KAMCO INVEST

Investment Strategy & Research

GCC Real Estate Update Mar-2022

Divergent cap rate narratives in 2022

Report Highlights:

This report analyzes GCC real estate fundamentals in 2021. We analyze demand-supply drivers and examine trends in transactions, prices and rents that drive the outlook for real estate in the region in 2022 and beyond. Segments covered in the report include:

- *Residential RE*
- *Commercial Office RE*
- *Retail RE*
- *Industrial RE*
- *GCC RE Equities*

Access previous reports:

- *Pinning hopes on a 'Resi'lient recovery - Aug 2021*
- *Cyclical or Structural Conundrum – Dec 2020*
- *Déjà vu or Different this time? – May 2020*

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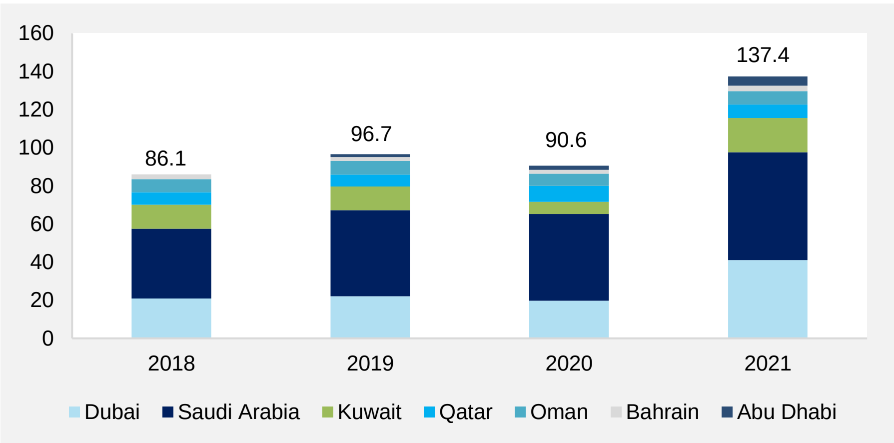
Nuanced cap rate moves within the GCC RE segments: Corporate occupier sub-segments in the GCC real estate market are expected to have idiosyncratic journeys of recovery in 2022. In the office space market, we believe that 2022 will be the new base year for demand going forward, ascribed to all the new sources of demand (TMT, Healthcare, Legal). Additionally, occupiers are more preferring sustainable built environments, and solidifying their on-premise + flexible/remote working strategies. In the industrial warehouse segment, leasing has turned into a two-tiered market as secondary assets are facing significant challenges in keeping occupancy rates and stable rents. Contrary to the office space segment, we believe retail real estate demand would continue to evolve beyond 2022. Retail developers are expected to revisit their floor plans for upcoming projects to combine social experiences encompassing retail, F&B and entertainment to stay ahead of competition. In terms of the impact of potential rate hikes, we expect cap rates to expand partially with a lag, as net operating incomes (NOIs) should partially track inflation depending on demand fundamentals, especially in the stronger sub-segments of prime residential and institutional grade industrial warehouses.

GCC RE transactions grow by almost 52% y-o-y in 2021; Residential outlook more balanced in 2022: Real estate value transacted in 2021 reached USD 137.4 Bn, eclipsing full year figures of 2020 (USD 90.5 Bn), and 2019 (USD 96.7 Bn) respectively, based on our analysis of official estimates. Saudi contributed to over 41% of the aggregate value transacted, while UAE (Dubai and Abu Dhabi combined) added 33.4% to the region's transactions in 2021. The higher transaction activity y-o-y in 2021 was largely due to opportunistic buying, mortgage investors who were keen to capture lower mortgage rates, and government-led home ownership and mortgage initiatives. For the residential market in 2022, opportunistic buying is likely to be slower, as investors are likely to monitor decisions around interest rates, and look at the trajectory of stabilized NOI growth and steady-state cap rates. However, over the medium term, segment fundamentals should be supported by government initiatives like visa programs, while the mortgage market develops further to improve home ownership.

EPS upgrades required for further re-rating in RE equities: The Refinitiv GCC Real Estate Total Return Index gained by 20.2%, but underperformed MSCI GCC index (+34.9%) in 2021. Gains in the Refinitiv GCC Real Estate Total Return Index were muted in H2-2021 at 1.3%, as the sector was already pricing in a structural rebound by H1-2021. We reiterate that fundamental KPIs of real estate sub-segments remain in different stages of recovery and would need significant growth from here on in to warrant a further rerating in related stock prices in 2022. Having said that, specific equity stories will continue to outperform broader indices, owing to announcement of higher IRR landmark projects, earnings accretive M&A activity geographically, through forays or additional exposure to more stable segments such as residential, and portfolio investments into PropTech and Property Management companies.

GCC RE Transactions Breakdown – USD Bn

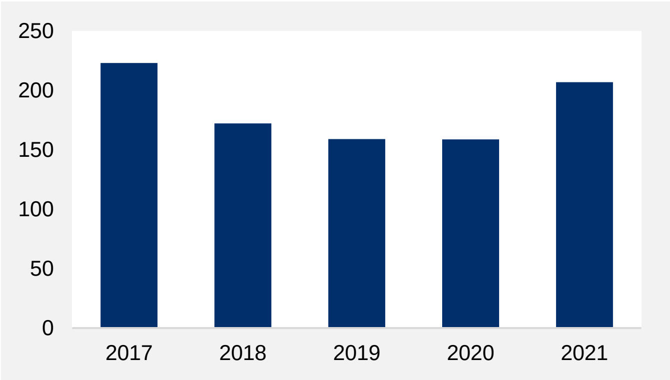


Source: Kamco Invest Research, Govt Sources

RE transactions witness a standout year in 2021

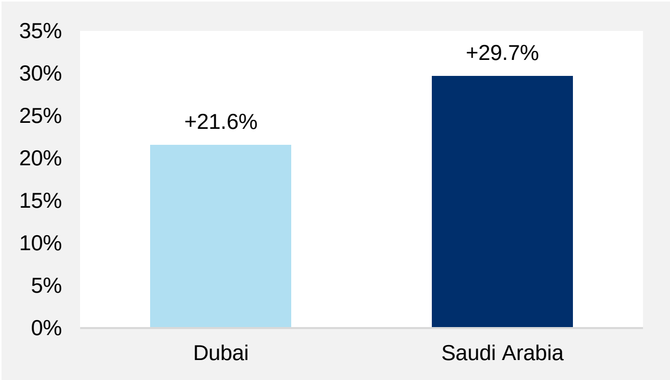
Real estate value transacted from the GCC in 2021 (USD 137.4 Bn) was 42% higher than the full year figure of a normalized 2019 (USD 96.7 Bn), driven by strong transactions growth in Dubai (+86%), Kuwait (+47%) and Saudi Arabia (+25%). The number of transactions in 2021 reached 663,323 from 570,080 in 2020. Saudi led all markets in terms of transactions and contributed to over 41% of the aggregate value transacted, while adding 46% to the region's 2021 transaction volumes. Dubai sales transactions (AED 150 Bn) witnessed higher growth as compared to the previous two years as higher transaction activity was largely due to opportunistic buying in the residential segment. This benefitted the villa and townhouse segment and was also aided by mortgage investors who were keen to capture lower mortgage rates, as discussions over the impact of potential rate hikes on loan rates continued to emerge.

GCC average value per transaction



Sources: DLD, Kamco Invest Research

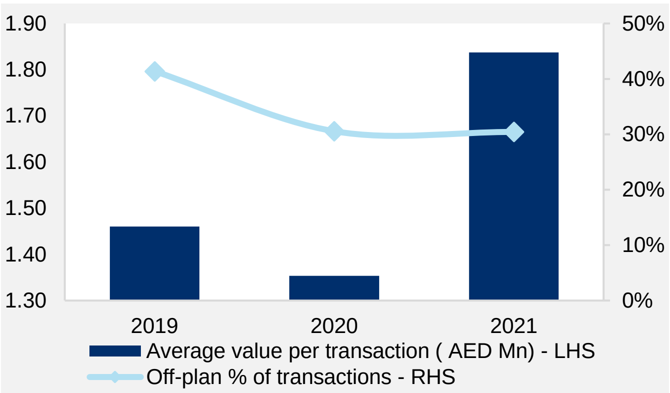
Average value per transaction in 2021 vs 2019 lows



Sources: MOJ, Kamco Invest Research

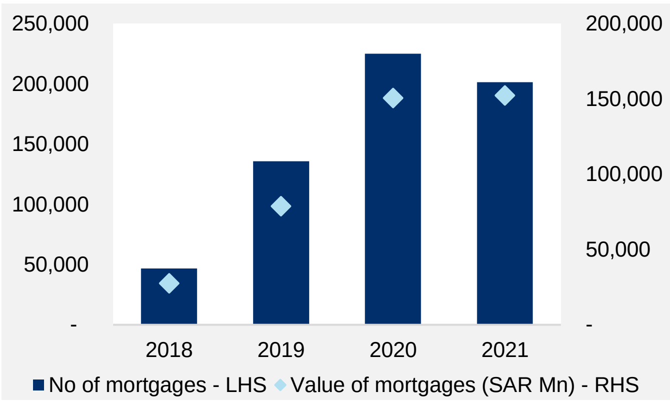
The average value per transaction in GCC bottomed out in 2021 (USD 207,000) and was only 7.1% lower than the 2017 average. Markets such as Saudi Arabia (+29.7%) and Dubai (+21.6%) witnessed significantly higher average transaction values, pointing towards investment appetite for attractively price real estate. The real estate transactions market in Dubai was particularly active in 2021, as transactions levels reportedly surpassed levels last seen in 2014, while the third highest transaction volumes in history were recorded, as per Property Monitor. Value transacted in Saudi Arabia and Dubai combined reached USD 97.6 Bn in 2021, and surpassed full year figures of the entire GCC from 2019. In Dubai, lower available inventory and more attractive prices pushed investors towards off-plan project launches from developers after a slow 2020 (AED 22 Bn), as off-plan transactions clocked over AED 45 Bn in 2021.

Dubai off-plan sales trends



Sources: DLD, Kamco Invest Research

Saudi residential new mortgages from banks



Sources: SAMA, Kamco Invest Research

Recovery in Saudi Arabia's real estate prices was driven by government support mainly, in the form of mortgage financing and housing initiatives such as the Sakani program from the Real Estate

Development Fund (REDF) that support the Vision 2030 objective of increasing the home ownership rate to 70% by 2030. This was also evident from the value of new residential mortgages in 2021 (SAR 152.4 Bn) which was higher than aggregate mortgage value of 2020 (SAR 150.8 Bn).

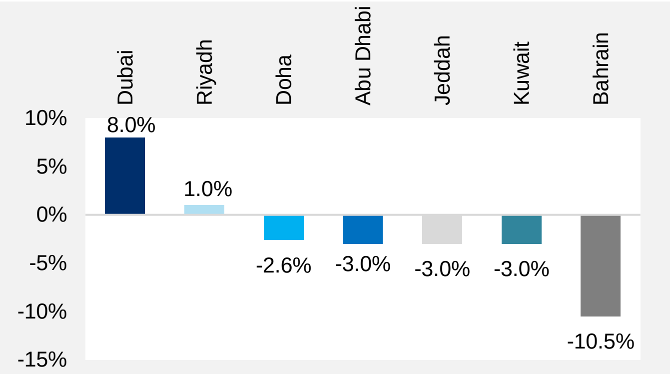
Expect divergent and nuanced cap rate narratives in 2022

For 2022, the discussion behind expansion of real estate cap rates in the GCC, amidst the backdrop of interest rate hikes, is more nuanced in our view, across sub-segments and type of property. Consensus economists estimate multiple rate hikes, ranging 5-6 hikes of atleast 25bps each by the Fed, which would impact lending rates in the GCC. Nevertheless, we expect cap rates to expand only partially, and with a lag as witnessed in previous cycles, as net operating incomes (NOIs) should atleast partially track inflation and demand fundamentals, especially in the stronger sub-segments of prime residential real estate and the institutional grade industrial real estate market. The cap rate-borrowing spread is also likely to be of interest to end users as lower spreads likely to move more buyers into renters of spaces, and remain asset light.

Further stabilization in Resi; rental yields to flatten

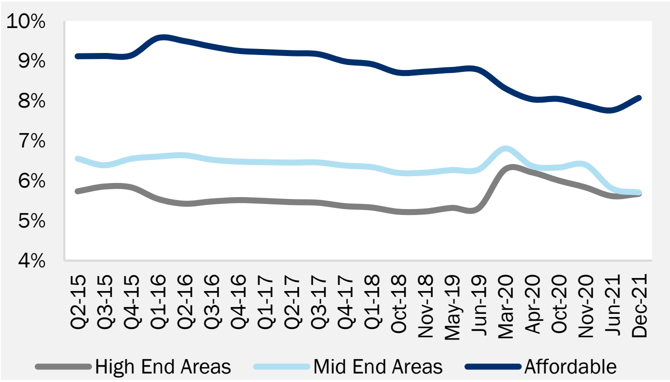
In our previous update *GCC RE Update: Pinning hopes on a 'Resi'lient recovery - Aug 2021*, we highlighted that our view on the residential real estate in the GCC has turned more constructive, as the recovery theme plays out. After bottoming out from the impact of Covid-19 led lows of 2020, prices and investor sentiment gained momentum in 2021 as opportunistic investors into residential real estate remained buyers throughout the year. As a result, prices across larger markets grew by atleast high single digits in percentage terms, with Dubai witnessing y-o-y increases of around 17% y-o-y, as per Property Monitor. The opportunistic buying benefitted the villa and townhouse segment and was also aided by mortgage investors who were keen to capture lower mortgage rates, as discussions over the impact of potential rate hikes on loan rates continued to increase. In the apartment segment, residential yields in Dubai compressed over 2021, as a result of higher prices, by around 15bps-70bps across apartment types. Prices in Riyadh and Jeddah also rose by 6% y-o-y in each of the markets as per JLL, as housing initiatives such as the Sakani program from the Real Estate Development Fund (REDF) and Ministry of Housing aided home ownership demand in Saudi Arabia.

Residential rents performance: 2021 (y-o-y%)



Source: Kamco Invest Research, ValuStrat, REMI, JLL

Dubai apartment yields performance



Source: Property Monitor, Kamco Invest Research

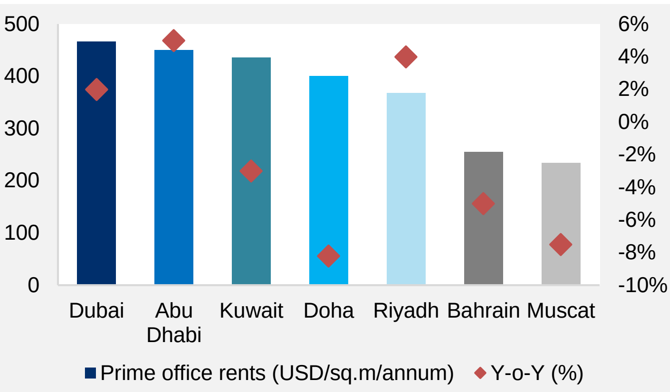
Rents recovered significantly across markets from our previous update as Doha, Abu Dhabi, Kuwait and Jeddah witnessed y-o-y declines of only 2%-3% in 2021, while y-o-y declines in H1-2021 were in mid-high single digit and double-digit percentages. Further, average rents in Dubai grew by 8% y-o-y as per JLL, which in our view reflects early-stage growth in the rental cycle, as the UAE market continued to remain tenant friendly, and as owners were pushed to lower rents and provide flexible payments through multiple cheques.

For 2022, our view on the residential real estate market is more balanced, as the bulk of the cyclical recovery is now behind us. We still require rents to move towards a late-stage recovery phase in the cycle. The more affordable segment of the residential rental market is expected to continue to see tenant migration, as supply increases which should prevent large rental increases, in our view. In terms of prices, growth is likely to be more muted than in 2021, as more inventory from developer supply pipelines emerge, and significant price rises are likely to be limited to the top-end of the market for prime and luxury properties. Moreover, opportunistic buying from investors is likely to be slower, as investors are likely to monitor decisions around interest rates, and look at trajectory of stabilized NOI growth and steady state cap rates. However, over the medium term, segment fundamentals should be supported by government initiatives like visa programs and ongoing initiatives and developments in the mortgage market to improve home ownership. Initiatives such as the golden and retirement visas, Dubai's plan to grow its population to 5.8 million by 2040 (Dubai 2040 Urban Master Plan - April 2021), and the Saudi government's vision to turn Riyadh into a global business hub should create additional demand for residential segment going forward.

Office market recalibrates to new base in 2022

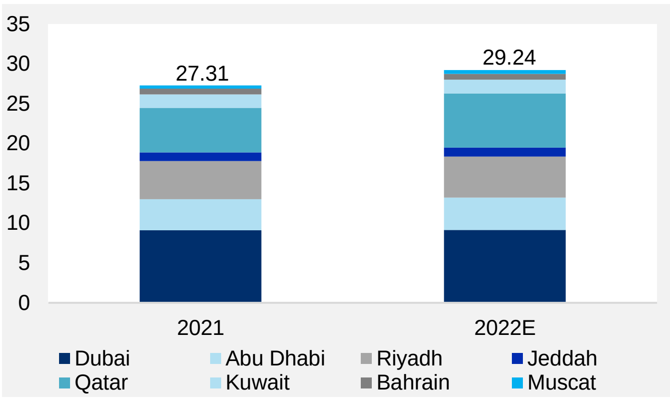
Office spaces witnessed the largest disruption in terms of demand in 2021 from the impact of covid-19, which led to growth in remote working and work from home (WFH) models being introduced. Moreover, newer sources of demand emerged like Technology, Media & Telecom (TMT), Healthcare/Pharma, Legal and occupiers preferring more sustainable built environments. This led office operators to optimize their office space portfolios between traditional and flexible spaces. Others had to repurpose certain spaces to accommodate demand from alternate sources such as data centers. While multiple idiosyncratic factors affected each office market in the GCC, average rents in Dubai (+2%), Abu Dhabi (+5%), and Riyadh (+4.0%) increased y-o-y in 2021, as per consultant data. Kuwait witnessed stability in rents y-o-y for quality Grade-A office spaces which ranged between KWD 9-11/sq.m/month, as supply additions for the top end of the office market remains limited, while secondary spaces did witness downward pressure on rents. The availability of limited quality stock of office spaces remains the key driver for the stability and growth in rents of such spaces. As per JLL, grade-A office spaces in Riyadh are experiencing the conversion of latent demand for take-up driven by international firms taking up spaces. This is partially due to a government mandate requiring foreign firms to establish their regional headquarters within Saudi Arabia, in order to enable them to participate for government contracts, according to JLL.

GCC prime office rents & y-o-y declines: 2021 (%)



Source: Kamco Invest Research, Knight Frank, JLL, Savills, REMI, ValuStrat

GCC key office markets office supply (Mn sq.m)



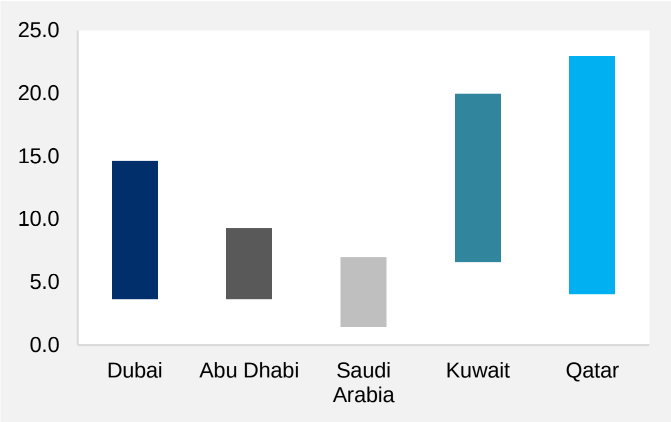
Source: JLL, Valustrat, REMI, Savills, Kamco Invest Research

Supply additions are expected to calibrate in 2022 in most GCC office space markets in our view, depending on fundamental demand factors. Aggregate office space in GCC's key markets is expected to grow to 29.24 Mn sq.m from 27.31 Mn sq.m, as per consultant data. These estimates could see downward revisions in our view, in lieu of the type of product that tenants are now looking for, and due to the rise in flexible space options such as serviced business centers. Across all markets, occupiers continue to express interest in good quality fitted office space in order to remain flexible for upgrades, and due to capital expenditure. Going forward, rents for Grade-A office spaces are likely to remain stable and turnover vacancies in such spaces will be taken up quickly, while the ongoing transformation of new space requirements, and tenants seeking upgrades to their existing spaces would keep the overall market tenant friendly. Moreover, ascribed to all the moving parts with the earlier mentioned new sources of demand, and corporates solidifying on their on-premise + flexible/remote working strategies, we believe that 2022 will be the new year base year for the office real estate demand going forward.

Industrial RE moves to a two-tiered market

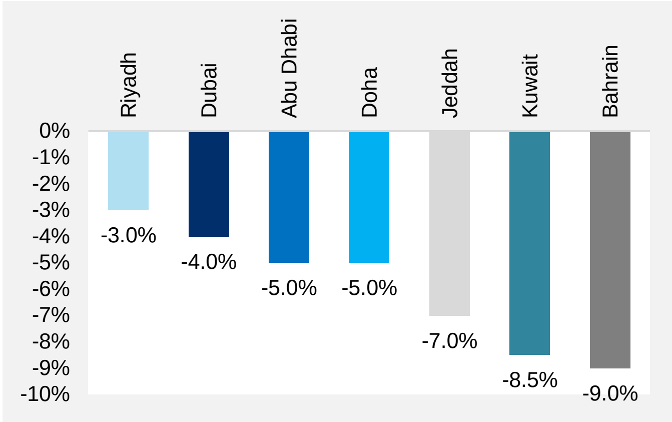
As outlined in our previous update report, the structural and cyclical trends favoring industrial warehouse demand for spaces tailored towards unique storage needs, normalized in 2021, after witnessing strong trends in 2020. Moreover, leasing has turn into a two-tiered market, as secondary and lower quality assets that are not refurbished adequately are facing significant challenges in keeping occupancy rates and rents stable. The two-tiered market is also visible from the widening range of rents between quality spaces and secondary spaces in 2021, as poorer quality stock has witnessed double-digit declines during the year.

GCC industrial warehouse rents (USD/sq.m/month)



Source: Valustrat, REMI, Kamco Invest Research

GCC retail space rents performance – 2021 (y-o-y%)



Source: JLL, Valustrat, REMI, Kamco Invest Research

Going forward industrial demand emanating from e-commerce, 3PL, pharma, and FMCG especially from large hypermarkets will continue for automated build-to-suit, temperature-controlled and chilled centers. Stabilized demand trends should also be witnessed from conventional sources of industrial warehouse demand such as construction and industrial materials, high value items such as cars, white goods etc, as economies look to operate in a normalized economic environment. While, we expect competition to remain, limited supply of institutional grade industrial warehouses with modern logistics facilities such as ample office space parking will keep demand for such spaces strong. The competition and aspirations of regional ports to become global multimodal transports and national initiatives like Saudi Arabia's National Industrial Development and Logistics Program, UAE's Operation 300bn, should support the industrial real estate segment.

Retail's floor plan & tenant mix optimization continues

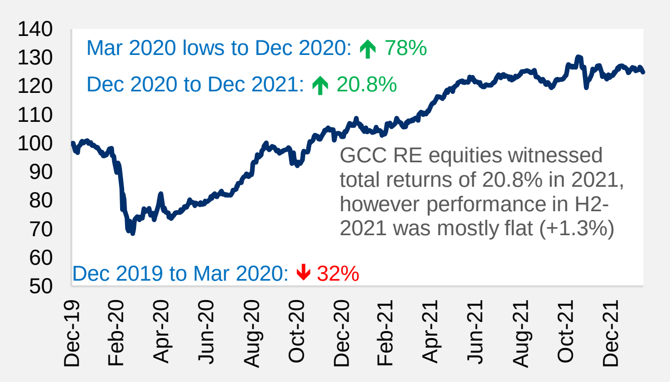
Retail rents in the GCC corrected between 3%-9% y-o-y across various markets at the 2021, as per consultant data. Retailers persisted with negotiations over restructuring tenancy deals, bargaining for additional rent-free periods. Consumer spending habits continued to change through the year, and retailers drove expansion plans via omnichannel strategies such Click & Collect to maintain profitability and market share.

While retailers would prefer floor plans more suitable for their profitability matrix such as sales/sq.ft and sales conversion rates etc, mall developers are likely to still look at large format malls to combine social experiences encompassing retail, F&B and entertainment. This is evident in Riyadh as there were almost no supply of the true super regional mall format, (Urban Land Institute & JLL define super regional malls with GLA >90,000 sq.m). This backdrop is set to change with the launch of Mabanee's Avenues Riyadh and Mall of Saudi by Majid Al Futtaim, both super regional malls with GLAs of 390k sq.m and 296k sq.m respectively. Both malls are expected to add significant scale of new international retail brands, luxury retail and entertainment experiences, leveraging on their best-in-class experience as mall operators, elsewhere in the GCC region. Macro catalysts support the launch of such large-format malls, as Saudi Arabia aims to reportedly increase the number of residents in Riyadh from 7.5 Mn in 2021 to 15-20 Mn in 2030, and establishing Riyadh as the regional headquarters for multinational companies. Contrary to the office space segment, we believe retail real estate demand and footfalls into mall spaces would continue to evolve beyond 2022, pushing developers to revisit their floor plans for upcoming projects, to stay ahead of competition.

EPS upgrades required for further re-rating in equities

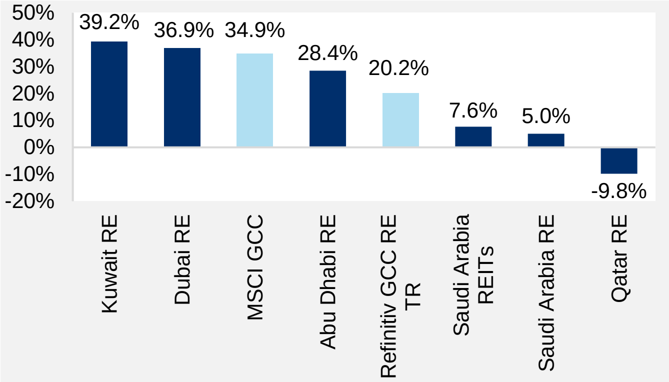
Real estate equity indices from all GCC markets barring Qatar witnessed gains in 2021, in line with broader indices. The Refinitiv GCC Real Estate Total Return Index gained by 20.2%, but underperformed MSCI GCC index (+34.9%) over the same period, mainly due to lower gains from Saudi RE developers and Saudi REITs. Gains in the Refinitiv GCC Real Estate Total Return Index were muted in H2-2021 at 1.3%, as the Saudi Arabian RE developers' index and REITs witnessed declines of 12% and 9% respectively over the period. Kuwait (+39.2%), Dubai (36.9%) and Abu Dhabi (+28.4%) were top performers, while Qatar declined by 9.8% YTD.

Refinitiv GCC Real Estate Total Return Index



Sources: Kamco Invest Research, Refinitiv

GCC RE equity indices – 2021 returns (%)



Sources: Kamco Invest Research, Bloomberg, Refinitiv

While the recovery and gains from certain regional real estate indices in 2021 comes after declines in 2020, we continue to believe that GCC RE equities are now pricing in a structural rebound, beyond a cyclical recovery from Covid-19. We also reiterate that fundamental KPIs of real estate sub-segments remain in different stages of recovery and would need significant growth from here on in to warrant a further rerating in the stock prices of developers and REITs in 2022, in our view. Having said that, specific equity stories will continue to outperform broader indices owing to announcement of higher IRR landmark projects, earnings accretive M&A activity geographically, through forays or additional exposure to more stable segments such as residential, and portfolio investments into PropTech and Property Management companies.

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