessing the debt capital market (DCM) is that it provides an alternative means of funding projects beyond the traditional toolkit of borrowing or taxation.

The thinking is understandable. Sovereign bonds offer stability and risk-free security to investors. Meanwhile, their issuance affords the UAE government a means to diversify its funding sources and cover future funding requirements. Local currency issuance – a relatively new development for the UAE – enables the sovereign to avoid any international currency fluctuations.

Local currency bond issuance will be an increasingly important policy instrument for the UAE authorities going forward. This is considering the important steps made in May 2022, when the federal Ministry of Finance issued AED1.5bn ($410m) in dirham-denominated treasury bonds (T-bonds) with two and three-year tenors. The T-Bonds programme contributes to building the UAE-dirham-denominated yield curve, strengthening the local DCM, developing the investment environment, providing safe investment alternatives for investors, as well as supporting sustainable economic growth.

A total of AED9bn ($2.45bn) was auctioned in 2022 alone. Meanwhile, the first auction of 2023, held in January, received bids worth AED6.85bn ($1.9bn) and was oversubscribed by more than six times, with a total issuance of AED1.1bn ($300m). Another AED1.1bn will be auctioned in March.

With guidance from the sovereign, Emirati corporates and financial institutions will now be able to issue their own dirham-denominated bonds and sukuk, thereby creating a domestic yield curve and pricing reference point. That yield curve will drive further issuance, creating a virtuous cycle for the nascent DCM.

This evolution of the DCM in the UAE is – ironically – taking place at a time when the UAE's fiscal position is flush, which has limited the requirement for sovereign debt issuance.

According to recent research, the UAE recorded the highest

Since 2015, the composition of GREs' debt borrowing has shifted from loans to bonds, while the maturity structure of debt has lengthened, according to the IMF. UAE GREs have been forthcoming in tapping global Eurobond markets in recent years, with bonds comprising 86 per cent of new borrowing in public markets in 2020, compared to just 15 per cent during 2015-17. Moreover, issuance of debt with a maturity of longer than 10 years increased from 27 per cent of the total in 2015-17, to 62 per cent in 2020.

number of issuances in the Mena region, but was second to Saudi Arabia in terms of the amount of debt issued. Saudi Arabia raised $5bn in debt in 2022, while the UAE raised $3bn.

As one bond market specialist notes: "Although Saudi Arabia has larger funding needs, the UAE is a more resilient market, partly due to the private sector playing such an active role. This establishment of relations with different groups of investors makes it more convenient to tap bond markets, when they feel the pricing is right. That means that, while the pace of issuance might come down, it is still likely to remain healthy."

FEDERAL ISSUANCE AND BEYOND

The transformation of the UAE DCM will expand the scope of issuance, with it shifting to the federal government beyond the traditional emirate-level governments.

There was a landmark moment in October 2021 when, for the first time, the federal government issued an international bond – a $4bn, multi-tranche offering — that attracted demand of $20bn, and which led the government to tighten pricing by 25 basis points (bps) on each of the 10-year and 20-year tranches, and by 30bps on a 40-year Formosa tranche. The strong demand for sovereign debt enables the authorities to tweak pricing in a favourable direction.

Despite a smaller portion of spending taking place at the federal level relative to the individual emirates' spending – notably the largest being Abu Dhabi and Dubai – this change represents a transformation of UAE fiscal policy. The establishment in 2018 of a Federal Debt Management Office (FDMO), issuing paper backed by all the emirates, is supportive of federal UAE agencies.

There will be challenges confronting the UAE sovereign's debt strategy. One is the higher interest rate environment, which will continue to inhibit issuance volumes, as will robust competition from equity markets as an alternative funding means. Rising interest rates mean maturing debt must roll over at higher rates, hiking debt service costs.

Those caveats aside, the UAE now has a strong incentive to return to a more active debt issuance stance, say experts.

"At the federal level, there's a structural need for issuance because whereas Abu Dhabi and Dubai can stand on their own feet, fiscally speaking, the northern emirates are in a very different position. Historically they have been able to issue thanks to Abu Dhabi," says a Gulf Finance Ministry adviser.

"Thus, it makes sense to have a more versatile toolkit available to them, which involves both having the ability to raise capital in the market through these federal bonds and sukuk, and potentially enabling other entities in the federation, whether it's the smaller emirates or municipalities or some of their corporate structures, to do the same."

The FDMO will also play a key role in helping to attract debt market investors. For one thing, the advent of greater transparency puts the government in a stronger position to contain the cost of raising debt. This is an important factor for Dubai, given that an estimated 30 per cent of the emirate's debt stock will mature over the 2022-25 period. According to IMF data, Dubai's long-term spreads are around 220bps, some 110bps higher than Abu Dhabi's. Dubai government debt is estimated at $49.4bn, a figure that rises to $153bn when government-related entity (GRE) debt is included.

Indeed, much of the impetus for issuance will emanate from the GREs. Since 2015, the composition of GREs' debt borrowing has shifted from loans to bonds, while the maturity structure of debt has lengthened, according to the IMF.

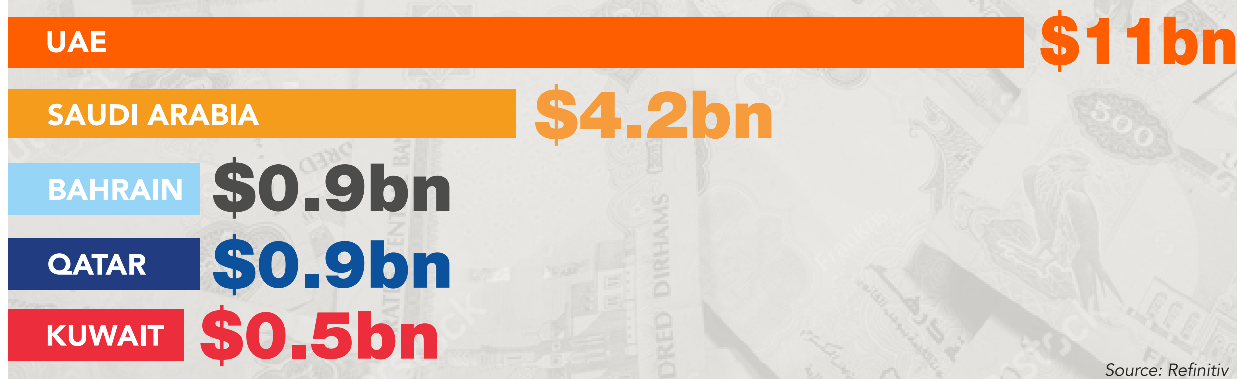
UAE GREs have been forthcoming in tapping global Eurobond markets in recent years, with bonds comprising 86 per cent of new borrowing in public markets in 2020, compared to just 15 per cent during 2015-17. Moreover, issuance of debt with a maturity of longer than 10 years increased from 27 per cent of the total in 2015-17, to 62 per cent in 2020.

This approach does not come without risk. Despite lengthened maturity profiles, GREs both in Abu Dhabi and Dubai face short-term rollover risks with a combined $68.8bn of debt maturing in 2021-23. These large obligations could prove challenging to meet in the context of tightening global financial conditions.

Green bonds and sukuk – which invest in renewable energy and other environmental assets – will also feature in UAE issuance strategies. The government estimates the size of the UAE market at $17bn, and the country has been more active than others in the region in tapping the green bond market.

SUKUK

Conventional bonds will continue to dominate in the UAE, rather than sukuk, despite an early 2022 burst of dollar-denom-



inated Islamic issuance.

According to Fitch Ratings, the growth in dollar-denominated sukuk halted in March 2022 following the Russia-Ukraine conflict and increase in oil prices, in addition to interest-rate hikes and inflation pressures. In the first half of 2022, sukuk issuance out of the UAE was scarce – with non-sovereign issuers postponing planned bond launches or seeking out alternative funding sources. In Q3 2022, the UAE issued dollar-denominated bonds, but not sukuk. All UAE fixed-income issuance was raised on the international market, none locally.

UAE sukuk issuance will remain subdued, with a mix of market volatility and increased interest rates stymieing activity. Issuance, both conventional and Islamic, will likely pick up pace in 2023 and beyond.

In the words of Bashar al-Natoor, global head of Islamic Finance at Fitch Ratings: "The sukuk pipeline is developing behind the scenes, and waiting for the right market conditions, despite the fall in issuance last quarter."

The UAE, like other Gulf oil exporters, has sustained funding needs over the longer term that will need to be met. Sukuk and bonds present a ready-made means of meeting that financing requirement.

INTEREST RATES IMPACT

For the UAE, higher interest rates – linked to the dirham's dollar peg – raise the cost of tapping the bond market, which will curb demand for lower-yield bonds. That in turn will lead to a drop in prices – reaffirming the typical inverse relationship between bond prices and interest rates. When the latter rise, bond prices go down, and vice versa.

This is because as interest rates rise, older bonds become less valuable as their coupon payments are lower than the newer bonds traded on the market. Rate hikes decrease cash flows, reducing the sovereign's ability to service and repay debt.

CREDIT RATINGS IMPACT

Sovereign credit ratings determine the price and performance of government-backed paper.

The UAE is fortunate in enjoying sovereign investment grade status from the three large ratings agencies, which enable the buyers of sovereign bonds – mostly institutional investors, such as pension funds – to invest with confidence. Most pension funds are only mandated to invest in investment grade bonds.

These investment grade ratings have enabled government-linked issuers in the UAE to price the interest rate lower, resulting in reduced borrowing costs. When the UAE previously issued multi-tranche bonds in 2022, that was in part due to its higher sovereign ratings, which meant a wider array of investors were willing to buy the bonds.

Those investment grade ratings are shaped by the ratings' agencies perceptions of creditworthiness. The UAE's strong GDP per capita, notably its main oil generating emirate Abu Dhabi, which is in excess of $10,000, indicates a broader funding base on which the sovereign can draw. That gives the agencies the confidence to determine the sovereign as investment grade.

One analyst notes that the UAE "has very good access to the international market".

"The ratings are all in the double-A levels and the spreads are much lower than the average for emerging economies," he says.

Credit default spreads for Dubai and Abu Dhabi remain low. In Dubai's case, it has declined, even for GREs. That is a positive indication that the balance sheets of these entities have improved over the past 10 years, due to the better supervision and prudential regulation.

"Quietly, away from the headlines, that work has had a positive impact. And with those GREs having better credit ratings, and better balance sheets, it gives more confidence to fiscal policymakers in the UAE," says the analyst.

COMPARATIVE CASE STUDY
Oman

The sultanate's long-term sovereign credit outlook was upgraded in 2022 after it introduced fiscal reforms, and on the back of higher oil prices.

Rating agencies have all upgraded Oman in 2022. S&P Global Ratings upgraded the sultanate to BB- in April 2022, with the outlook revised to stable at a time when other Gulf sovereign ratings were either stable or down. S&P was the first of the major ratings agencies to put Oman into sub-investment grade status in 2017, downrating it to BB+.

Meanwhile, Fitch Ratings upgraded Oman's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) to 'BB' from 'BB-' in mid-August. In October 2022, Moody's also upgraded its credit rating for Oman from stable to positive, anticipating the government's debt to fall to less than 45 per cent of GDP by the end of the year, compared to 63 per cent of GDP in 2021.

With a stronger financial footing and firm commitment to fiscal reforms, Oman has been in a position to buy back small volumes of international bonds this year ($700m of Eurobonds were completed in July) and is committed to repaying some of its outstanding commercial loans, including $1.7bn of debt maturing in 2023 or later. With its interest savings, Oman has reduced the amount of variable-rate debt it holds and streamlined its debt portfolio.

H1 2022 saw no issuance from Oman, compared to $6bn in total issuance in 2021. According to the IMF, despite the pandemic and oil price shocks, financial markets have remained supportive of Oman. Although major credit rating agencies downgraded Oman's credit risk assessment by two notches in 2020 after an initial spike in April 2020, Oman's borrowing spreads have since declined, allowing for two international bond issuances in 2021, including at long-dated maturities, benefitting from the retreat in spreads and investors' search for yield.

According to the IMF, despite the pandemic and oil price shocks, financial markets have remained supportive of Oman.

Moody's noted in 2021 that the prospect of sharply lower borrowing needs and the improved outlook for Oman's debt and debt affordability metrics have already facilitated a large decline in Oman's sovereign credit spreads, which returned to the pre-Covid level of around 400bps earlier in 2021 after more than doubling during 2020.

One rating agency official noted that the question of how Oman meets external debt repayment has become less pressing this year.

This points to the influence that rating agencies' decisions have over pricing. Oman's sovereign bonds have become less vulnerable compared to rival high-yield emerging-market bond issuers, as witnessed in the prices of its dollar-denominated bonds.

Omani bonds continued to offer attractive carry with the short end trading in the low-mid-5 per cent yield and the

DATA TALKS

Available data suggests that a solid, sovereign-grade credit rating will help reduce borrowing costs

Global investors prefer sovereign debt, particularly when it is a highly rated one such as the UAE – which can draw on a wide range of funding sources, not just from the substantial hydrocarbons export receipts that are the bedrock of the nation's finances.

Emerging markets (EM) are facing a worsening of credit conditions, which Moody's notes will permeate to sovereigns. But in a comment issued in November 2022, the credit rating agency says that higher-rated EM issuers – which include the UAE – have the credit fundamentals to weather the turn in the cycle. That compares to weaker entities with ratings of B or below that are vulnerable given their limited financing options and reduced capacity to absorb shocks.

The UAE has shown its mettle in the fixed income marketplace in 2022. The $4bn, multi-tranche international bond issued by the federal government in October 2021 drew such strong demand (five times oversubscribed) that pricing was tightened by 25bps on each of the 10-year and 20-year tranches and by 30bps on a 40-year Formosa tranche.

This shows that sovereign-rated debt affords the authorities the capacity to tweak pricing in a favourable direction. The debut federal international bond's resilient orderbook, which grew to $22.5bn, enabled a 35bps, 30bps and 35bps respective tightening from the initial price talk on 10-year, 20-year and 40-year tranches.

UAE bond performances may have dipped in line with the wider economic situation, but evidence suggests these are still doing better than other fixed income markets.

According to investment manager Franklin Templeton, GCC bond market declines are little more than half of those witnessed across emerging markets as a whole in 2022, as reported by the JPMorgan Emerging Markets Bond Index Global Diversified in mid-October. Market volatility has impacted GCC issuance however, with bonds and sukuk down

Comparison of sovereign bond yields

	GCC Sovereign Yields — 30 March 2022			GCC Sovereign Yields — 31 October 2022		
Sovereign	**Maturity**	**Yield %**	**Price (YTD %)**	**Maturity**	**Yield %**	**Price (YTD %)**
Abu Dhabi	2027	2.59	-4.79	2027	4.58	-13.14
Abu Dhabi	2031	2.88	-7.09	2031	4.77	-19.07
Abu Dhabi	2050	3.7	-12.48	2050	5.39	-33.48
Saudi Arabia	2027	2.69	-4.17	2027	4.85	-11.97
Saudi Arabia	2032	3.12	-6.41	2032	5.1	-20
Saudi Arabia	2050	4.24	-12.37	2050	6.07	-32.99
Oman	2027	4.83	-2.97	2027	6.44	-9.08
Oman	2032	5.64	-2.96	2032	7	-12.5
Oman	2051	6.89	-4.04	2051	8.29	-18.66

Source: Markaz, MEED

57 per cent relative to 2021.

What provides some comfort, says Franklin Templeton, is that absolute yields for GCC bonds are approaching the highest levels in 20 years, excluding the global financial crisis.

"We see current valuations as compelling, particularly for higher-quality issuers. Despite the risks, or rather because of the abundance of risk, we believe higher-quality, fixed income assets are poised to better defend portfolios, especially those with active mandates," it notes in a fixed income comment in October 2022.

UAE government-backed issuers already enjoy strong ratings and tend to operate in strategic and defensive sectors such as utilities or telecoms. Companies that enjoy a higher fixed interest-rate component in their capital structures and with staggered and longer-term maturity profiles are better positioned to manage the rising rate outlook. Moody's estimates that almost two-thirds of the debt on rated GCC companies' balance sheets has a fixed interest rate.

Throughout 2022, yields on sovereign Abu Dhabi, Saudi Arabian and Omani bonds rose amid heightened global risk conditions. Since Oman started the year with some non-investment grade ratings, its yields were already higher than its better rated peers in the UAE and Saudi.

But taking the six-month interval between March and October, data shows that while yields in the sultanate were higher at the end of October than its neighbours, the yields rose in broad tandem. For example, the yield on its 2051 bond was 6.89 per cent in March, rising to 8.29 per cent at the end of October.

This was a smaller increase than the equivalent yield on Saudi Arabia's 2050 maturity bond, which rose from 4.24 per cent to 6.07 per cent in the same timeframe. Abu Dhabi's 2050 bond yield rose from 3.7 per cent to 5.39 per cent, also a larger increase than Oman's. The key shift here may be the upgrading of Oman's sovereign ratings, which S&P hiked to BB- from B+, and Fitch increased from B+ to BB.

In its H2 2022 review, consultant PwC notes that activity dropped in the GCC debt markets in the second half of the year due to rising interest rates, when compared to H1 2022.

Notable debt offerings in H2 2022 include bonds listed by the UAE federal government with a total value of $2.1bn on Nasdaq Dubai and a $1.4bn sukuk listing by the Qatari government on the Qatar Stock Exchange. The Omani government also listed $385m of sovereign sukuk on the Muscat Stock Exchange.

In the corporate debt market, Bank Muscat and Ahli Bank listed corporate bonds with a value of $988m and $192m respectively on the Muscat Securities Exchange to further enhance their Tier 1 capital. IsDB Services and Dar al-Arkan listed a $1.2bn and a $400m corporate sukuk, respectively, on Nasdaq Dubai.

Comparison of GCC sovereign bond ratings

	GCC Sovereign ratings — 30 March 2022			GCC Sovereign ratings — 31 October 2022		
Sovereign	**Moody's**	**S&P**	**Fitch**	**Moody's**	**S&P**	**Fitch**
Kuwait	A1	A+	AA-	A1	A+	AA-
Saudi Arabia	A1	A-	A	A1	A-	AA-
UAE (federal)	Aa2	NR	AA-	Aa2	NR	AA-
Abu Dhabi	Aa2	AA	AA	Aa2	AA	AA
Ras al-Khaimah	A3	A-	A+	A3	A-	A
Sharjah	Baa3	BBB-	A	Ba1	BBB-	A
Qatar	Aa3	AA-	AA-	Aa3	AA-	AA-
Bahrain	B2	B+	B+	B2	B+	B+
Oman	Ba3	B+	B+	Ba3	BB-	BB

Source: Markaz, MEED

Bulking up equity prospects

The UAE's IPO activity is making an impact on global capital markets

The UAE authorities' long-term ambition is to create broader and deeper markets and to help the diversification of the economy. It has made an impressive start in this endeavour, with an active pipeline of IPOs in 2022. The aggregate value of UAE IPOs in 2022 is higher than in any year since before 2008, according to data from S&P Global Market Intelligence. Dubai got the ball rolling in early 2022, when it announced plans to divest stakes in 10 state-owned entities, the centrepiece of which was the listing in April of 18 per cent of Dubai Electricity & Water Authority (Dewa) on the Dubai Financial Market (DFM).

As the first government organisation in Dubai to stage an IPO on the DFM, the Dewa IPO broke all records, with proceeds of $6.1bn. It was oversubscribed 37 times. This was not just the UAE's largest, but also the biggest IPO in Q2 2022 in global terms. The utility nearly tripled the offering to 18 per cent of the share capital and received $86bn-worth of orders from investors.

The sheer scale and impact of Dewa's float has served to revitalise the UAE IPO market, outpacing its regional rival Saudi Arabia. As 2022 progressed, there was no sign of a let-up.

In June 2022, business district owner and operator Tecom raised AED1.7bn ($463m) from investors, after floating 12.5 per cent of its shared capital.

Dubai's motivation in pushing IPOs of its most creditworthy institutions is to revive a stagnant market that had been overtaken by its regional neighbours, and which had seen only one IPO in five years before the Dewa listing. The latter would, the DFM said, further empower the growing prominence of the UAE and Dubai's equity capital markets.

The other listings in the offing include road-toll operator Salik, for which the government has increased the size of the floated stake from 20 per cent to 24.9 per cent, as well as district cooling services provider Empower, which was more than 47 times oversubscribed. That said, the IPOs do not mean that the UAE equity market is booming.

In fact, Dubai's benchmark index has fallen about 5.5 per

cent since Dewa went public. A more than 20 per cent drop in oil prices from the June 2022 peak has heightened investor risk aversion, showing that the UAE is not immune from the global economic downturn.

The UAE IPO boom is not just a Dubai story. Abu Dhabi's own privatisation push got off the starting blocks in 2020, when it presented $1bn of shares in the distribution business of Abu Dhabi National Oil Company (Adnoc) on the Abu Dhabi Securities Exchange (ADX).

This was followed by IPOs of companies including Adnoc Drilling, Fertiglobe, Al-Yah Satellite Communication Company (Yahsat), Abu Dhabi Ports, Borouge, Burjeel Holdings and Bayanat. Meanwhile, fast-food operator Americana became the first company to be dually listed in the UAE and Abu Dhabi, raising $1.8bn at its market debut.

ADX recorded a market capitalisation of AED2.5tn ($680m) at the end of 2022, making it the second-largest exchange in the Middle East after Saudi Arabia's Tadawul.

There was no coincidence that Dubai kicked off its capital market plan by starting with its highly valued monopoly electricity and water provider Dewa. Investors like its substantial credit linkages to the Dubai sovereign. Not only will the IPO stand to improve the utility's disclosures and oversight, as a listed company, it will also have easy access to the equity capital markets should it require additional funding, noted Moody's.

INVESTMENT GRADE IMPACT

The UAE's slate of investment grade institutions is key to the success of the UAE IPO boom.

An investment grade credit rating indicates a low risk of a credit default, making it an attractive investment vehicle.

Back in February 1996, the UAE was one of four Gulf states issued with debut investment grade ratings by Moody's Investors Service — Baa1 for long-term investments and Prime-2 for short term credit.

According to bond market specialists Franklin Templeton, investment grade yields are at a level similar to the lows of 2018 and 2020 and present a compelling opportunity, justifying an increase of fixed income allocations. Absolute yields for investment grade-issues are at the highest levels in 20 years, excluding the global financial crisis.

Not all emirates enjoy investment grade status. Sharjah, for instance, saw its credit rating cut by Moody's Investors Service to Ba1 in 2022, pushing it into sub-investment grade territory. The downgrade was based on the rating agency's expectation that Sharjah's fiscal position would come under renewed strain in the next few years.

In January 2023, S&P revised Sharjah's outlook from negative to stable with the view that the government will introduce sufficient measures to stabilise its debt burden over the coming two years. S&P previously highlighted a surge in Sharjah's debt, rising from 15 per cent of GDP in 2018 to 45 per cent in 2022, with the cost of servicing those debts now absorbing 20 per cent of government income. This was seen as a risk towards Sharjah's capacity to stage any listings of its own companies, since a higher risk premium would be priced into them – putting off potential buyers of its debt.

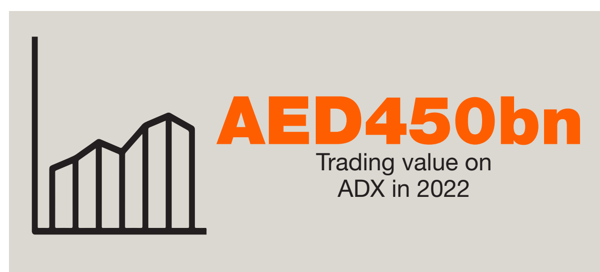
Moving forward, it is expected the emirate's overall fiscal

position will gradually stabilise over the period to 2026, with the primary fiscal deficit (the deficit excluding debt interest costs) trending toward balance, in-line with the government's medium-term fiscal outlook.

A common theme to Emirati IPOs is that only a small portion of company shares have been floated. Most float under 25 per cent of their shares, reflecting the sovereign's lack of need for funds. Instead, the prime motivation for the IPOs is to boost the liquidity of the bourse. And the evidence suggests the active issuance pipeline has indeed helped shore up the performances of the main UAE exchanges.

The ADX average share price index increased by 53.8 per cent in year-on-year terms in Q2 2022 and extended to AED2.1tn ($570bn) in August 2022. The ADX recorded its highest rise in terms of market value and trading value at the end of the second quarter of 2022, according to the Arab Monetary Fund (AMF).

In its quarterly bulletin on the performance of Arab stock markets issued in July 2022, the AMF noted that the ADX achieved an increase of $29.23bn in terms of market value, rising from $513.19bn at the end of the first quarter of 2022 to $542.42bn in the second quarter of 2022. The market value of the DFM increased by some $24.45bn, reaching $143.57bn by the end of the second quarter of 2022.



DFM's average share price index rose by 25.3 per cent in year-on-year terms in the second quarter of 2022 and reached AED568.5bn ($154.8bn) in August 2022. According to the Central Bank of the UAE, the performance was due to the listing of new companies, and the increase in share proxies, volumes and market caps.

Though the DFM's gains have been more muted since then, registering a rise of just 3.9 per cent by 11 October compared to the start of the year, it compares favourably with the likes of the New York Nasdaq (down 33.4 per cent), Hong Kong's Hang Seng (down 27.7 per cent) and the MSCI Emerging Markets Index (down 28.2 per cent).

UAE IPOs in 2022

Emirate	Company	% sold in IPO	Amount raised ($m)	Listing date	IPO price (AED)
Abu Dhabi	Adnoc Drilling Co	11	1,100	Oct 2021	2.3
Abu Dhabi	Fertiglobe	13.8	795	Oct 2021	2.55
Abu Dhabi	Yahsat	40	731	Jul 2021	2.75
Abu Dhabi	Abu Dhabi Ports	24.6	1,100	Feb 2022	3.2
Abu Dhabi	Borouge	10	2,000	Jun 2022	2.45
Dubai	Dewa	18	6,100	Apr 2022	2.48
Dubai	Tecom	12.5	463	Jul 2022	2.67
Dubai	Salik	24.9	1,018	Sep 2022	2
Abu Dhabi	Burjeel Holdings	11	299.9	Oct 2022	2.4
Abu Dhabi	Bayanat	22.2	171.1	Oct 2022	1.10
Dubai	Empower	20	724	Nov 2022	1.33
Dubai	Taaleem Holdings	25.32	204.2	Nov 2022	3
Abu Dhabi*	Americana*	30	901.3 *(1,800 total)*	Dec 2022	2.62 *(2.26SR)*

**= dual listed on Saudi Arabia's Tadawul*

DATA TALKS

The UAE leads IPO activity in the Mena region on the back of strong market fundamentals and investor appetite

According to EY, global IPO activity in 2022 was impacted by increased market volatility and other unfavourable market conditions, along with the dismal performance of many IPOs listed since 2021.

Amid an environment defined by higher inflation and rising interest rates, investors have spurned new public companies and turned to less risky asset classes.

The picture is radically different in the Mena region. According to EY, 2022 marked a record year for IPOs in the region with a y-o-y growth of 179 per cent in total proceeds raised from both state-owned and private companies. And it is the Gulf giants such as the UAE that have driven that performance.

"The region is coming together with the recent first-tim regional dual listing and concurrent IPO of Americana Restaurants on the ADX and Tadawul, and announced collaborations with regional and international exchanges, as well as a unified set of ESG Disclosure Metrics by the GCC Exchanges Committee," according to Gregory Hughes, EY Mena IPO leader.

Despite being both dollar-pegged economies, the UAE and

Mena IPO activity

	Q4 2022	Q4 2021	% change
Number of IPOs	20	13	+53.8%
Proceeds ($bn)	7.3	5.6	+30.3%

GCC IPO activity

	2022	2021	2020	2019
Number of IPOs	48	17	7	12
Proceeds ($bn)	24	7.3	1.8	33

Source: EY, Kamco Invest, Bloomberg

IPOs in Q4 2022 – Saudi Arabia vs UAE

Issuer	Country	Exchange	Proceeds ($m)
Emirates Central Cooling Systems Corporation (Empower)	UAE	DFM	724.1
Taaleem Holdings	UAE	DFM	204.2
Americana	UAE/Saudi Arabia	ADX/Tadawul	901.3
Burjeel Holdings	UAE	ADX	299.9
Bayanat	UAE	ADX	171.1
Saudi Aramco Base Oil Company (Luberef)	Saudi Arabia	Tadawul	1,317
Arabian Drilling Company	Saudi Arabia	Tadawul	710.6
Marafiq Power & Water Utility	Saudi Arabia	Tadawul	894.7
Riyadh Cables Group Company	Saudi Arabia	Tadawul	377.6
Perfect Presentation For Commercial Service Company	Saudi Arabia	Tadawul	221.7
Al Saif Stores for Development & Investment Company	Saudi Arabia	Tadawul	321.2

Source: EY (excludes listings on Nomu)

Saudi Arabia's IPO markets were not affected by the interest rate increases – in stark contrast to the rest of the world.

UAE CONTINUES MOMENTUM

The UAE's IPO boom has been underpinned by a move to attract new capital from other parts of the world. A common thread in the spate of IPOs is the small percentage sold in public offerings, with all but one seeing floats of 25 per cent or under. This underscores the reality that the UAE is not undertaking these privatisations solely to raise cash, but also to boost the liquidity of the local UAE exchanges and spread the wealth to local nationals and residents.

While Saudi Arabia secured the position with the highest number of IPO issuances in 2022, the UAE dominated in terms of the volume of proceeds and types of IPO issuances, raising nearly $14bn from its 11 issuances.

The sheer scale and impact of Dewa's float, which raised $6.1bn, has served to revitalise the UAE IPO market, outpacing its regional rival Saudi Arabia. Overall the UAE had an exceptional performance in 2022 with annual IPO proceeds of USD12.2 billion generated across DFM and ADX, compared to USD2.7 billion in 2021. This level of activity is expected to continue in the near future, supported by both state owned entities and private companies.

Oman also had some activity in H2 2022 with the listing of The Pearl REIF of $71.6mn. The Pearl REIF is the first leveraged sharia-compliant REIF in Oman. With regards to the future Oman IPO activity, the Oman Investment Authority (OIA) is reportedly looking to exit a number of its investments through IPOs in 2023.

2022 is the best performing year for GCC since 2019 from an IPO perspective in terms of both volume and proceeds. Against a backdrop of strong regional pipelines across both the public and private sectors, and increased investors' awareness of the region's potential, the momentum in IPO activity is expected to continue into the near future.

SECTION C

LOOKING AHEAD

Collaborative efforts

The UAE has a long history of successful PPP deals, with Dubai and Abu Dhabi leading the way. A new federal PPP law recently agreed by the cabinet could pave the way for more transactions across the country

Public-private partnerships (PPPs) have long been seen as a way for countries to attract investment, create jobs, develop skills and even reduce costs.

In the UAE, the potential benefits that could accrue from encouraging the public and private sectors to cooperate has long been recognised.

Article 24 of the country's founding constitution in 1971 says: "The national economy … shall mainly depend on faithful cooperation between the public and private activities, and shall seek to achieve economic development, increase productivity, raise the standards of living, and achieve prosperity for citizens as provided in law."

The Abu Dhabi authorities led the way from the late 1990s onwards, but the focus was firmly on power and water projects. Difficulties with demand forecasts and state guarantees made it hard to structure deals in other sectors. That has changed in more recent years with new regulations and PPP structures successfully adapted for other areas – for example, the $1bn Zayed University PPP in Abu Dhabi awarded in 2009.

SOURCE OF FUNDS

The early PPP deals were generally covered either by sector-specific laws or the legal framework of the federal Commercial Transactions Law of 1993 and the UAE Commercial Companies Law of 2015. However, since 2015, laws have been adopted by individual emirates or at the federal level, which set out a framework that is more carefully tailored to the needs of PPP transactions.

Dubai was the first emirate to move, with Dubai Law 22 of 2015 Regulating Partnerships between the Public and Private Sectors (the Dubai PPP Law), which set up the regulatory framework for PPPs in the emirate. That was followed in Abu Dhabi by Law No. 2 of 2019 on organising public-private partnerships.

$20.6bn

Value of PPP contracts awarded in the UAE in 2015-21, more than any other country

At the federal level, there have been several notable developments, including a 2017 cabinet resolution on procedures for partnerships between federal and private sector entities and a further cabinet resolution in 2019 on procedures for partnerships between the public and private sectors in the UAE. The first of these only dealt with projects involving federal government entities; the second covered both local and federal government bodies.

More recently, in September 2022 the UAE cabinet agreed to a new PPP law, described by one senior Dubai-based consultant as a "much-awaited" piece of legislation.

Vice President and Prime Minister of the UAE and Ruler of Dubai Sheikh Mohammed bin Rashid al-Maktoum said the aim of the new federal law was "to create opportunities and encourage the private sector to engage in developmental, economic and social projects and to develop partnerships that lead to improving the quality of public services."

The UAE has been the most active market in the Middle East and North Africa for PPP deals in most recent years. According to MEED Projects, the UAE awarded $20.6bn-worth of PPP contracts between 2015 and 2021, more than any other country. The second-busiest market was Egypt with $18.5bn, followed by

Saudi Arabia with $16.6bn and Iraq with $11.2bn.

The power and water sectors remain by far the most active area in the UAE. Among the biggest projects have been the $25.5bn Barakah nuclear power plant in Abu Dhabi, the $3.2bn Shuweihat 2 independent water and power project and the Mohammed bin Rashid al-Maktoum Solar Park developed by Dubai Electricity & Water Authority (Dewa).

Major PPP projects currently underway include the $3.2bn Hassyan independent power plant (IPP) in Dubai and the $2bn Hamriyah IPP in Sharjah.

FINANCING CONSIDERATIONS

PPP activity has provided a boost for the local finance market, with each deal requiring a bank or (more usually) a syndicate of regional and international lenders to provide the funds to develop the scheme.

Under a typical PPP scheme, a private sector company is responsible for a combination of the financing, design, construction, operation and maintenance of an asset. In exchange, they will receive fees from users of the asset or payments from the government over the lifetime of the contract – or a combination of the two. These revenues are used to repay the debt and, assuming all goes well, provide a profit for the company. The asset is then usually transferred to the government at the end of the contract period.

This arrangement is attractive to governments as it means infrastructure projects can be developed with limited impact on a state's budget and balance sheet, as the private sector partner is responsible for the finance. However, there are costs – under Basel III international banking rules, lenders need to set aside more regulatory capital for long-term project financing, which increases the cost of that funding.

Private debt is in any case usually more expensive than government borrowing, so a PPP deal needs to offer other benefits, such as efficiency gains through construction being carried out on-time and on-budget, the quality of the asset and better maintenance.

There are some other risks too. The IMF among others has warned that, if not well-managed, PPPs can be a source of major liabilities for governments, including the guarantees that a state sometimes offers in terms of the use of an asset or the revenues it is likely to generate. To date, the UAE's experience in PPP deals has not thrown up many problems though, even during the financial crisis of 2008/09.

The environment is likely to remain conducive to PPP activity in the future, offering opportunities for banks to get involved in more power and water projects in particular. Given the positive approach the authorities are taking to PPP deals at the federal level, there may also be scope for encouraging public and private sector actors in overlooked sectors to get more involved.

Largest PPP markets in the Mena region in 2015-21 ($m)

	2015	2016	2017	2018	2019	2020	2021	Total
UAE	3,461	885	5,090	3,561	2,164	2,105	3,304	20,570
Egypt	2,587	700	2,114	1,177	3,735	2,526	5,638	18,477
Saudi Arabia	2,030	942	1,515	298	3,332	2,557	5,884	16,558
Iraq		1,820	120	430	480		8,307	11,157
Iran	1,895	4,660	2,682	1,183	80	24		10,524

Source: MEED Projects; as of October 2022

Number of UAE PPP main contract awards in 2015-21

	2015	2016	2017	2018	2019	2020	2021	Total
Contract awards	4	5	4	7	6	4	5	35

Source: MEED Projects; as of October 2022

Selected major PPP projects in the UAE

	Emirate	Sector	Budget ($m)	Status	Contract type	Award	Completion
Barakah Nuclear Power Plant	Abu Dhabi	Power	25,500	Operation	Build Operate Transfer (BOT)	2009	2022
Dubai Municipality - Dubai Strategic Sewerage Tunnel	Dubai	Water	8,500	FEED	BOT	2023	2030
Adnoc - Project Wave	Abu Dhabi	Water	5,000	Bid Evaluation	Build Own Operate Transfer (BOOT)	2022	2025
Noor Energy 1 - 950MW MBR Al-Maktoum Solar Power Plant CSP (Phase 4)	Dubai	Power	4,400	Execution	BOT	2017	2023
Abu Dhabi OPT - Sub-Sea Power Transmission Network	Abu Dhabi	Power	3,800	Execution	BOOT	2021	2025
FAPCO - Fujairah F2 IWPP	Fujairah	Power	3,500	Operation	Build Own Operate (BOO)	2007	2010
Hassyan Energy - Hassyan Gas Power Plant IPP (Phase 1 & 2)	Dubai	Power	3,400	Execution	BOO	2015	2023
RPHC - Shuweihat 2 IWPP	Abu Dhabi	Power	3,200	Operation	BOO	2007	2011
Adnoc - Mirfa Seawater Treatment Plant	Abu Dhabi	Water	2,500	Bid Evaluation	BOOT	2022	2025
Shuweihat Asia Power Company - Shuweihat 3 IPP	Abu Dhabi	Power	2,500	Operation	BOOT	2010	2014
Taweelah Asia Power - Taweelah B IWPP	Abu Dhabi	Power	2,500	Operation	BOOT	2004	2008
Adnoc - Al-Nouf Seawater Treatment Plant	Abu Dhabi	Water	2,000	Main Contract PQ	BOOT	2023	2026
SHIPCO - Hamriyah IPP	Sharjah	Power	2,000	Execution	BOOT	2018	2023
Shuweihat CMS International - Shuweihat 1 IWPP	Abu Dhabi	Power	2,000	Operation	BOT	2001	2004
Ewec - Sweihan Photovoltaic IPP (Noor Abu Dhabi)	Abu Dhabi	Power	1,500	Operation	BOO	2017	2019

Source: MEED Projects; as of October 2022

ESG considerations shape bond issuance

Charles Russell Speechlys' William Reichert and Sarah Alaiwat discuss how environmental, social and governance (ESG) principles are increasingly shaping the UAE government and its stakeholders' ability to raise finance

Q HOW ARE ESG PRINCIPLES IMPACTING THE UAE'S FISCAL POLICIES AND PUBLIC DEBT MANAGEMENT?

The integration of ESG factors by investors, corporates and governments has implications for both private entities and sovereign debt management as it has the potential to noticeably impact investment decisions, investment tools and country credit assessments. Public debt management plays a key role in supporting government ESG agendas by signalling to investors that a government is committed to improving environmental and social outcomes and, in doing so, financing such initiatives through the issuance of green bonds.

Considering the growing imminence of a global sustainability crisis and in the wake of a recent pandemic, which has undeniably had a salient impact on the cultural zeitgeist, the prevalence of environmental and social considerations has been paramount in recent years.

The UAE's Energy Strategy 2050 seeks to increase the contribution of clean energy in the total energy mix from 25 per cent to 50 per cent by 2050 and reduce the carbon footprint of power generation by 70 per cent.

The strategy provides an important opportunity for investment in green finance and will facilitate a significant pipeline of renewable projects, which in turn could lend itself to the issuance of sovereign green bonds by the UAE government.

The fact that renewable projects require tangible physical assets also lends itself well to the further issuance of green sukuks, as sharia principles often require the existence of identifiable assets. The use of sukuks will facilitate borrowers receiving funding from Islamic investors, as has been done in other countries such as Indonesia and Malaysia.

Q WHAT SHOULD THE PUBLIC ENTITIES KEEP IN MIND WHEN IT COMES TO GREEN BOND ISSUANCE?

The key motivation for issuing an ESG-labelled bond, or green bond, is to align with the government's ESG policy agendas. This subsequently raises several challenges for sovereign debt management offices as it requires expertise and information

UAE debuts green bond and sukuk initiative at Cop 27

The UAE's Ministry of Climate Change and Environment (MoCCAE) announced the issue of a new situation analysis report of the green bond and sukuk market in the UAE as part of its efforts to support the growth of sustainable finance in the country.

The document lays out the fundamentals of green bonds and sukuk and the current market conditions in the UAE. It also offers recommendations for further development of the domestic sustainable finance market.

The report builds on the UAE Sustainable Finance Framework, launched in January 2021, and supports investments in low-carbon, environmentally sustainable and climate-resilient projects.

Source: UAE Ministry of Climate Change & Environment

that they do not typically have. Further standardisation of ESG products in terms of minimum reporting requirements, and a clear and consistent definition of green spending, would help facilitate the issuance process and build a robust and liquid ESG bond market.

Moreover, it remains uncertain how issuers of debt securities, such as green bonds, should disclose climate change and other ESG risks and opportunities within their public offer documentation. Public and sovereign entities in the UAE ought to consider the changing landscape for both regulatory requirements and market practice.

Q WHAT ESG CONSIDERATIONS SHOULD THE UAE GOVERNMENT PRIORITISE?

In order to enhance confidence and investor appetite for ESG-linked instruments, government stakeholders would do well to consider how to successfully withstand investor scrutiny. One way to do this is to ensure that corporate governance fundamentals are strong, and they must encourage more private companies in the region to pay attention to ESG considerations.

A practical way to start is to begin reinforcing the corporate governance "basics", including strong protection for minority shareholders, robust policies on reporting and transparency, a clear separation of the executive and oversight roles, a majority of independent, non-executive directors, separate audit, nomination and remuneration committees and comprehensive policies on compliance and ethics, etc. It would then be prudent to develop an ESG framework from there – for instance, green bond principles and specific eligibility criteria.

Sustainability within the ESG framework is a relatively new area of reporting. Government stakeholders should consider engaging an external consultant on sustainability criteria to provide a specialised opinion. This may add transparency as to the use of proceeds and to the credibility of the bonds.

Once a green bond has been issued, it is also important to consider implementing controls to track and record data, and to regularly report the use and allocation of proceeds to investors.

Green versus sustainability-linked bonds

Sustainability-linked bonds (SLBs), for which the coupon paid to investors depends on the issuer's performance against measurable targets, are a newer type of debt instrument than use-of-proceeds bonds like green and social bonds.

In the case of use-of-proceeds bonds (green, social and sustainability bonds), the issuer commits to using the funds exclusively to finance environmentally sustainable projects or activities. As such, the size of eligible green projects constrains green bond transactions, although green bonds are well recognised and well accepted. The use of proceeds is easy to track, and the annual reporting of expected environmental impact is relatively simple.

SLB proceeds, on the other hand, can be used for general purposes. This flexibility allows issuers that may not have enough green or social capital expenditure to access sustainability focused investors.

However, labelling a bond as an SLB can be more complex than labelling it as a use-of-proceeds bond. The issuer must select key performance indicators and one or more sustainability performance targets according to the indicators.

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CONCLUSION

At the outset of 2023, Sheikh Mohammed bin Rashid al-Maktoum, Vice President and Prime Minister of the UAE, and Ruler of Dubai, set out the nation's five key priorities during the first Cabinet meeting of the year.

These include consolidation of national identity; championing the environment and sustainability; developing the education sector; boosting Emiratisation policies; and expanding economic partnerships across the globe.

It is natural that these priorities will shape the UAE's fiscal prudence in the coming year.

Typically, the UAE's approach to fiscal policymaking has centred around maintaining a balanced budget and ensuring long-term financial stability.

In line with this, the government has continually diversified its revenue streams to reduce reliance on oil and gas, introducing VAT and excise taxes, boosting non-oil sector growth, as well as reducing government spending and increasing efficiency in order to maintain fiscal sustainability.

In 2023, it is expected that factors such as Emiratisation, climate action and attracting foreign investments will further influence the state's approach to policymaking, expenditure and raising capital.

In its recent creditworthiness outlook report, Moody's noted that the fiscal balance of the UAE will remain in surplus, as it continues to enjoy windfall from elevated oil prices and healthy tax receipts.

2023 will also see the IPO flurry continue in the UAE amid strong investor demand, with 12 companies raising $11bn last year. The March listing of Dewa was the largest GCC IPO in 2022, raising $6.1bn. Meanwhile, state-owned Salik, Empower and Tecom, collectively raised $2.2bn in June, September and November, respectively. All of these are indicative of concrete shift in mindset.

However, macroeconomic conditions are expected to significantly moderate growth across the board.

In the coming year, government entities, SWFs and GREs will have to brace for external uncertainties in the form of volatile commodity prices, rising inflationary pressures and business disruption caused by factors such as supply chain issues and the Russia-Ukraine war.

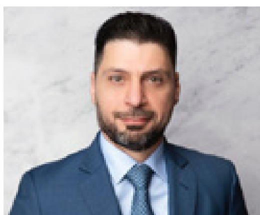
Equally crucial to study and implement are policies geared at climate action, and in areas such as food security, water management and circular economy. Fiscal policy is a key navigator in enabling environmental and socially responsible behaviours across value chains. In the run up to Cop28, the global scrutiny on the UAE and its stakeholders are only expected to rise.

As the host, the UAE says it will aim to build consensus and coalitions to achieve a practical, pragmatic and just energy transition and reform land use and food systems, while scaling up adaptation and operationalising the new loss and damage fund.

In line with this, sustainable finance is one of the areas that is expected to rise in relevance, as the UAE seeks to become a regional and global hub for investments underpinned by ESG principles.

The UAE has consistently set its sights on the future when taking stock of the present, evident through long-term national targets and large-scale urban expansionary plans. This was recently evidenced by Dubai's announcement of an $8.7tn economic plan spanning the coming decade, geared at boosting the emirate's status as a global financial hub by doubling foreign trade and investment.

Corporate taxation is further expected to support the development of the UAE's status as a competitive financial hub. Ahead of its levying from 1 June, selected companies have been invited by the Federal Tax Authority to register using the EmaraTax platform.



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About Mashreq

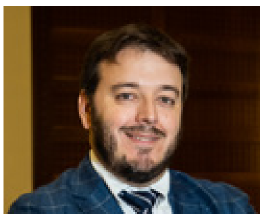
Mashreq is more than half century old bank, yet proudly thinks like a challenger, startup, and innovator.

Mashreq has pioneered key innovations and developments in banking, starting with entry-level digital-first customers, all the way through to powering some of the region's most prominent corporations and wealth accounts.

The bank's mandate is to help customers find their way to Rise Every Day, partnering through the highs and lows to help them reach fulfillment, achieve financial goals, and unlock their vision of success.

Reassuringly present in major financial centers of the world, Mashreq's home and global headquarters remains in the Middle East, offering services whenever and wherever opportunity takes its customers.

Find your way to Rise Every Day at Mashreq.com/RiseEveryDay



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MEED has been integral to delivering business information, news, intelligence and analysis on the Middle East economies and activities for over 65 years.

Attracting a key senior management audience through its content and activities, MEED is a media brand, publication and data business that covers a spectrum of services which inform, engage, connect and ultimately support our subscribers and partners in their business development and strategic growth.

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Our purpose is to support the region's companies make better and more timely decisions through our innovative data solutions and grow through our comprehensive and world-class marketing solutions. To find out more, email: info@meed.com

This report was prepared between October 2022 to March 2023.

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