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Key Investment Themes in UAE Real Estate & Real Estate Finance Markets

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The end of 2017 proved to be very busy in UAE real estate and real estate finance markets. Here we put the spotlight on 3 key investment themes that characterised those markets in 2017. We also look forward to some of the trends and patterns that we anticipate will emerge in 2018.

Market update: green shoots emerging as we build towards Expo 2020

UAE real estate and real estate finance markets have, on the whole, performed sluggishly over the past 2-3 years. This has been principally attributable to macro-economic headwinds brought about by persistent low oil prices, reduced government spending, job cuts and the strong US dollar (which has made UAE real estate comparatively more expensive for non-US dollar participants). These headwinds have resulted in reduced demand and lower levels of bank liquidity with sale values, rents and transaction volumes decreasing accordingly.

Although core real estate sectors (most notably retail) continued to witness downward pressure into Q4, there is increasing evidence that the market is now starting to bottom-out, particularly in Dubai. The Dubai Land Department (DLD) has published data showing that H1 (2017) transaction levels were up 16.8% year-on-year by value and 25.9% year-on-year by volume. We also saw a marked uptick in investor sentiment at the Cityscape Global event in Dubai in September 2017, where a number of new mega-projects were launched (with District 2020, a master-planned mixed-use development on the Expo 2020 site, perhaps being the most significant of these) and developers reported extremely robust sales activity, particularly in the residential sector (for instance, Azizi Developments reported headline sales of AED 1.3 billion, with Phase 1 of its Riviera Waterfront development in Meydan apparently selling out during the event).

As such, we are seeing green shoots emerging in the market data. We are also now starting to see the first concrete signs of the catalysing effect that Expo 2020 (which is expected to generate up to 300,000 new jobs and 300,000 visitors per day) will have on the UAE real estate sector, as developments such as District 2020 start to come online.

Investment Theme 1: the rise of REITs

A Real Estate Investment Trust (REIT) is, in essence, a vehicle for monetising income-generating real estate assets through collective investment. REITs have arrived in force throughout the GCC in the last 12-18 months. Facilitated by new legislative frameworks in the ADGM, Saudi Arabia and Bahrain (alongside the established REITs regime in the DIFC), we have seen various new REITs launch across the region. White & Case have acted on multiple REIT and real estate fund transactions in 2017, including the IPO of DIFC-domiciled ENBD REIT on Nasdaq Dubai in March. Clients have been particularly interested in the option of establishing a private (i.e. unlisted) REIT in the ADGM (a structure that is not available in the DIFC at present), and we have advised on the proposed formation of a number of such vehicles.

Why REITs, why now?

Historically, the main driver for REITs globally has been tax-efficiency, as these vehicles are generally exempt from income or capital gains taxes. However, this is clearly of less relevance in the UAE and wider GCC context. Rather, it seems that the main driver behind the rise of REITs here has been the liquidity they provide. As mentioned a REIT is, in essence, a vehicle for monetising income-generating real estate assets and, at a time when bank lending has generally been hard to achieve, REITs have provided an attractive alternative source of liquidity to real estate companies through collective investment from both private and institutional capital. From an investor's perspective, REITs are attractive because they offer the opportunity to obtain a liquid exposure to a diversified portfolio of real property assets, at a lower price-point than acquiring the underlying assets. This is done without the need to take on ownership or financing risk, and by way of a security that is readily tradeable on a secondary market. There is also a wider investor confidence point here – REITs are well-known international vehicles that are highly-regulated and subject to stringent corporate governance rules. As such, clients tell us that real estate companies in the GCC believe there is significant merit in the REIT "brand" and the confidence this provides to investors.

Lender considerations

From a lender's perspective, REITs are, on the one hand, a threat, because they offer an alternative source of funding for real estate companies. However, on the other hand, they also represent a significant opportunity. REITs still use leverage (subject to regulatory LTV caps), and, given that they tend to be large borrowers acquiring high-value assets, their effect should be to increase overall demand for bank finance over time. Depending on the assets they hold, it is relatively easy to structure REITs so as to be Sharia compliant, meaning that this positive effect will be felt across both Islamic and conventional lending markets. Furthermore, REITs – being highly-regulated and subject to stringent corporate governance obligations –are generally seen as being good credit.

Looking ahead in 2018

Over the next 12 months, we foresee sustained growth in the REIT sector across the GCC. We expect to see increased specialisation, with new REITs increasingly focusing on the asset classes that predominate here, such as malls, hotels, hospitals, warehousing and logistics. We may also start to see overseas REITs (i.e. a domestic REIT holding overseas assets) enter the market, and we are currently talking to a number of clients about tax and legal structuring options for these.

In the longer term, we foresee that REITs will be positive agents for change in UAE real estate markets, driving up transparency and governance standards, stimulating investment markets, increasing demand for (and thus supply of) Grade A stock, creating new markets for complex structured transactions (like sale-and-leaseback) and, ultimately, paving the way for increased overseas institutional investment into the domestic real estate sector.

Investment Theme 2: increasing prevalence of "structured" real estate transactions

The softening of real estate markets in the UAE in the past 2-3 years has coincided with the increased prevalence of sale-and-leaseback, build-to-suit and other complex and sophisticated real estate transaction structures that are relatively new to the region. As a firm, we were involved with a number of these deals in 2017, particularly in the context of hospitals and shopping malls.

What is a sale-and-leaseback?

In its simplest form, a sale-and-leaseback involves a party selling a property to a buyer, with the buyer simultaneously leasing the property back to the seller on a long-term basis (typically 20 to 30 years). Sale-and-leaseback structures are common globally, particularly in markets such as the UK and the United States, but they have only come to the fore in the UAE over the last couple of years. These structures are most relevant in the context of owner-occupied properties of relatively high capital value. As such, they have historically been used in connection with assets such as hospitals, hotels, shopping malls, supermarkets and schools. However, we are also increasingly seeing them used in the context of alternative asset-classes such as data centres, warehousing and logistics facilities.

From the seller's perspective, a sale-and-leaseback is essentially an alternative financing method, whereby the seller unlocks capital (in the form of real estate assets) from its balance sheet. However, unlike with an outright disposal, the seller remains in occupation of the property and can carry on running its business. From

the buyer's perspective, a sale-and-leaseback involving a long lease to a tenant with a strong covenant is an attractive proposition – the lease delivers a long-term, stable and predictable income return akin to a bond, but typically also with the benefit of regular rent escalation, as well as the potential for capital uplift if the value of the underlying property increases.

What is build-to-suit?

In its simplest form, a build-to-suit transaction involves a developer constructing a building for a designated occupier, to the occupier's specification. Upon practical completion, the building is handed over to the occupier, usually by way of a freehold transfer or the grant of a long lease or usufruct. The model is common globally, and is relevant in any scenario where an occupier requires customised premises that may not be generally available on the open market in the required location. However, whilst the structure has been used in the UAE for some time (mostly due to the historic lack of availability of Grade A stock), like sale-and-leaseback it has only really come to prominence in the last couple of years. Here, we are increasingly seeing it used in the context of hospitals, shopping malls, schools and staff accommodation.

From the occupier's perspective, a build-to-suit structure provides bespoke, customised space without the occupier having to assume development or financing risk. From the developer's perspective, a build-to-suit structure provides certainty – from day one, the occupier is contractually bound to acquire the relevant interest in the property upon practical completion at the pre-agreed price.

Why did these structures rise to prominence in 2017?

These structures are both, in a sense, products of the economic downturn. Sale-and-leaseback is an alternative financing tool which has given owner-occupiers access to a new liquidity pool at a time of generally constrained bank liquidity. Similarly, build-to-suit has been used by occupiers as an alternative way of funding development, by shifting the initial costs and risks onto the developer, at a time when many occupiers have been unwilling or unable to raise development finance and reluctant to assume development risk.

However, as well as being a product of underlying market conditions, it is also the increasing sophistication of investors, developers and other market participants as well as (inextricably linked to this) the increasing maturity and robustness of legal frameworks in the UAE, that is facilitating the growing use of such transaction structures.

Indeed, it is significant that REITs have been one of the main drivers of these transaction structures in the region. For instance, Emirates REIT holds GEMS World Academy Dubai in Al Barsha South under a sale-and-leaseback arrangement with GEMS Education. Similarly, ENBD REIT acquired Uninest Dubailand, a student accommodation development, under a sale-and-leaseback in May 2017, and is also currently developing South View School in Remraan on a build-to-suit basis on behalf of schools operator Interstar Education. In part, this is due to the fact that REITs are, by their nature, sophisticated investors with the bandwidth and ability to engage in these complex transactions. However, the other key driver has been the fact that there is a limited stock of investment assets and a relatively small secondary market in the UAE. This has led to REITs, cleverly, using sale-and-leaseback and build-to-suit structures to "create" income-generating investment assets from scratch.

Looking ahead in 2018

Although these structures have increased in prominence during (and as a result of) the softening of real estate markets in the UAE, it is our view that they are here to stay, and will continue to be used increasingly as markets strengthen through 2018 and beyond. We foresee that this process will be driven by REITs and other sophisticated institutional investors as they increasingly compete for a relatively small pool of investment stock.

Although these structures are simple in concept, in practice they can be complex and intricate, with a host of variances, subtleties and moving parts, and with many legal and commercial issues to be addressed and worked through. For instance, what legal interest (freehold, musataha, leasehold etc.) will the relevant parties have in the asset before and after completion? How and when does title and risk transfer? Do foreign ownership issues apply? What security is being taken over the asset and related contracts? It is of central importance to consult your legal and other advisers at the outset if you intend to partake in these structures.

Investment Theme 3: widening the liquidity pool through combined conventional & Islamic financing structures

A clear outcome from the stretch on liquidity is the alternate ways in which that pool of liquidity is being accessed. Real estate finance deals are now frequently being structured on a combined conventional and Islamic basis. This is to facilitate a wider reach to market participants for syndication. This preference for structuring deals this way applies whether or not there is an upfront syndication as it allows sell-down as widely as possible. With this increased flexibility for potential participants comes the need for careful and considered structuring to be put in place up-front. It is much harder to try and build this in at a later date.

The asset: different considerations for conventional and Islamic banks

Real estate is often held up as being the perfect partner for sharia compliant financing. There is a tangible asset with a value that can be easily discerned. But it is not that straightforward, particularly when looking at high value assets such as hotels and shopping malls. Consideration needs to be given as to the use of the property. Buildings that contain bars, restaurants serving alcohol and pork products, casinos, conventional banks or, in the most conservative of interpretations, cinemas or other entertainment outlets may not be acceptable. This creates a potential difficulty in a co-financing – do these asset classes need to be avoided altogether? In general Sharia boards have taken the view that either: (a) revenues generated from non-permitted activities will need to be ring-fenced and cannot form the basis for income calculations nor repayment; or (b) if the non-permitted activities are minor relative to the overall business operation, they may be permissible on a de minimis basis (an example being a conventional bank taking retail space in a shopping mall). This will ultimately be decided on a case-by-case basis by the relevant Islamic participants with their Sharia advisory teams. But, in the context of co-funded facilities it is important that the Islamic and conventional participants agree from the outset on the applicable financial definitions, financial covenants and revenue streams for repayment.

Inter-creditor questions

There are common Islamic structures such as istisna (or procurement construction) and ijara (lease) for development financing and sale/leaseback for acquiring a built asset. When combined with a conventional tranche, new issues arise. The conventional facility will be disbursed through a loan agreement, the Islamic tranche will be disbursed through one of the structures we have mentioned but the commercial terms, voting rights, representations, warranties, development or property related covenants, events of default etc. will all need to be documented under a common terms agreement applicable to both facilities. The way in which prepayments are dealt with, the circumstances for fixing interest/profit/return and the repayment provisions all differ between Islamic and conventional facilities so it is important that these aspects are sufficiently clear at a broader commercial bank level before documentation is started.

Asset ownership and security

In Islamic transactions which involve ownership being transferred, title vests with the bank(s) until the facility is paid down and the structure is collapsed. In real estate transactions this is somewhat complicated by legislation in the UAE stating that all transfers of property shall be void unless title is registered with the relevant Lands Department. To avoid making substantive payments for land title transfers (and so that the company can keep the legal ownership of the asset) these transfers usually remain unregistered and participants accept that position and take a mortgage as security for the facility or, in some cases, seek to use a variant of a title agency agreement. There are any number of issues to be considered here including whether it is legally possible to hold the real estate asset (due to, for example, foreign ownership restrictions) and how the conventional banks, in a co-financing structure, may react to the Islamic bank having (at least on the face of it) a proprietary claim over the asset when the conventional lender did not. Sharing of security over an asset, particularly if the asset is a "contributed" asset for the purpose of the Islamic structure, can also create issues between conventional and Sharia compliant banks. All of these points ought to be discussed and agreed at the outset. We are seeing that financiers are much more amenable to these discussions as co-financing structures become more commonplace at all transaction value levels.

Conclusion

Undoubtedly there are still questions over sector performance and the direction of the market but we see a legislative and regulatory environment which has and continues to evolve to align with international best practices. We see financial institutions being more actively involved in due diligence, feasibility studies and

structuring which brings accountability and realism to the financing market and helps build resilient and sophisticated products. As Expo 2020 draws closer there are many infrastructure and tourism projects in the pipeline. Combined with a good supply of residential properties at the affordable price point and strengthening regulatory frameworks, we see a healthy outlook for UAE real estate in 2018 and beyond.

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