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Gulf Investment Companies Face The Need To Rethink Their Business Models And Financial Policies

Primary Credit Analyst:
Mohamed Damak, Paris (33) 1-4420-7322; mohamed_damak@standardandpoors.com

Secondary Credit Analyst:
Peter Kernan, London (44) 20-7176-3618; peter_kernan@standardandpoors.com

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Gulf investment companies, including those with banking licenses and private equity firms, navigated through testing times in 2009, some more successfully and some less. A few defaulted on their financial obligations. And their moves to raise capital met with far higher obstacles than in the past. This has consequently called into question the sustainability of their business models. Standard & Poor's Ratings Services is of the view that some of these companies, many of which were created in the past decade, will likely find it difficult to pursue their operations without dramatic changes in the wake of the global financial downturn and its implications for Gulf Cooperation Council (GCC) countries.

The main reasons behind this deterioration, in our opinion, are investment companies' generally high maturity mismatches they carry in their funding profiles and the ensuing weakened liquidity, weak business profiles, high leverage, and high exposure to real estate for some of them.

We believe that the GCC countries will continue to be net exporters of capital in the medium term, thanks to high oil prices that prevailed over the past five years and that we expect will likely remain high in the future. A substantial portion of this oil money will likely continue to find its way to local, government-sponsored projects and to global investment banks offering solutions for wealth management; we think the remainder will likely still flow to smaller investment companies in the Gulf.

But in the short term, we see some major hurdles for Gulf investment companies to overcome on the potential road to recovery. These consist essentially in corrective measures that are, in our view, necessary to enable these companies to enhance the maturity profiles of their funding bases and reduce their leverage, as a means to prepare for better days.

Although Potentially Risky, Business Profiles Are Not The Real Root Of The Problem

Standard & Poor's rates or has rated four investment companies in the Gulf: Gulf Finance House (GFH; CCC-/Negative/C) and Arcapita Bank (not rated), both Islamic investment companies; and Investcorp Bank B.S.C. (not rated) and Global Investment House KSCC (GIH; not rated), which are conventional companies. While we believe that this group is small, we are of the view that it provides a good illustration of the recent developments that took place in the sector.

Over the 2005-2007 period, these companies consistently delivered good profits, given the benign economic environment and investors' strong appetite for their asset class offerings. We note, however, that the business profiles of these companies are inherently risky. They are typically active in one or more of four main business lines:

- Private equity in emerging and developed markets (Arcapita).
- Infrastructure project sponsoring (GFH).
- Fund management and creation (GIH).

- More diversified investment banking activities including proprietary investment in alternative asset classes (Investcorp).

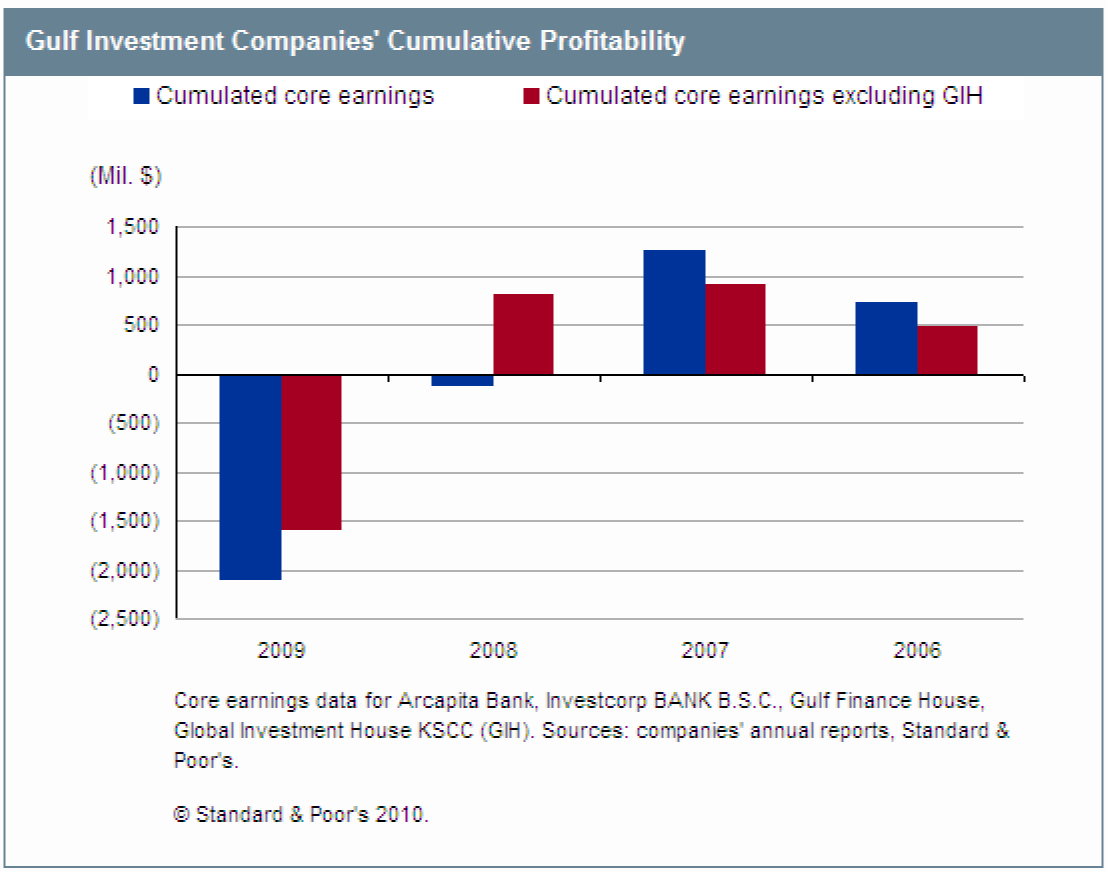
These activities by their nature are vulnerable to depressed economic conditions. Consequently, we factored into our ratings our view that these companies' capability to withstand unexpected shocks was not as strong as their profitability numbers suggested. We took various downward rating actions on these companies in the aftermath of the shift in their operating environment. In addition, GIH and GFH defaulted on or restructured some of their financial obligations.

Nonrecurring placement and exit fees made up a large portion of these companies' revenues and depended on:

- The companies' ability to launch and exit projects; and
- Investors' appetite to invest in these projects or asset classes.

When the financial turmoil started, these two income sources vanished, pulling down Gulf investment companies' profitability (see chart 1). Their ability to create new revenue-generating opportunities swiftly declined, because of the adverse affects on numerous asset classes and the ensuing absence of appetite from investors, who adopted a wait-and-see approach, focusing mainly on lower risk investments.

Chart 1



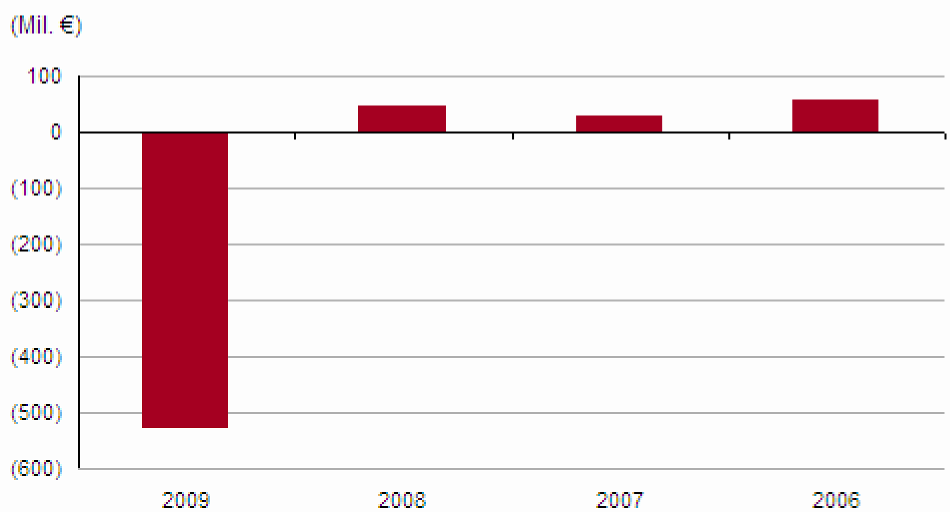
Apart from the unfavorable repercussions we've seen on banks' and companies' profitability around the world, the financial crisis triggered a large loss in investor confidence in international markets, taking a toll on the valuations of various unrelated asset classes at the same time. The valuations of not only structured products but also those of equities and private equity tumbled. We have since witnessed the ill effects on financial institutions in Western European and, in some instances, in the Gulf.

Turning back to investment companies, the valuations some of them used were somewhat excessive, in our opinion, which in turn led us to believe that some provisioning or impairment needs would emerge. The losses reported by some investment companies in 2009 effectively stemmed from provisions and impairment charges linked to falling asset values, and these are likely to continue, in our view, in the absence of any near-term recovery.

The drop in revaluation reserves of Gulf investment companies in the past 12 months illustrates this point (see chart 2). But we note that these reserves tell only part of the story because they relate to investments accounted as available for sale. For investments accounted either as "held for trading" or "at fair value through profit and loss," changes in fair value generally appear on the income statement and contribute to explaining the rapid decline in companies' bottom-line results. In light of investment companies' sizable stocks of negative revaluation reserves and their somewhat aggressive valuations in the past, Standard & Poor's expects to see some impairment charges in the next few quarters.

Chart 2

Gulf Investment Companies' Cumulative Revaluation Reserves



Data for Arcapita Bank, Investcorp Bank B.S.C., Gulf Finance House, Global Investment House KSCC. Sources: companies' annual reports, Standard & Poor's.

Funding Profiles Are What's Creating Vulnerability To Market Ups And Downs

Gulf investment companies typically carry a high proportion of short-term wholesale funding and also run sizable maturity mismatches. Raising long-term funding is, in our view, consequently key for these companies. It enables them to reduce mismatches and operate in an environment where access to wholesale funding sources is difficult. This is all the more important because Gulf investment companies tend to carry a large portion of illiquid assets on their balance sheets.

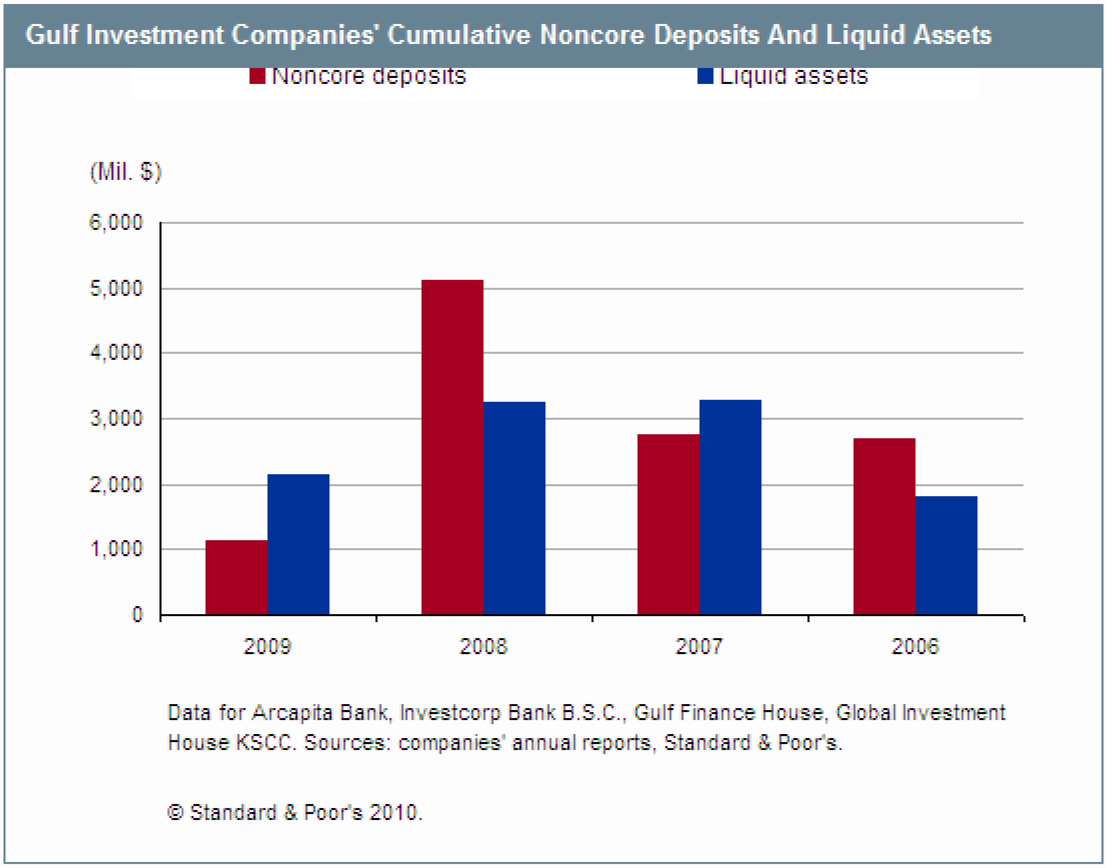
The maturity mismatches that investment companies run are like those of their commercial banking counterparts. But we emphasize that investment companies and commercial banks differ:

- Investment companies generally do not benefit from any external support when liquidity is lacking. In addition, regulators generally forbid investment companies from accessing retail deposits; and
- Commercial banks, especially systemically important ones, tend to benefit from government and regulatory measures to soften liquidity pressures as they emerge. For instance, authorities in the United Arab Emirates intervened on several occasions to ease the squeeze on banks' liquidity.

We note that Gulf investment companies have so far carried large concentrations in short-term wholesale funding sources (mainly short-term interbank deposits). For the purposes of this analysis, we have assumed that the majority of these companies' interbank deposits are short term in nature (defined as less than one year). Generally speaking, this is effectively the case, and often, maturities are even shorter.

With the onset of the financial market downturn, European and U.S. banks' appetites for placing funds with investment companies started to decline, in some cases quite markedly. Similarly, GCC commercial banks gradually began to withdraw their funds from the region's investment companies. As a result, the liquid assets sitting on companies' balance sheets quickly started to erode (see chart 3).

Chart 3



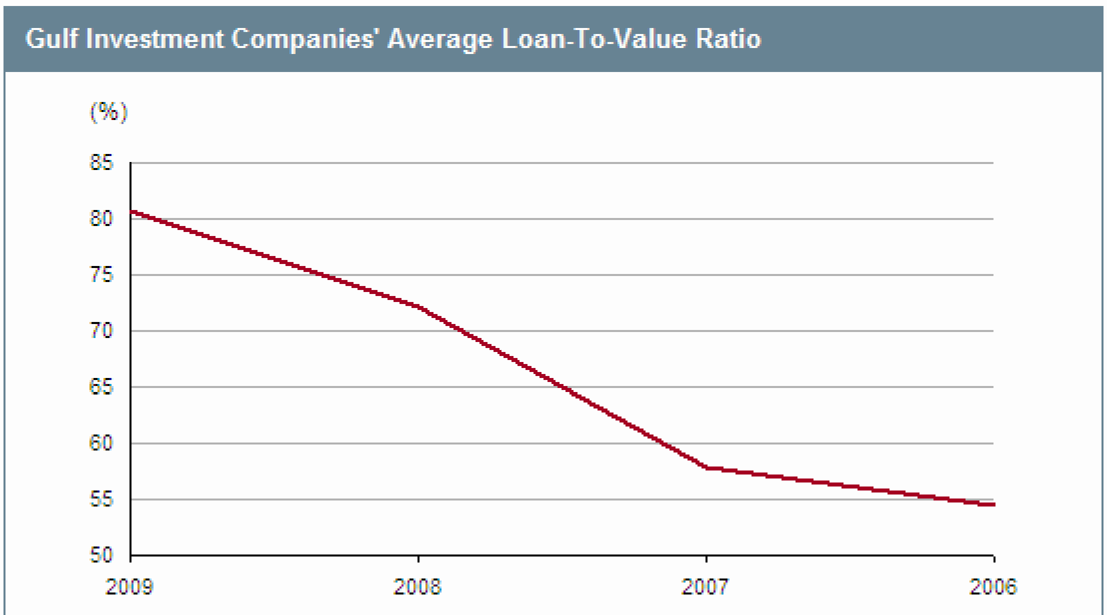
Investment companies have, in recent quarters, implemented various measures to improve their funding profiles, however, including:

- Renegotiating original terms and conditions of their interbank deposits and other liabilities, focusing especially on maturities, in order to convince banks to roll-over funds when they become due;
- Requesting capital injections from their shareholders, despite uncertainties surrounding the sustainability of these companies' business models; and
- Divesting massively from certain asset classes (even at a loss), in some cases, in order to unlock liquidity and be able to face debt maturities as the come due. At the same time, though, some companies have held onto their assets because of the sharp decline in their valuations.

High Leverage Is Not Helping

In our view, investment companies in the Gulf tend to be highly leveraged compared with their counterparts in other parts of the world. Standard & Poor's estimates companies' leverage using a loan-to-value (LTV) ratio. Based on company reports, we calculate our LTV ratio by dividing an investment company's net debt by the estimated value of the investment portfolio. In some cases, particularly when we believe that the value of the investment portfolio is inflated, we factor in our own assumptions or haircuts. For this article, we have included, as reported on companies' balance sheets, all debt--meaning interbank deposits, customer deposits, long-term debt, and sukuk issuance--and all the investment or the potentially liquefiable assets, comprising investment portfolios, stakes in equity associates, and loan portfolios to investee companies. The ratio of average net debt to the investment portfolio for the investment companies that we focus on in this article has increased substantially in the past 12 months, as have the fall in their investment portfolios' value and their usage of liquidity either to launch new investments or to finance activity costs (see chart 4). For some of these companies, our calculation doesn't take into account the corrective measures that the respective managements implemented since fiscal 2009 year ends (June 30 for some companies and Dec. 31 for other), such as selling assets or raising additional equity as the effects of these steps will likely become visible only during the quarters to come. Our LTV ratios for these investment companies are markedly higher than those for rated peers in emerging markets or in some developed markets.

Chart 4



Data for Arcapita Bank, Investcorp Bank B.S.C., Gulf Finance House, Global Investment House KSCC. Sources: companies' annual reports, Standard & Poor's.

This Could Be Where The Story Ends, For Now

Standard & Poor's believes that the Gulf will continue to be a net exporter of capital and that some of the wealth accumulated or to be created will still flow through the region's investment companies. But in our opinion taking measures to rebalance funding composition, leading to educed short-term maturity gaps, is important for sustaining credit quality. And sizable capital infusions to reduce these companies' leverage and increase their ability to absorb future losses will, in our opinion, be critical for their development.

Table 1

Gulf Investment Companies: Standard & Poor's Rating History

	Rating action			
Investment Company	**To**	**From**	**Date**	**Rationale**
Arcapita Bank	BBB/Negative/A-2	BBB/Stable/A-2	Dec. 10, 2008	The rating action reflects our expectation that the difficult environment--limiting investment exits and placements--will linger through 2009, and our concerns about the bank's liquidity profile and the value of its investments.
	BB+/Watch Neg/B	BBB/Negative/A-2	Jan. 28, 2009	The downgrade and CreditWatch placement reflect our opinion of Arcapita's weakened liquidity profile amid an increasingly difficult operating environment.
	BB/Watch Neg/B	BB+/Watch Neg/B	April 6, 2009	The rating action reflects the very weak investment climate, which has challenged Arcapita's business model and has decreased the value of its assets in Standard & Poor's view. In this light, we believe Arcapita's leverage indicators have weakened, which has pressured its credit profile.
	BB-/Negative/B	BB/Watch Neg/B	June 1, 2009	The rating action reflects our opinion of Arcapita's high leverage in the context of a very difficult economic and investment climate, which has challenged Arcapita's business model, reduced the value of its assets, and put pressure on its financial performance.
	NR	BB-/Negative/B	June 30, 2009	The ratings affirmation reflects our conclusions that the assumptions factored into the ratings are still holding up. The ratings withdrawal is subsequent to the issuer's request and means that Standard & Poor's will no longer carry out surveillance on the bank. At the time of withdrawal, the bank had no rated debt outstanding.
Gulf Finance House	BBB-/Negative/A-3	BBB-/Stable/A-3	Jan. 26, 2009	The outlook revision reflects the increasingly difficult environment in which the bank operates, which is likely to limit its capacity to execute new transactions and therefore lead to a weaker financial performance.
	BB+/Negative/B	BBB-/Negative/A-3	Nov. 26, 2009	The rating action reflects our opinion that GFH's stand-alone credit profile (SACP) is no longer consistent with an investment-grade rating owing to uncertainties on the bank's implementation of its revised business model and delivery of sustainable profitability.
	B+/Watch Neg/B	BB+/Negative/B	Jan. 14, 2010	The rating action reflects our more negative assessment of the bank's funding and liquidity position as well as its ability to implement its revised business model to boost revenues.
	CC/Negative/C	B+/Watch Neg/B	Feb. 2, 2010	The downgrade and negative outlook reflect our view of GFH's very weak liquidity position because of the bank's inability so far to put into place measures to strengthen liquidity.
	SD/--/SD	CC/Negative/C	Feb. 10, 2010	The downgrade to 'SD/SD' follows GFH's completion of the extension of maturity of $100 million of its $300 million syndicated loan facility due on Feb. 10, 2010.
	CCC-/Negative/C	SD/--/SD	March 3, 2010	The rating action follows GFH's completion of the partial extension of maturity of a $100 million facility. The first tranche of this facility was a $50 million payment due March 3, 2010, with the remainder due on March 3, 2011.
Investcorp Bank B.S.C.	BBB/Watch Neg/A-2	BBB/Stable/A-2	Nov. 21, 2008	Standard & Poor's placed its 'BBB/A-2' counterparty credit ratings on Investcorp Bank B.S.C. and Investcorp S.A. on CreditWatch with negative implications. This is in response to our concerns of growing financial pressures in the current turbulent environment.

Table 1

Gulf Investment Companies: Standard & Poor's Rating History (cont.)				
	BB+/Watch Neg/B	BBB/Watch Neg/A-2	Jan. 28, 2009	The two-notch downgrade reflects our view of the increasingly difficult operating environment for Investcorp's principal business lines of hedge fund investing, private equity, and real estate. We understand that Investcorp is in the process of significant deleveraging, and we view this and the relatively conservative approach to originating deals in 2008 as positive for creditworthiness. However, in our view, global deleveraging, falling equity and real estate prices, and tight credit are combining to lower the value of Investcorp's proprietary investments, strain funding and liquidity, and reduce capitalization. Moreover, the prospects for higher quality fee income from the core asset management businesses are likely to be constrained by broader weaknesses in economies and financial markets alike, and we expect this to reduce Investcorp's interest service metrics.
	NR	BB+/Watch Neg/B	Jan. 28, 2009	Standard & Poor's withdrew the ratings on the company's request.
Global Investment House KSCC	SD/--/SD	BBB/Stable/A-3	Dec. 17, 2008	The rating action follows GIH's nonpayment of a $200 million syndicated loan due on Dec. 15, 2008. GIH has been unable to fulfill its obligations toward its creditors and has extended the maturity of the loan by one week to Dec. 22, 2008. Under our methodology, we classify this as a distressed exchange offer and have therefore downgraded GIH to 'SD'.

NR--Not rated. SD--Selective default.

Related Criteria And Research

- Rating Methodology For European Investment Holding And Operating Holding Companies, May 28, 2004
- Industry Report Card: The Economic Slowdown Reveals A Growing Divergence In Credit Quality Among Gulf Banks, Feb. 22, 2010

Additional Contact:
Financial Institutions Ratings Europe; FIG_Europe@standardandpoors.com