REAL ESTATE INVESTMENT TRUSTS
INSIGHTS ON SAUDI ARABIA | Q3 2017

Key findings

REITs traditionally appeal to investors looking for a more liquid exposure to the real estate sector, with the added benefits of diversification as well as regular dividend income and potential capital appreciation.

GCC countries are moving forward with the establishment of a regulatory framework for the use and listing of REITs, with listings intensifying in recent months.

In Saudi Arabia six REITs have been listed on the Tadawul to date reflecting pent up demand for income producing real estate. To this end all existing REITs initially traded at a premium to NAV.

As the market matures, we see pricing moving closer in line with NAV as quality of assets and asset managers become paramount.

While the majority of existing REITs are non-thematic, it is likely that this trend will reverse as the market develops enabling investors to gain exposure to specific real estate sectors.

RAYA MAJDALANI
Research Manager

"The take-up of REITs in Saudi Arabia shows appeal for the asset class. This appears to bode well with a real need for investing capital in the kingdom's real estate market."

Viewpoint

In light of the recent implementation of a regulatory framework paving the way for the use and the listing of REITs in Saudi Arabia, we have witnessed the listing of six REITs on the local exchange (Tadawul). Early indications show that demand for exposure to the real estate sector via a REIT structure is growing and we expect more listings to occur going forward as the market matures.

The emergence of REITs is likely to assist in institutionalizing the real estate market in Saudi Arabia and will provide a wider range of investors exposure to the commercial real estate market. In turn investors will be able to take advantage of diversification benefits, long-term stability and potentially appealing returns from regular dividend income and potential capital appreciation.

REITs are expected to increase private sector participation in the financing of real estate markets over the longer term by accessing additional pools of capital. This is in line with government efforts to stimulate the real estate sector in Saudi Arabia by attracting private sector investments while serving the broader target of the strategic economic reforms aimed at diversifying the kingdom away from its dependence on the hydrocarbon sector.

Whilst we welcome the recent regulation which provides investors with additional options to participate in the kingdom's real estate market, we remain cautious about some external challenges that may hinder the growth of the REIT market namely the constrained pipeline of income producing assets that are available in the market.

What are REITs?

Real Estate Investment Trusts, commonly referred to as REITs, are types of property funds that invest directly in income generating properties either through the underlying real estate or through mortgages. REITs can be non-listed vehicles but on the whole are listed on relevant exchanges allowing investors improved access to commercial real estate investments.

Depending on the level of fund management expertise and on the investment strategy, REITs can channel investments into one real estate sector or target a mixed portfolio ranging from traditional sectors such as offices and residential to alternative asset classes such as healthcare and educational assets.

In a typical listed REIT structure investors purchase shares or units in the REIT following which the management team allocates the funds to various investments that the REIT is authorized to undertake. In return, the REIT distributes income periodically to investors in the form of dividends. One of the key characteristics of REITs is that they are required by law to distribute the majority of income to unit holders via a dividend pay-out. While the ratio of net income that must be distributed varies across jurisdictions, this stipulation normally stands at approximately 90%.

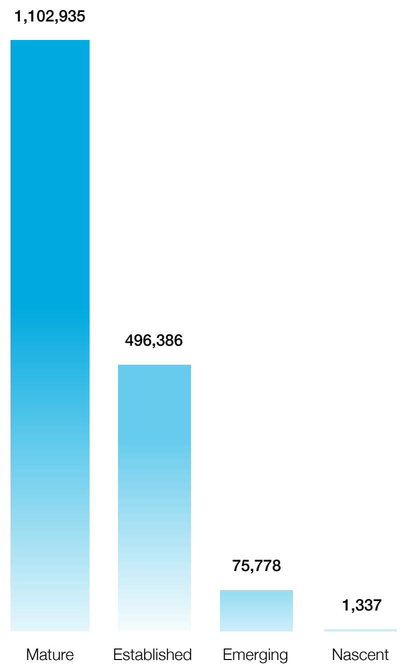
Property management is either arranged internally or through an external service provider. In some jurisdictions only externally managed REITs are permitted, Saudi Arabia being an example. In that case the REIT appoints a property manager to manage real estate held by the fund in return for management fees. The trustees oversee the fund's properties and operations to ensure shareholders' interests are upheld in return for a fee.

In addition to distributing regular dividends to unit holders, a key benefit of a REIT structure is the ability for a range of investors to gain exposure to institutional quality commercial real estate, a sector that is typically illiquid and has large minimum entry requirements. In the past two decades, REITs have emerged globally as a popular and efficient market theme for investors of all categories to access the real estate asset class.

FIGURE 1
REIT jurisdictions—maturity

Sources: EY (Global Perspectives: 2016 REIT report), Knight Frank Research

FIGURE 2
Market capitalization by category, (USD millions, year-end 2016)



Sources: EY, SNL Financial

Global REIT Markets

Key highlights

While the US remains the largest and most mature market for REITs, with established REIT markets in much of Europe and Asia, the concept is being increasingly adopted globally. Over the past two decades we have seen a surge in the number of countries enacting REIT legislations. According to the National Association of Real Estate Investment Trusts (NAREIT), legislations which mirror the US REIT approach have been enacted in 37 countries at the date of writing, with Saudi Arabia being the most recent *(Figure 1)*.

The global REIT market capitalization stood at USD 1.7 trillion at the end of 2016 *(Figure 2)*, up from USD 734 billion in 2010, primarily driven by the emergence of the Australian and Japanese REIT markets, which have overtaken France and the UK to become the second and third largest global REIT markets respectively. The US market still dominates the global landscape and accounts for more than 60% of the global REIT market capitalization with over 200 listed REITs[1].

GCC REIT Markets

Key milestones

While unlisted real estate vehicles and funds are not new to the GCC, listed REITs were only introduced to the region in 2014 with the listing of Emirates REIT on the Nasdaq Dubai. Following the initial listing there has been limited new REIT formations. The approval of the REIT regulations in Saudi Arabia in November 2016 has dramatically altered the GCC landscape with six REITs being listed in Saudi Arabia since inception while a further listing in both Bahrain and the UAE has taken place *(Figure 3)*.

In the UAE, whilst a legal framework for the listing of REITs has been in place for over 10 years in the Dubai International Financial Centre (DIFC), the first REIT was only introduced in March 2014 with the listing of Emirates REIT. In March 2017, we saw the launch of a second REIT on the exchange with the listing of ENBD REIT.

In Abu Dhabi, a law enabling and regulating the use of both public and private REITs was enacted in June 2015. The first REITs were established as private REITs in the Abu Dhabi Global Market (ADGM) in 2017 including The Residential REIT and The Logistics REIT from Equitativa and Etihad REIT from Abu Dhabi Financial Group. This suggests a relatively soft uptake for the REIT market in the UAE to date and a future room for growth in the market.

In Saudi Arabia, non-listed real estate vehicles are not new to the market, with one of the most prominent being the vehicle which was created in 2015 for the development of Jeddah Economic City including Jeddah Tower.

Since legislation was passed outlining the rules governing the listing of REITs in November 2016, the sector has seen significant growth, with six REITs already listed in the kingdom and a number currently preparing for listing. The listings so far include: Riyad REIT, Al Jazira Mawten REIT, Jadwa REIT AlHaramain, Taleem REIT, Al Maather REIT and Musharaka REIT. The number of successful listings and the number of applications that are currently in the pipeline clearly show the pent up demand for REITs in Saudi Arabia.

In Bahrain, a new trust law which came into force in November 2016 has established REITs as a regulated investment structure. The first REIT listing of Eskan Bank Realty Income Trust was formed and listed on the Bahrain Bourse shortly after the introduction of this regulation.

In Oman, the introduction of a regulatory framework for REIT listings is among a set of initiatives defined by Tanfeedh, the country's national plan to help drive economic diversification and investment inflows into the country. A draft regulation to cater for the listing of REITs has been formulated and is awaiting final approval.

Key characteristics

In *Figure 4*, we have provided key highlights about REITs which have been listed in the GCC to date. While it is still premature to draw firm findings given the relatively nascent nature of the market, we have derived some key trends that are currently shaping the industry including some thoughts on the outlook.

REIT investment strategies in Saudi Arabia are split between the mixed-asset approach and the specific-asset class approach. In the UAE, both existing listed funds have their investments spread

Note: (1) NAREIT

across a mixed portfolio of real estate holdings, though announcements have suggested specific asset class REITs may arise shortly. Although the blended approach provides important benefits for the long term with regards to performance given the diversification of risk, we anticipate to see a trend towards the specialization of REITs in the GCC with a focus on asset classes that are prevalent to the region e.g. office, retail, education, healthcare and logistics.

Mainly driven by the amount of capital seeking exposure to the commercial real estate market, every REIT that has been listed in the kingdom initially traded at a large premium to Net Asset Value (NAV) indicating investor appetite for income producing real estate as well as the potential depth of the market.

This trend for trading at a premium to NAV is in part a function of the relatively small number of listed vehicles available to investors; as the REIT market gains in maturity, we expect pricing to move more in line with NAV. Within the UAE the general valuation trend for listed REITs is one where REITs are now trading below their NAV, in common with the more mature markets of the UK, the US and Asia.

FIGURE 3

GCC REIT markets key milestones to date

United Arab Emirates
First established market for REITs in the GCC

Dubai

- REIT law: enacted in 2006
- Regulatory Authority: DFSA (Dubai Financial Services Authority)
- REIT listings on Nasdaq Dubai: Emirates REIT (March 2014), ENBD REIT (March 2017)
- REIT market size[1]: USD 538.0 million

Abu Dhabi

- REIT law: enacted in June 2015. Law authorized the use of both private and listed REITs
- Regulatory authority: FSRA (Financial Services Regulatory Authority)
- Private REITs incorporated in the Abu Dhabi Global Market : The Logistics REIT, The Residential REIT (February 2017), Etihad REIT (April 2017)
- No REIT listing to date

Bahrain
One listing following the regulation approval

- REIT law: enacted in November 2016
- Regulatory authority: Central Bank of Bahrain
- REIT listings on the Bahrain Bourse: Eskan Bank Realty Income Trust (January 2017)
- REIT market size: not available

Oman
Draft regulation for the use and listing of REITs awaiting final approval

- REIT law: awaiting final approval

Kuwait
Absence of regulation for the use and listing of REITs to date

Qatar
Absence of regulation for the use and listing of REITs to date

Saudi Arabia
Six REIT listings following the regulation approval

- REIT law: enacted in November 2016
- Regulatory authority: CMA (Capital Market Authority)
- REIT listings on the Tadawul:
  - Riyad REIT (November 2016)
  - Al Jazira Mawten REIT (February 2017)
  - Jadwa REIT AlHaramain (April 2017)
  - Taleem REIT (May 2017)
  - Al Maather REIT (August 2017)
  - Musharaka REIT (October 2017)
- REIT market size[1] : USD 742.7 million

Sources: Knight Frank Research, Macrobond, Nasdaq Dubai, Tadawul, Bahrain Bourse

Note: (1) REIT market size based on market capitalization as of 28/09/2017

FIGURE 4

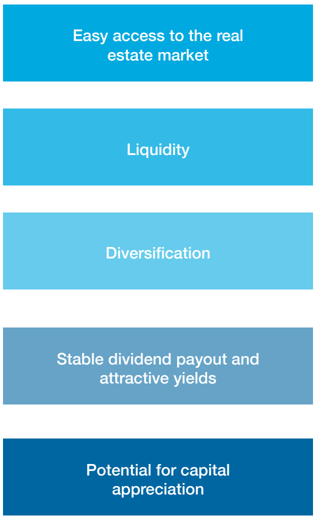
Comparative overview of GCC REIT markets

GENERAL INFORMATION						PRICING METRICS (28/09/2017)			YTD PERFORMANCE (28/09/2017)	
REIT Name	**Regulatory framework setup**	**Stock exchange**	**Date of REIT listing**	**Fund manager**	**Investment approach**	**NAV (USD millions)[2]**	**Market cap (USD millions)**	**P/NAV ratio**	**REIT (%)**	**General index (%)[3]**
Emirates REIT	April 2006	UAE / Nasdaq Dubai	March 2014	Equitativa	Mixed	487.8	284.0	0.58	-17.6	0.7
ENBD REIT	April 2006	UAE / Nasdaq Dubai	March 2017	Emirates NBD	Mixed	292.4	254.0	0.87	-14.5	0.7
Riyad REIT	November 2016	Saudi Arabia / Tadawul	November 2016	Riyad Capital	Mixed	129.1	159.2	1.23	6.2	1.0
AlJazira Mawten REIT	November 2016	Saudi Arabia / Tadawul	February 2017	Al Jazira Capital	Warehouses Jeddah	32.7	69.1	2.11	116.8	1.0
Jadwa REIT AlHaramain	November 2016	Saudi Arabia / Tadawul	April 2017	Jadwa Investment Company	Holy Cities	176.7	211.5	1.20	18.7	1.0
Taleem REIT	November 2016	Saudi Arabia / Tadawul	May 2017	Saudi Fransi Capital	Educational / training	77.3	108.7	1.41	41.3	1.0
AlMaather REIT	November 2016	Saudi Arabia / Tadawul	August 2017	Osool & Bakheet Investment Company	Mixed	n/a	194.2	n/a	17.2	1.0
Musharaka REIT	November 2016	Saudi Arabia / Tadawul	October 2017	Musharaka Capital Company	Mixed	n/a	n/a	n/a	n/a	1.0
Eskan Bank Realty Income Trust	November 2006	Bahrain / Bahrain Bourse	January 2017	Eskan Bank	Mixed	52.7[4]	n/a	n/a	n/a	5.2

Sources: Knight Frank Research, Macrobond, Tadawul, Nasdaq Dubai, Bahrain Bourse

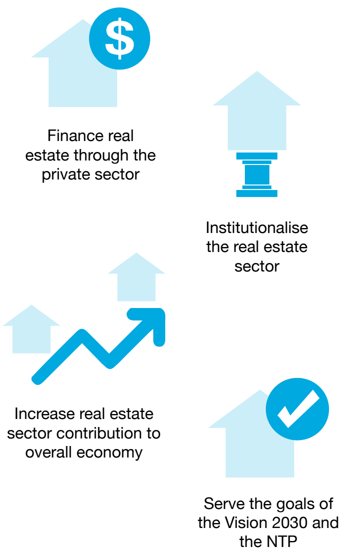
Notes: (2) Net asset value (NAV) as of 30/06/2017; (3) General index refers to the Tadawul All Share Index for Saudi Arabia, the DFM General Index for the UAE and the Bahrain All Share Index for Bahrain; (4) As of 31/08/2017

FIGURE 5
Selected positive implications of REITs for investors



Source: Knight Frank Research

FIGURE 6
Selected positive implications of REITs for the real estate sector and broader economy



Source: Knight Frank Research

Saudi Arabia REIT Market

Regulatory framework

In Saudi Arabia a REIT is a closed-ended investment company which invests in income generating properties. REITs adhere to the rules and regulations issued by the Capital Market Authority (CMA) in November 2016.

Key requirements of this regulation are listed below:

- **Capital requirement:** The minimum capital requirement for a REIT in Saudi Arabia is SAR 100 million though this requirement is set to be increased shortly.
- **Dividends distribution:** A minimum of 90% of the REIT profits must be distributed to shareholders with only 10% of profits allowed to be re-invested.
- **Investments:** A minimum of 75% of total asset value should be invested in income-producing properties. The fund manager is prohibited from investing in vacant land. A maximum of 25% of the REIT's total asset value can be invested in real estate development or redevelopment.
- **Geographic allocation:** REITs can invest locally, regionally and globally. A maximum of 25% of the REIT's total value is allowed to be invested outside Saudi Arabia.
- **Financing:** REITs borrowing level is capped to 50% of the fund's total asset value.
- **Shareholders:** The minimum required number of investors in a REIT is 50 and at least 30% of the REIT units must be owned by the public. Subscription in the fund is open to any Saudi, GCC citizens or non-Saudi residents in Saudi Arabia.

Positive implications for investors

- **Liquidity and easy access to real estate investments:** The establishment of REITs in Saudi Arabia provides individual and institutional investors with easier access to local real estate investments. Publicly listed REITs offer investors the simplicity of trading them just like shares while also providing investors with a clear exit strategy, which implies greater liquidity than investing directly into the property market.
- **Effective tool for portfolio diversification:** REITs could present an attractive opportunity for investors looking to diversify their portfolios and hedge their risk. REITs are perceived as an effective tool for investment diversification given that real estate, the underlying asset class has a relatively low correlation to more traditional asset classes such as stocks and bonds, which can mitigate exposure to systematic risk.

  Another key aspect of diversification offered by a REIT investment is the possibility to gain exposure on various geographies and market sectors. In addition to potential geographical diversification of assets across various provinces and cities within Saudi Arabia, diversification outside the kingdom is possible as 25% of a REIT total value can be invested abroad.

  Regarding diversification by market sectors, we note that the sensitivity to overall market and economic conditions varies across real estate asset classes. There is a notable difference between defensive sectors such as healthcare and education which tend to be more stable than cyclical sectors such as hospitality and retail which have a higher sensitivity to economic conditions.
- **Stable dividend distribution and attractive yields:** REITs are attractive for investors given that they offer a regular and stable pay-out. REITs in Saudi Arabia must distribute 90% of their net income to shareholders as dividends. While REITs yields currently look compressed, we expect them to widen as the market matures which will provide investors with a more robust dividend yield.
- **Potential capital appreciation:** REITs offer the opportunity for capital appreciation and a corresponding increase in the value of its equity.

Positive implications for the real estate sector

From a macro perspective, the introduction of REITs falls in line with the broader goals of the Saudi Vision 2030 and the National Transformation Plan (NTP) which aim to stimulate the real estate sector and increase its contribution to the overall GDP, while encouraging private sector participation in this process *(Figure 6)*.

The establishment of REITs as an alternative investment vehicle looks set to provide access to a new pool of capital that has henceforth been invested in land, the Tadawul or kept in cash, as the only options widely available to retail investors. The recent successful listings of the initial six REITs have shown the level of pent up appetite for income producing commercial real estate with all REITs initially trading at a premium to net asset value (NAV).

To date the investment strategy for REITs has on the whole been non-thematic, partly as a result of a chronic lack of good quality assets with long term, sustainable income. As the market matures we see the emergence of thematic REITs being a logical development whereby investors will be able to target specific real estate sectors rather than taking blended real estate exposure. This will be particularly important for investors seeking exposure to non-cyclical, defensive sectors such as healthcare and education.

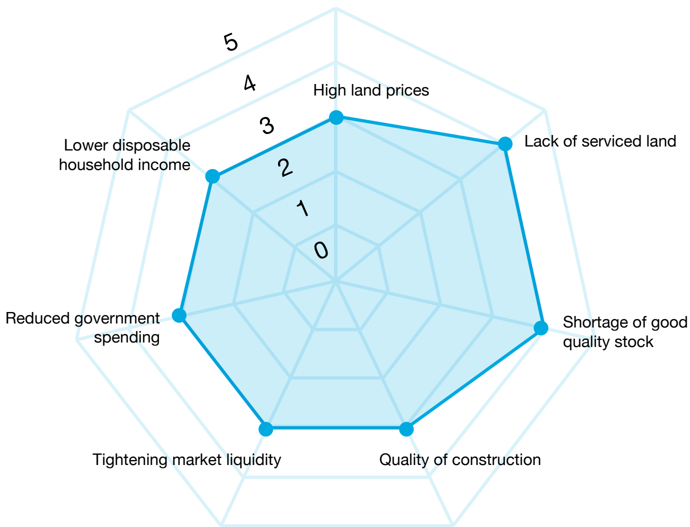
In turn, and as mentioned above, we see market pricing coming more in line with NAV and the underlying real estate; this is a positive development as investors will be able to more accurately deploy funds in line with a set strategy and risk profile. As more REITs are listed, investor choice will increase which will lead to a deeper market where pricing becomes segmented and where poorer quality REITs will trade at discount to those that follow best in class practices. To this end the quality of the REIT, both in terms of real estate and asset manager will become paramount which will provide more transparency for investors and market participants.

Key challenges

We believe there are number of external factors challenging REITs which needs to be addressed.

FIGURE 7

External factors challenging the REIT market



Source: Knight Frank Research

Note: A higher number reflects a higher risk for the market.

Whilst we welcome the establishment of the recent REIT regulations as another step toward a more transparent market, there are a number of headwinds that could face the sector. A major factor will be the quality and supply of suitable assets that can be placed within potential REIT structures. In general the Saudi Arabian market is dominated by lack of institutional grade real estate when compared to the markets of both emerging and mature REIT jurisdictions.

As the success of the REIT market will in part rest on a sustainable pipeline of future assets, the softening of the current economic climate could hinder the development of the sector and with it future supply.

Conclusion

Since a law for the use and listing of REITs was enacted in late 2016, market has been buoyant with six listings to date and a number of additional listings planned for the coming quarter. Following initial buoyancy, we have seen pricing for REITs moderate throughout October. Whilst it is too early to judge the ramifications of the recent REIT regulations on the wider real estate market, we welcome the regulations as another step toward a more transparent real estate market, a key factor when it comes to attracting international capital to the sector.

STEFAN BURCH
Partner, Saudi Arabia

"The recent approval of the REIT regulations signal an important step in the government's drive to increase transparency in the real estate markets where visibility around asset performance, ownership and legislation are key to attracting capital to the sector."

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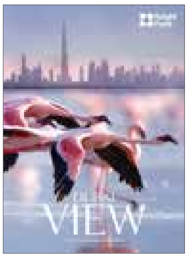

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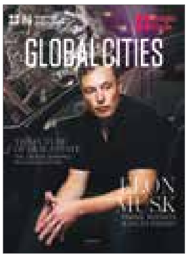

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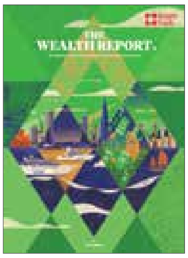

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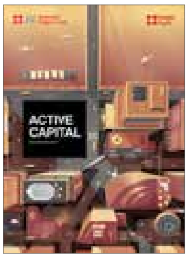

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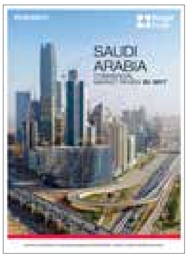

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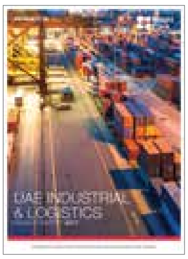

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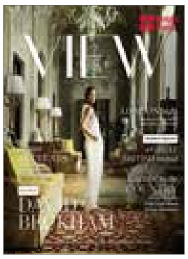

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