ABN·AMRO

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Commodities: *Seizing Opportunities in the Gulf?*

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An ABN AMRO industry roundtable was held in Dubai on May 19 where senior stakeholders in the local and global energy and financial markets discussed the best strategies to navigate the opportunities and risks within the Gulf's commodity market.

Investors who are eyeing opportunities in the Gulf's commodity market are battling against the economic pressures of low oil prices and a sluggish local lending community. Against this challenging backdrop, how can the Gulf elevate its trade finance activity with minimal risk?

Rising above the noise of daily trades and price fluctuations, the statistics circulating the global commodity markets suggest a bullish long-term outlook for investors and traders. The world's population is set to soar by nearly a third from today's 7.4 billion (bn) to 9.5bn by 2050 and the US' Energy Information Agency (EIA) forecasts a 48% increase in global energy consumption alone by 2040.

In the Gulf alone, the 220 million (m) tonnes of oil consumed in 2001 nearly doubled by 2010 and is expected to nearly double again by 2020[1]. Europe's dying refining sector is being reborn in the form of complex and large scale refineries in the Middle East and Asia, with a greater emphasis on petrochemical facilities. The vast majority of the 7.1 million barrels a day (m b/d) of new distillation capacity in the pipeline in 2015-2020 will be from the Middle East, China and the wider Asia-Pacific, according to OPEC's 2015 World Oil Outlook[2].

While the Gulf's commodity market is home to many opportunities, there are also risks. Some of which are more difficult to hedge, such as volatile oil prices and economic and political instability. The domino effect of low oil prices – Brent has hovered below $50 a barrel throughout the second quarter – means the short-term outlook is proving to be a financial assault course for foreign and local investors alike. Though a single commodity, oil holds immeasurable global significance to daily economics and trade, as components are used in thousands of mainstream products.

Oil also forms the nucleus of most Gulf countries' economies and, in turn, it significantly impacts their political influence on the global stage. This year, ratings agency Moody's has reduced the long-term issuer rating on Saudi Arabia, the world's largest oil producer and exporter, by one notch to A1, while Oman and Bahrain were downgraded to Baa1 and Ba2, respectively[3]. As expected, political instability tends to negatively impact the accessibility of local trade finance. Bar turbulence in Iraq, politics and security in the Gulf Cooperation Council (GCC) is relatively stable. But, political and security challenges are occurring in the wider Middle East, as seen in Syria, Lebanon, Egypt and Yemen, for example.

Igniting Local Banks' Appetite

In the Gulf, local and national banks' appetite to support trade finance can sometimes be more subdued when compared to foreign investors' appetite to provide debt packages that support the region's low-risk infrastructure projects. Whether national and local banks' reluctance to grow their presence in the region's trade finance market is due to a lack of interest or a lack of understanding is an oft-debated topic amongst investors.

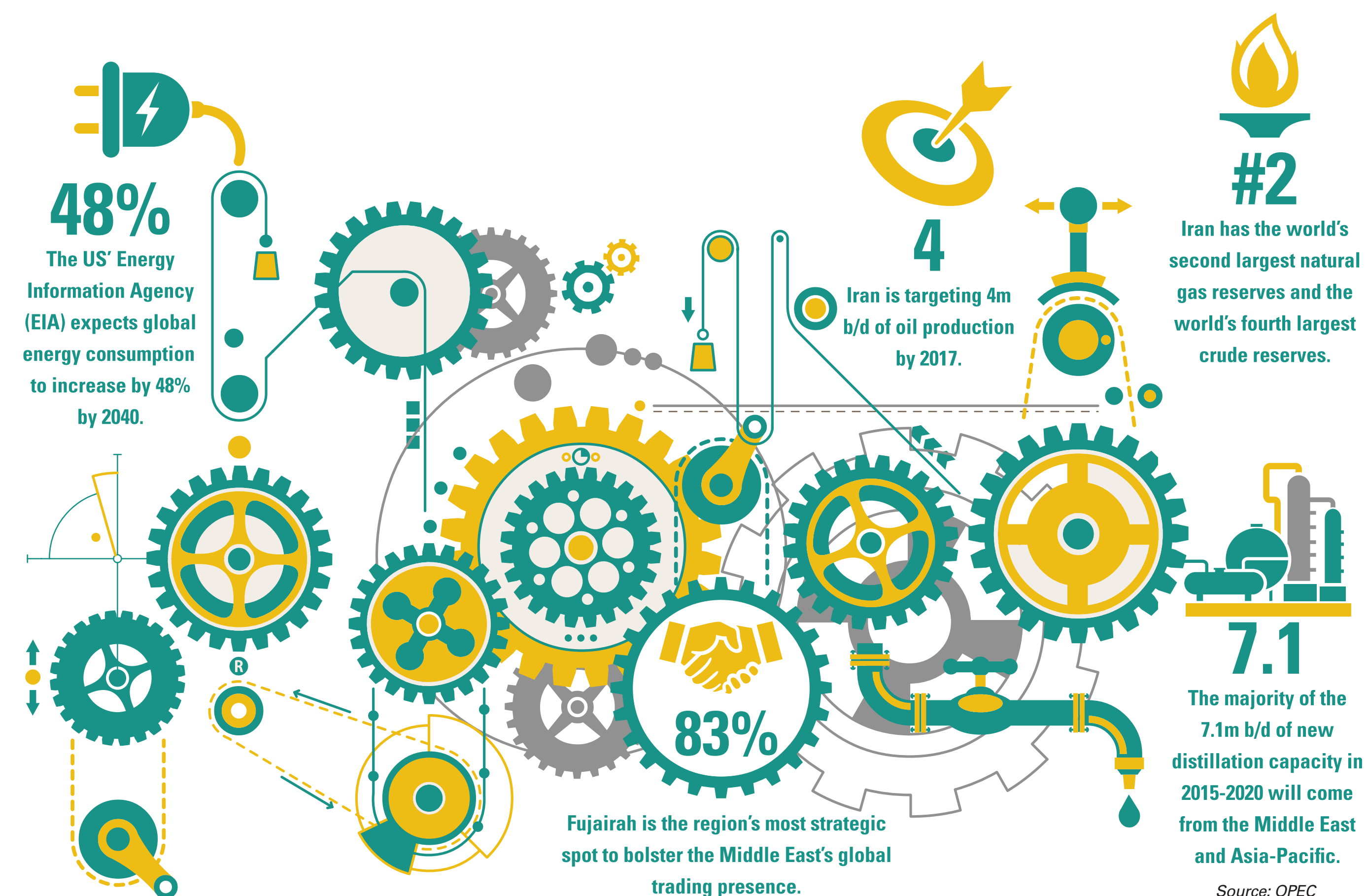
On a macro level, increasing local and national banks' trade finance activity would help accelerate the region's commodity flows, especially considering highly-competitive lenders in Europe, the US and Asia. Foreign banks with a presence in the Middle East – Citi, JPMorgan, SMBC and HSBC, for example – are well versed in trade finance, be it via bonds, syndicated loans or mezzanine financing.

Some argue that despite some local banks' significant financial reserves, they have little inclination to explore new lending avenues and prefer to support property deals, for example. But, continually treading only the well-worn financing paths just enables foreign banks to step in and fill the vacuum, which means that local banks' lending architecture does not mature as quickly as it could.

Others counter that national banks are receptive to building their trade finance desks, but a gap in local knowledge and the subsequent need to hire foreign workers curbs local entities' progress. The region's small local talent pool is partly explained by Gulf countries' young age demographic and small populations – most are below 5m, bar Saudi Arabia's population of 31m[4].

Foreign investors and trading houses can help plug the Gulf's local knowledge gap by importing talent from other commodity hubs where trade finance is the norm, such as Singapore, Hong Kong, London, Chicago and New York. But, this would serve as a short-term solution and fail to address the need for local lenders to elevate their employees' capabilities and increase nationalisation in the Gulf, with the latter being a key long-term goal for all Gulf countries.

55%
Today's 9m tonnes of oil storage at Fujairah is expected to climb by over 55% to 14m by 2020.



Bolstering local banks' lending capabilities could prove transformational for small and medium-sized enterprises' (SMEs) ability to expand, especially as SMEs have been earmarked by local governments as vital players in the push for diversified economies. Such support would be well-received, as low oil prices and a limited local talent pool have especially shrunk SMEs' profit margins.

Join Forces, Cut Risk

As expected, the Gulf's regulatory and financial rule book is not as sophisticated as other global commodity hubs; London has had centuries to fine tune its expertise, for example. To accelerate the Gulf's progress, local banks with an appetite to become adept at trade finance could benefit from foreign investors' guidance and make a concerted effort to participate in international lenders' syndicated loans, or tripartite deals. Either route would enable novice trade finance lenders to hedge their risk and familiarise themselves with

> *"The Gulf's potential as a global commodity hub is underpinned by its position at the heart of the New Silk Road – which stretches from Beijing to Lagos – so blooming economies in Asia and Africa are on the Gulf's doorstep."*

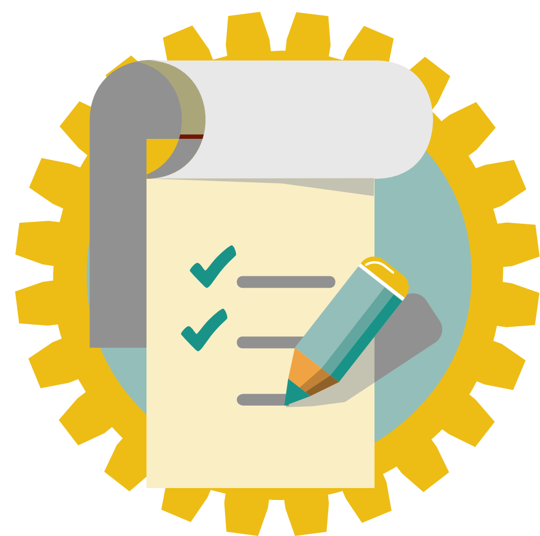
the characteristics of highly competitive financing packages, which are becoming increasingly common in the Gulf. While this would generally require local banks to lower their price points, such a short-term adjustment would enable them to competitively access the region's rapidly evolving commodity markets.

Leveraging the Region's Emerging Hubs

Geography is at the crux of the Gulf's potential as a commodity hub on par with behemoths Singapore and Rotterdam. Nestled in the heart of the New Silk Road – stretching from Beijing to Lagos – and on the doorstep of blossoming economies in wider Asia and Africa, the increasingly extensive facilities at Fujairah's port in the UAE, for example, could act as a strategic parking space. Asia's ravenous energy demand

84
Iran's population of 80m is expected to soar to 84m by 2021.

> *"Iran's vast potential is potentially gold dust for investors, but financiers and traders need to tick off two key criteria – transparency and a refined regulatory structure."*



continues to be spearheaded by China and India; now the world's first and fourth largest energy consumers, respectively.

National banks in the UAE have the opportunity to support Fujairah's ambition to establish itself as the Gulf's local commodity hub for regional and global trade, especially as the port is already the world's second largest bunkering hub after Singapore. Fujairah's location south of the Straits of Hormuz makes it the region's most strategic spot to bolster the Middle East's global trading presence, according to 83% of respondents to a Gulf Intelligence (GI) Industry Survey in April 2016. Surprisingly, Sohar in Oman and Bahrain did not receive a single vote, with 11% preferring Dubai.

Fujairah's current 9m tonnes of oil storage is expected to climb to 14m tonnes by 2020[5] and the port's multi-million dollar investment to launch a new very large crude carrier (VLCC) jetty in June 2016 will sharpen the Gulf's competitive edge as the region aspires to rival the size and global importance of Rotterdam and Singapore by the 2020s[6]. Elevating the Gulf's trading profile on a global basis could be accelerated by the establishment of independent Middle East oil pricing benchmarks.

The Region's New Dawn?

The geopolitical shift most likely to significantly impact the Gulf's commodity market so far this year is the lifting of the Western-imposed sanctions on Iran on January 17. Saudi Arabia's recently-announced Vision 2030, which details an overhaul of the world's biggest oil producer's economy, is a close second.

The jury is still out on whether the lifting of sanctions signals a new dawn for Iran, or a false start. Investors are tentatively confident that Iran will actualize its pledge to leverage the country's position as home to the world's second largest gas reserves and the fourth largest oil reserves. Tehran plans to increase its oil production by over a third on sanction levels to 4m b/d of oil production by 2017[7] and lock in several gas supply contracts in Europe, Asia and the Gulf, namely Oman.

But, Iran's largely archaic financial architecture – some aspects mirroring the 1960s – means the country will remain in the gloomy wings of the global growth story without foreign support. Some of the country's food safety management techniques are also decades behind developed countries' standards.

Still, Iran's population of 80m – nearly 60% of whom are under thirty years old and well-educated[8] – need a myriad of commodities, including iron, steel and agriculture. Financiers and traders who patiently navigate the country's financial and regulatory hurdles will be rewarded with "mountains of trade".

Investors operating in the Gulf with links to US-based companies will inevitably take a while longer to embrace Iran's need for and supply of commodities. Washington and Tehran's political ties need to strengthen, with greater clarity likely to depend on the outcome of the US elections and Iran's ability to stick to its revised nuclear rule book.

Opportunities in the Gulf's ever-growing commodity market abound, but local investors need to act fast to ensure their balance sheets and talent are part of the long-term economic boom. Those, on both the local and international front, who embrace collaborative strategies this year will especially thrive, as heftier coffers will ease the blows from what will inevitably be a rocky road.

References:

1 Gulf Intelligence

2 http://www.opec.org/opec_web/static_files_project/media/downloads/publications/WOO%202015.pdf

3 http://www.bloomberg.com/news/articles/2016-05-14/saudi-arabia-bahrain-ratings-cut-by-moody-s-on-lower-oil-prices

4 2015 UN data - http://esa.un.org/unpd/wpp/publications/files/key_findings_wpp_2015.pdf

5 Gulf Intelligence

6 Gulf Intelligence

7 This is an oft-repeated target. Production targets in Iran and all Gulf countries tend to be overly bullish and various figures emerge depending on the minister speaking. Considering Tehran's targets and today's production, 2017 is a fair statement.

8 http://fordhampoliticalreview.org/the-baby-boomers-of-iran/

220

The Gulf's oil consumption of 220m tonnes of oil in 2001is expected to nearly double by 2020.

9.5

Today's global population of 7.4bn is expected to soar by nearly 28% to around 9.5bn by 2050.

WHITEPAPER – Commodities: *Seizing Opportunities in the Gulf?*

Moderator: Sean Evers, Gulf Intelligence

List of Participants:
Khaled Bassatne, Managing Director, B.B. Energy (Gulf) DMCC
Petri Pentti, Chief Financial Officer, ENOC
Jeroen Leenen, Chief Executive Officer, NCT
James Wild, Chief Executive Officer, Louis Dreyfus Commodities MEA Trading DMCC
Tom de Kort, Partner, Toma Capital Investment
Siby Antony, Managing Director, E3 Energy DMCC
Silvan Doorenspleet, Chief Financial Officer , Amesco
George Moustakas, General Manager, Aegean
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Roger Dekkers, Head of Energy Commodities Clients, MENA, East Africa & Indian Subcontinent , ABN AMRO
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Francesca Taylor, Author of Mastering the Commodities Markets and Managing Partner of The Matrix Partnership
Owain Johnson, Managing Director, Dubai Mercantile Exchange
Eric Salomons, Director Head of Markets, Dubai Financial Services Authority
Mr. Sam Naylor, Chief Financial Officer, Oman Trading International (OTI)
Capt. Salem Al Hamoudi, Deputy Manager, Fujairah Oil Tanker Terminals
Dyala Sabbagh, Partner, Gulf Intelligence

Sean Evers: We are in a region in which domestic oil consumption is doubling every decade. The scale of refineries construction is growing significantly and as we emerge out of each cycle of economic cycle, the geography in which the opportunity presents itself seems to continue to grow. Africa has emerged as part of our wider economic zone of activity and opportunity. Iran is opening up, a country of 80 million people with the need for everything. Similarly, Saudi Arabia is going through what would appear to be a departure of a significant economic reform program.

And so in that regard there are opportunities and with that inevitably, challenges. We've seen oil prices jump around 75% in the last two months although they seem to have struggled to get their head above $50/bl. Agricultural commodities have soared this year and commodities in general have woken up from the dead and taken a big leap forward. Perhaps this a new dawn, perhaps not.

Bas – what is your view that the recovery that we've seen this year will sustain?

Bas Welling: When we see oil prices go under $40, global profits are dented and maybe even more so in this region. So now is the time for Middle Eastern stakeholders in the commodity sphere to show their adaptability. We've seen a lot of investors coming in and many are also looking at China.

Sean Evers: Owain – the Dubai Mercantile Exchange has had a pretty robust 2016 – countercyclical in a lot of ways to what might be the global macro picture, but you seem to be hitting records every month. Your outlook?

Owain Johnson: An exciting departure recently has been a take-off in intraregional trade. I'm thinking particularly of Fujairah where we are seeing fuel oil and jet fuel trade take place intra-Gulf. That's where it's a bit more exciting for us because we can see new customers emerge from within this region. And with that, financing as well. All our letters of credit typically have come out of the U.S. or Europe until now but for example, ABN AMRO is planning to finance cargoes from Asia for us for the first time - a breakthrough in financing - matching where the customers actually sit.

Sean Evers: What's underpinning that change?

Owain Johnson: I think it's recognition that you serve the customers better when you sit locally.

Sean Evers: Francesca – one of the challenges that has been identified to using the opportunity regionally is competence; that we don't have a sufficient depth of trading skill sets in the banks, in the trading firms - that the ecosystem is relatively immature. What is your view on that?

Francesca Taylor: I think one of the biggest challenges at the moment is a lot of the so-called finance professionals aren't here. I mean they have sales teams here, they have marketing teams here, but the actual people who are doing the deals are often in New York or London.

Sean Evers: How would you see the difference between the indigenous talent here being elevated versus the need for the talent to be brought in? What's your outlook for those two different solutions?

Francesca Taylor: I think there's going to be a natural resistance to bringing talent in unless you have pure specialist skills that you've honed over years and you have a specific role to fill. Increasingly, we're going to be looking at training of people coming out of local universities. I'm a great believer that you can only learn so much at a university, which is mostly theoretical, so the training in this market has to be applied by people who frankly know the markets themselves – i.e. the industry.

Sean Evers: One of the new developments in the region, with the emergence of the opening of Iran, is the availability of a huge talent pool. When you think of the development opportunity of Iran, companies can perhaps go into Iran with a certain confidence that they won't need to import a lot of expensive expat talent.

Let me introduce one of our guest speakers - Eric Salomons with the DFSA. What changes are you seeing, and are they reflecting the emerging opportunities? Is the regulatory structure maturing and evolving with sufficient pace to cater for the emerging opportunity?

Eric Salomons: Let me give you an example of what we're witnessing. Listings of local companies previously were done in London. Increasingly, we now see more interest in actually listing them here. Clients are increasingly trading with each other in the region; HSBC Middle East has decided this year to bring their holding company into the DIFC - so the amount of activity transaction in essence in Dubai and in the UAE and in the DIFC is growing. I think that in the end, that will drive the talent pool as well. The nature of firms is also changing. The bigger finance houses are already here. What we have seen in the first quarter is a bigger flow of firms coming into the DIFC with a different risk profile – smaller companies that you don't necessarily know.

Jeroen Leenen: I'm a very strong believer in Dubai and the Middle East but today's scenario is, as far as I'm concerned, very shaky. When you're in the commodity business, 5 years is a long time and a lot of things can change. We can all agree that China and the Far East are going to be the drivers of the world economy. And we have India. We have Africa. We also probably agree that Europe will be very flat and growth in America is also questionable. If you are a manufacturer, if you're a Dow Chemical or ExxonMobil, you can look at the Asian market with a 5-10 year view but shorter term, in commodities things can change overnight.

Sean Evers: What about the thought that the lower oil prices of the last 18 months were choreographed by Saudi Arabia and OPEC to be that way for the benefit of this region rather than for its detriment? In the sense that the ultimate possible barrier to opportunity in this region is the structural economic reform that it needs. Without a level oil price, you're not going to get structural economic reform.

Tom – what's your outlook on this as a strategy and whether it can sustain going forward two years or more?

Tom de Kort: I think it's more of a geopolitical question. I think that America is going to have a big influence on what OPEC's going to decide. In my opinion, the UAE, Saudi or the Gulf states, have people who are in favour of a lower oil price at this moment because, from a foreign policy perspective, it is less capital for Iran. But the only countries benefitting at the moment from lower oil prices are large consumers like China and the U.S.

Sean Evers: The lower oil price has a multiple of triggers that from a regional point of view are not inherently negative. They have an increased private sector economic opportunity built-in and particularly with the example of Aramco and its prospective IPO. You have new leadership in ADNOC, clearly making some dramatic changes. And numerous other examples where, in this current window of time, the national energy sector does seem to be committed to a serious reform program in which there are increasing possible opportunities for the private sector in triggering the new economic opportunity.

Sam Naylor: Some of the economies in the Gulf are looking for diversification, looking at refinery projects, petrochemicals when markets are already oversupplied, but they're having to compete, for example, with the Chinese. Diversification creates jobs and helps with the reform that we are talking about and the some of the consequences of this

will impact the supply and demand balance for hydrocarbons - so a very interesting time in the region.

Sean Evers: Companies like OTI and the Oman Oil Company Group are seizing the opportunity of the wider geography ecosystem, reaching out to East Africa – what's the outlook for that opportunity?

Sam Naylor: We have to invest in places like Africa and Asia where there is growth, to ensure that in our case of being Oman government owned, that we have homes for our products. In an oversupplied market that is likely to remain that way for the next number of years at least, this is becoming increasingly important. Investing in assets, investing in distribution networks or partnerships where we can work with countries and companies in order to secure demand for our products is crucial for OTI. We have natural length from Oman and elsewhere in our portfolio and we need to ensure that that balance is addressed in the longer term because maintaining that length in an oversupplied market in the midterm is a very dangerous position to be in.

Sean Evers: Captain Salem – can I bring you into the conversation and ask how Fujairah is looking at this current period? Is it economically challenged? Is it an opportunity that you see that Fujairah is looking to take advantage of?

Capt. Salem Al Hamoudi: Fujairah is now looking at its long-term prospects for example, to have a benchmark for pricing, and to be a trading hub rather than only a storage or bunkering hub.

Sean Evers: When you look at the outlook for the development of infrastructure, are you agnostic to the commodity? Are you thinking very much oil products or are you thinking grains and a wider diversified group of commodities?

Capt. Salem Al Hamoudi: At this time I believe it's mainly oil. There is a platform for grain as well; we have grain silos and there are projects being undertaken by Abu Dhabi, the intention of which was a strategic reserve for the country, but it's changing into more of a commercial project now. So maybe there will be some sort of commodity platform as well in the future. The infrastructure is available for different types of commodities.

Sean Evers: What do you think of Jeroen's very concerned comments for the outlook of the greater macro story? Do you share those concerns or are you moving forward with greater optimism? What is an example of where you are putting money on the table right now?

Capt. Salem Al Hamoudi: We are stimulating more trading activities into crude rather than just trans-shipment of products. This is an area which could really materialize in the near future. We have a VLCC jetty which will be operational in June so that is a very big addition to Fujairah logistics. There are crude projects coming up for storage and different international players are investing more long term into crude storage tanks.

Sean Evers: James – could I bring you in on your thoughts on this recovery narrative vis-à-vis agriculture? We've seen Ags have a very robust last month.

James Wild: In Ag products today, you still have seven out of every ten soybeans produced ending up in China. China itself is sitting on nearly 1 years' supply of corn stocks, and at the same time we've had quite a balance in the last month as the funds have largely flipped from incredibly short positions to some sizeable longs, at least in maize and corn. Wheat still remains a bit ugly.

Unknown Male: If I look at China and then if I look at this region, China has gone abroad across the world to secure supply through investments, whereas this region is still importing. I would expect that from a strategic point of view, at a certain moment, a Saudi Arabia has to say that instead of being such a big importer, it should go buy producing assets elsewhere especially being already so integrated with the commodity market.

James Wild: Definitely. You can see Almarai, for example, already outside with a big production in Argentina and plans for the U.S. Despite the fact that right now, the world is full of food, the importance of logistics is crucial so the interest is in securing the South America or U.S. elevation.

Sean Evers: I'd like to address the emerging obstacle here in the Gulf of liquidity and the access to capital. Petri, maybe you could speak a little bit to your views on that. Is the liquidity crunch going to get worse?

Petri Pentti: The liquidity that has been taken out of the local banking system has been fragmented. For example, ENOC hasn't seen any issues linked to oil pricing. It's really the SME segment and the private sector that this is most likely encountering some issues with liquidity.

Sean Evers: The national banks are definitely struggling with liquidity – are they not a vital pillar in order for the sort of overarching economic opportunity here to be holistically healthy?

Owain Johnson: We've spent a lot of time working with UAE banks, Gulf banks, talking about how trade finance works because our customers tell us they need a lot more trade finance. But local banks are putting uncompetitive bids to customers - for example at two points more expensive than an ABN or BNP because their alternative is simply to lend to a property developer, at 7% or 9%.

Siby Antony: For a medium-sized company like ours, liquidity a few months ago was very tough. The local banks are keen to extend trade finance but there aren't enough people with relevant experience. Local banks don't understand trade finance but it's time for them to get into that segment as there are great opportunities.

Sean Evers: How important is the evolution of the local banks rather than the international banks, to serve the growth opportunity? What would they need to do to be confident to do this?

Siby Antony: They need to recruit more talent from outside, at least in the initial stages.

Sam Naylor: In this current commodity environment that we're in, whether it be producers, refiners, consumers or petrochemical plants, everybody has a need for financing at a competitive rate. It's the bigger traders like Vitol and Trafigura, with bigger balance sheets and bigger access to capital, who can supply this.

Sean Evers: So do national oil companies like Aramco and ADNOC have to reform themselves? They have started to do so but we can't be sure what they'll come out with exactly; one would imagine it'll be a much more robust and flexible company structure. How big of a change is that for the trading space?

Khaled Bassatne:
Traders have much greater flexibility than NOCs. Would Aramco take a cargo from Yemen? Would Shell or BP? Probably not but maybe BB Energy would do it, Vitol would do it, Trafigura would do it. So there's always an opportunity in that one-on-one space for the trading community to open accounts and grow balance sheets.

Sean Evers: Do you see that changing in anyway, that NOCs may take more of a risk on their balance sheet?

Khaled Bassatne: I don't think so.

Sean Evers: Maarten – you have a global remit and responsibility so having heard these comments from some of the regional players, what does the world look like from a much bigger picture perspective?

Maarten Terlouw: Business will always be cyclical. Seeing the opportunity is one thing but extracting value is a very different ballgame. On balance, although I'm paid to be pessimistic, I am quite optimistic. The years of the commodity boom and big oil are now being tested and probably also being found to be untrue. So much excess capacity has been created by irrational investment working with $100 oil budgets and all the characteristics that go into that. That bubble has completely gone down now.

Longer term, I'm not so negative on the oil industry. Oil is depleting quite heavily. Shale is of course there and it will be a swing supply factor out of the U.S. OPEC is less meaningful. If you just look at supply-demand, you see demand being much more resilient than people expected. India has been an unknown factor, but it's now driving demand strongly.

We believe that the world and producing nations need a break even rate of $70/bl and that this needs to be achieved within 24 months.

Shipping is also a good bellwether to what's going on. Dry ports have had their worst crises recently but now you see rate fixes recovering out of China; you see real fixtures much higher than the benchmark and that's positive as there's a lot of supply taken out of the market.

I do see a lot of challenges but for example at ABN AMRO, we have grown our business four times over the last three or four years, and we're probably going to double it in the next five years. But you need to be very careful. Our philosophy is to stay very close to your clients as they know the market better than everyone else.

Sean Evers: Will we see less volatility?

Maarten Terlouw: We will see more 'normal' and modest growth. But until we have solved the banking crisis, we will see a lot of volatility. We need to solve the negative interest rates in Europe and Japan – get them out of the system. ■