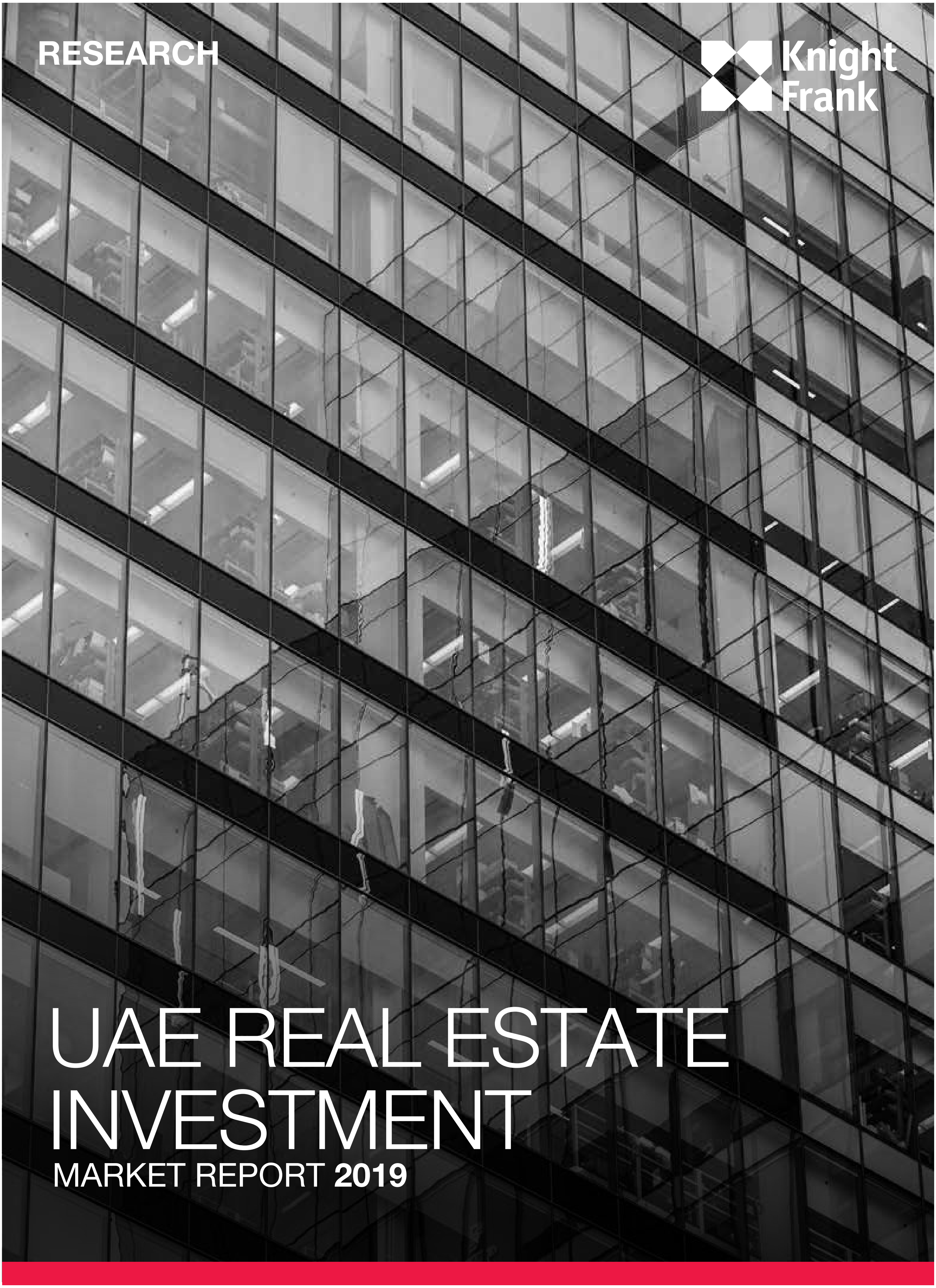


RESEARCH

Knight Frank

UAE REAL ESTATE INVESTMENT

MARKET REPORT **2019**

UAE INVESTMENT MARKET TRENDS AND OUTLOOK

RESEARCH

UAE REAL ESTATE INVESTMENT MARKET REPORT 2019

Key findings

During the course of 2018 we saw upwards pressure on yields throughout the UAE

The spread between prime and secondary yields continues to widen

Financing rates have risen over the course of the last 12 months, putting pressure on returns, though these now seem to be peaking

The logistics and industrial sector remains of high interest to investors, though viable investment opportunities are rare

More corporates are exploring sale and leasebacks as a way to free up capital for core business activities

There remains significant amount of capital in the region allocated to real estate, much of which remains undeployed due to a lack of quality assets available

We expect a fairly resilient market for well let, institutional quality, single ownership assets, which will continue to attract investor interest

JOSEPH MORRIS
Partner, Middle East Capital Markets

"Divergence between prime and secondary yields continues to widen, reflecting the fact that investors are willing to pay a premium for better quality assets, seen as lower risk, in core locations and with credit-worthy tenants."

Please refer to the important notice at the end of this report.

Economic environment

Over the course of 2018, the Central Bank of the UAE's Economic Indicator showed GDP growth improving on the back of higher oil prices, higher levels of production in the hydrocarbon sector and a strengthening non-oil sector. The overall annual growth rate is expected to register at 2.8% for 2018 and is projected at 4.2% for 2019 *(Figure 1)*.

Despite this optimistic outlook, volatility and a decline in oil prices toward the end of 2018 and into the start of 2019 demonstrate the fragile nature of the economic environment.

This in turn has impacted business confidence, with firms generally looking for short to medium term stability before committing to any expansion plans.

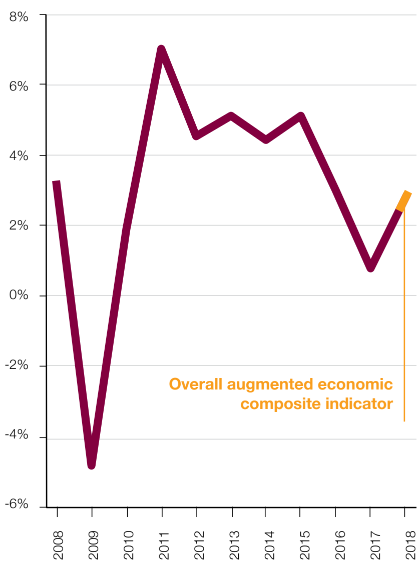
As a result, the UAE has seen slowdown in employment growth, with the year-on-year figures falling from 3.0% in Q3 2017 to 0.6% in Q3 2018. In almost all major employment sectors over this period we have witnessed the annual rate of growth slow or the rate of declines accelerate *(Figure 2)*.

Markit's Purchasing Manager's Index (PMI), which tracks non-oil economic activity in the UAE, registered a reading of 54.0 as at December 2018. This reading is the lowest registered since October 2016 and indicates a slowdown in the UAE's non-oil private sector (*Figure 3*). However, any figure over 50 still indicates expansion in the non-oil private sector.

Despite the reality checks provided by the latest economic data releases, there remains room for cautious optimism. Announcements of economic stimulus packages, cuts in energy costs in industrial zones and a host of changes to ease residency and investment laws may help change the long term fundamental drivers for the economy and help deliver stronger economic growth going forward.

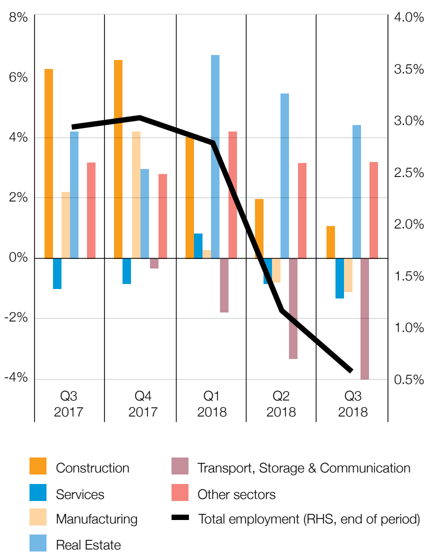
It is envisaged more changes will be announced during the course of 2019 to further increase the attractiveness of the UAE as an investment destination.

FIGURE 1
UAE GDP, Y-o-Y % change



Source: Knight Frank Research

FIGURE 2
UAE employment growth by sector, Y-o-Y % change, end of period



Source: Ministry of Human Resources and Emiratization

Investment sentiment

During the course of 2018 we saw upwards pressure on yields throughout the UAE.

The office sector has seen a widening in yields between prime and secondary, with well located, best in class assets still commanding a premium to the wider market and continuing to attract robust interest from investors.

Investments in logistics and industrial assets continue to be perceived as an attractive proposition by the market, though during the course of the year we saw minimal transaction activity in this sector, mainly due to a dearth of credible investment opportunities.

Education and healthcare also generally remain attractive as investment targets, in part due to the extended lease structures on offer, which are not prevalent in other sectors. However, with fundamentals in some instances under pressure and some recent insolvencies in this sector we see investors taking a much more granular approach to the covenant strength of the tenant.

The retail sector continues to face headwinds, though we see a divergence between the wider retail market and well located community retail with established catchments, which continue to perform reasonably.

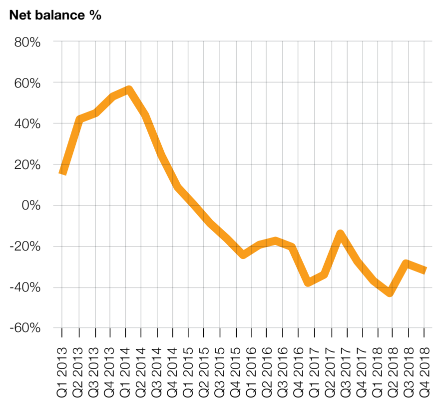
The hospitality market continues to be challenging and whilst we have seen resiliance to a degree in occupancy, Average Daily Rates (ADR) have been under pressure across the UAE.

In respect of general investment sentiment, the Royal Institution of Chartered Surveyors' (RICS) UAE Commercial Property Monitor Q3 2018 Investment Sentiment Index continued to register weakening sentiment and has now shown a negative balance since Q2 2015.

During the course of the last couple of years we have seen buyer demographics change within the market with family offices starting to be slightly more cautious over their investment programs. This has been offset by a number of new institutional investors entering the market, with the intention of creating real estate funds – both private and listed. This theme follows the trend we have seen in Saudi Arabia, where we have seen 16 REITs listed since the end of 2016, with a current market cap of circa USD 3bn. However, more recently we have seen some private groups return to the market as there are opportunities to acquire assets at significant discounts to historic valuations.

FIGURE 4

RICS commercial property investment sentiment index



Source: Knight Frank Research

Financing and liquidity

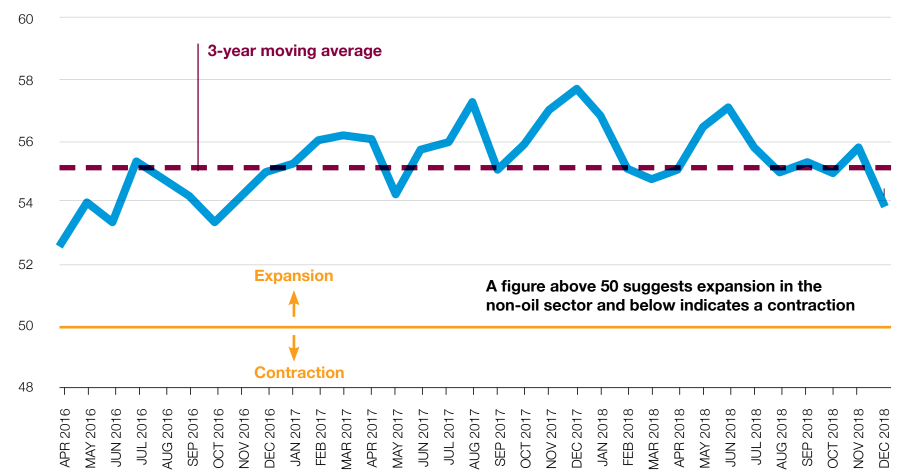
Over the course of 2017 and 2018 as interest rates have risen in the US, we have seen a corresponding hike in UAE interest rates given the Dirham's US Dollar peg, which has pushed up lending rates in the UAE (*Figure 5*).

This has put pressure on financing rates across all sectors of the real estate market, with the spread between yields and lending costs narrowing, which in turn places upwards pressure on yields.

That said, there is still competition from lenders for exposure to high quality real estate assets and we have seen a number of significant real estate lending transactions complete during the course of the year. The recent decision by the Central Bank of the UAE to loosen the 20% lending cap to real estate previously imposed on banks may also bring further liquidity to the sector.

FIGURE 3

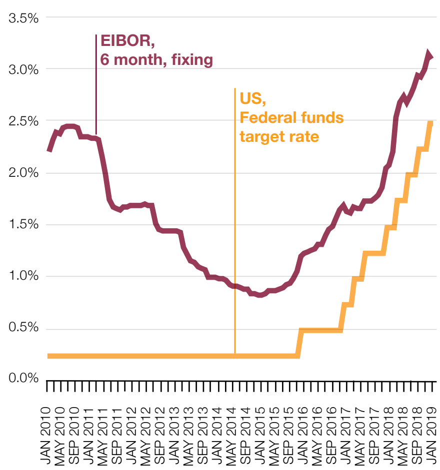
UAE, PMI



Source: Knight Frank Research

FIGURE 5

Borrowing costs



Source: Knight Frank Research

Yields

The divergence between prime yields and secondary continues to widen, reflecting the fact that investors are willing to pay a premium for assets seen as lower risk, in core locations and with credit-worthy tenants.

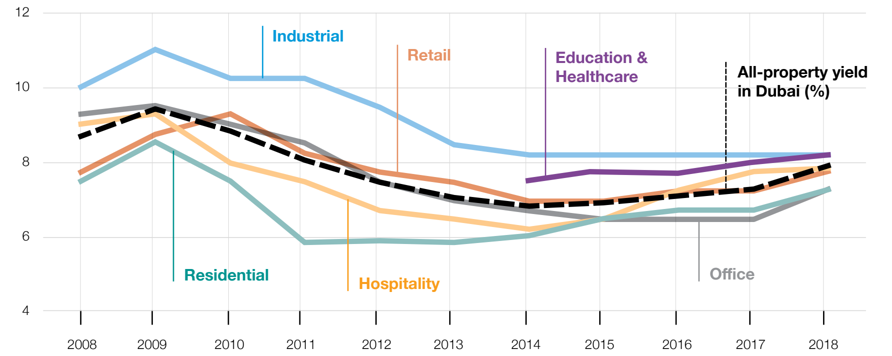
Whilst there remains a lack of transactional evidence in the market, at the end of 2017 we did see a new benchmark for prime yields set with ENBD REIT's acquisition of The Edge Building in Dubai Media City for 6.5% net, reflecting a capital value of over AED 3,000 per sq ft. This again demonstrates the fact that investors are willing to pay market leading yields for best in class assets.

However, yields across the wider real estate markets in the UAE continued to move outwards during 2018, led by a number of factors including increased financing rates, a challenging occupational market and investors risk appetites diminishing further.

Positively, over the last 12-18 months we have witnessed the bid-ask spread narrowing as sellers adjust expectations given current market conditions and as a result are becoming more realistic to the pricing levels that can be achieved. We envisage this trend to continue during 2019.

FIGURE 6

Prime Dubai yield trends

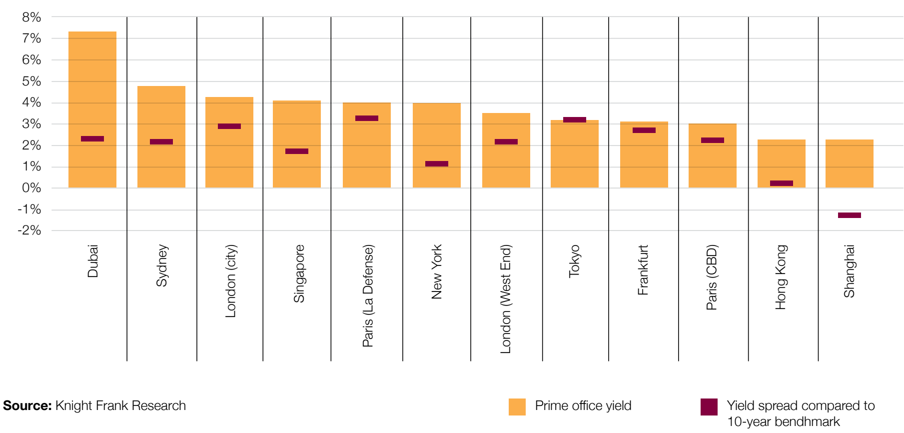


Note: The above graph comprises Knight Frank's view of yield trends across a number of real estate sectors. It is not intended to be definitive and represents wider sector themes only. Yields where possible are based on transactional activity. Where no or limited transactional activity exists the data is based on Knight Frank's view of a Grade A (or relative) hypothetical building let at a fair market rent to a credit worthy tenant in an international freehold or long leasehold area. It excludes super prime transactions which may trade at a premium. The data should not be relied on for any valuation purposes and is indicative only.

Source: Knight Frank Research

FIGURE 7

Prime office yield spreads, major global cities



Source: Knight Frank Research

FIGURE 8

Recent UAE investment transactions (reported)

Building	Sector	Location	Seller	Buyer	Tenant	Price (AED)	Net Initial Yield
U-Bora Tower	Office	Business Bay, Dubai	Midas REF	Confidential	Multi-let	Confidential	8.1%
Emaar Hospitality Portfolio	Hospitality	Various, Dubai	Emaar	ADNH	Emaar Hospitality *(operator)*	2.2 bn	Confidential
ADCB Tower	Office	Deira, Dubai	ADCB	Private investor	ADCB	Confidential	6.75%
Souq Extra, DSO Phase 1	Retail	Dubai Silicon Oasis, Dubai	Souq Extra	ENBD REIT	Multi-let	84 m	8.0%
Lycée Français Jean Mermoz	Education	Al Quoz, Dubai	Lycée Français Jean Mermoz	Emirates REIT	Lycée Français Jean Mermoz	75 m	9.75%
North London Collegiate School	Education	MBR City, Dubai	Sobha	Amanat	North London Collegiate School	360 m	Unreported
Binghatti Vista and Binghatti Sapphires	Residential	Dubai Silicon Oasis, Dubai	Binghatti Developers	Izdihar Real Estate Fund	Binghatti *(Master Lease)*	200 m	8.25%
The Edge Building	Office	Dubai Media City, Dubai	SWEID & SWIED	ENBD REIT	Oracle, Snapchat and McGraw Hill	280 m	6.5%
European Business Center	Office	Dubai Investment Park, Dubai	WAFRA	Emirates REIT	Multi-let	130 m	c. 10%
Hartland International School	Education	MBR City, Dubai	Sobha	NBK Capital Partners	Hartland International School LLC-FZ	345 m	c. 8.5%
International Tower	Office	Capital Centre, Abu Dhabi	Eastgate Capital Group	Aldar	Multi-let	658 m	c. 8.5%

Source: Knight Frank Research

Note: Details may have been provided by third parties and whilst efforts have been made to verify these, they should not be relied upon as accurate.

TAIMUR KHAN
Research Manager

"Despite the short term concerns raised by Brexit, over two thirds of the capital originating from GCC countries is actively seeking opportunities in UK real estate. Whilst a substantial proportion still show a preference for London we have witnessed more and more investors moving into the regional cities across the UK, searching for more attractive returns."

Outbound investment trends

Given the current regional economic climate, volatility in financial sectors and general lack of institutional grade commercial assets available, Knight Frank has witnessed sustained levels of demand for cross-border commercial real estate investment.

Whilst overall outbound investment volumes from the Middle East have fallen in recent years, this is mainly due to a general slowdown activity from the regional sovereign wealth funds. Private capital and the smaller institutions remain extremely active.

Knight Frank's private wealth data shows that of the US$6.3 billion of private capital being targeted at commercial real estate the vast majority is focused towards Continental Europe, the United Kingdom and the United States.

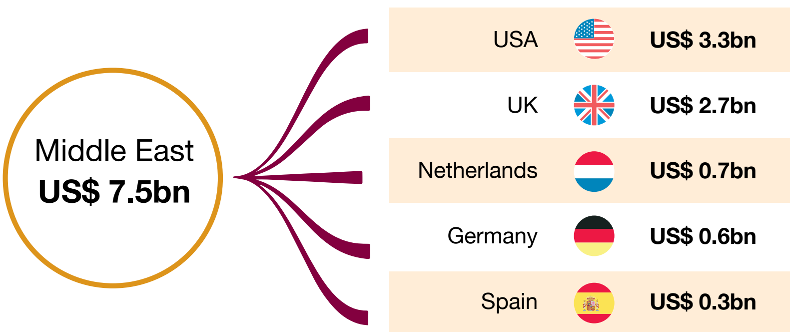
Despite concerns raised by Brexit, over two thirds of the capital tracked from GCC countries is actively seeking opportunities in UK real estate. Whilst a substantial proportion still show a preference for London, over the course of the last cycle we have witnessed more and more investors moving into the regional cities across the UK, searching for more attractive returns.

Knight Frank's Active Capital 2018 report showed that on a global level the UK has been the top destination for cross-border capital for six of the past ten years, and London the top global city destination for office investment for nine of the past ten years. For Middle Eastern investors the attraction to UK real estate remains strong, despite current political uncertainty. This trend is aided by the range of benefits that investors can take advantage of in the UK commercial market, from the size of the commercial market, large and high quality assets and good levels of transparency.

From the Middle East, the USA still sees the majority of outbound capital by absolute volume, though this is more consolidated, generally with larger transactions being completed by larger institutions, many of whom have a programmatic investment strategy to build up portfolios in this geography.

Continental Europe continues to grow as a key investment target for many GCC based investors. In June 2017, 81% of private investors were looking at the UK as their preferred investment location, by June 2018 this number had reduced to 67%. Current preferred target destinations include the Netherlands and Germany. In part investors have been attracted by stable real estate markets and an extremely competitive debt market, which can assist in generating heightened cash on cash returns from relatively suppressed property yields.

FIGURE 9
Cross-border flows from regions into countries, top five destinations by region (2018)



Source: RCA Analytics, Knight Frank Research

Outlook

Looking ahead, 2019 will not be without challenges including concern over supply conditions in the wider real estate market and expectation of continued economic volatility.

Survey data from the RICS' UAE Commercial Property monitor expects office capital values on average to fall by up to 2% over the coming 12 month period, although this projection is down from almost 4% a quarter earlier. At the same time the data indicates that office rents are expected to fall by almost 4% during the course of 2019.

The prime and secondary market continue to diverge, with the outlook in prime markets across all sectors expected to fare better over the coming year on both a capital and rental value basis.

We still expect that there will remain a fairly resilient market for institutional quality, single-ownership assets. Well managed assets will continue to trade at lower yields and attract interest from a range of investor classes. However as these types of transactions are relatively rare in the market, they will not have a marked impact on the wider real estate environment.

On a relative basis, Dubai yields are significantly higher than other global centres. Whilst this is reflective of current market uncertainties and risk, we envisage more international investors will start looking closely at the risk/reward parameters (*Figure 7*).

Finding opportunities still remains challenging, especially those of scale, however given the current environment we have seen more of a willingness for both government related and private developers to look at exiting their yielding assets in order to focus on their core business. We expect this to bring new, potentially scalable investment opportunities to the market, which in turn may attract new institutional capital, something that would be received very positively by the market.

Overall, whilst there remains pressure on the wider market, given the right opportunities we envisage continued investment activity, as there continues to be a significant amount of undeployed capital allocated to real estate.

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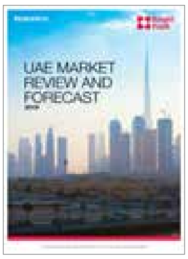

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