SAUDI ARABIA OFFICE MARKET REVIEW 2018

Key findings

In Saudi Arabia, market wide rents and occupancy levels have been under pressure since 2016, with the trend continuing into 2018 amid increasing levels of supply and subdued occupier demand.

Prime office schemes have been outperforming the market as a result of a historic lack of quality stock. A major headwind is that a large portion of upcoming supply falls within this category, which could put pressure on performance in this segment.

Although there was an improvement in business sentiment in 2018, on the back of higher oil prices, this has yet to result in an increase in demand for office accommodation across major cities.

Long term demand drivers include: an acceleration of growth in the non-oil sector, an increasingly attractive business environment for global occupiers and the implementation of various urban regeneration initiatives.

SAUD SULAYMANI
Partner, Saudi Arabia

"The implementation of various urban regeneration programs, mixed use communities, and large scale infrastructure projects is expected to act as a catalyst for the real estate market in the Kingdom."

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

Whilst there have been a number of notable commercial office transactions throughout 2018, as key occupiers both from the public and private sector look to expand or move to upgraded premises, the market continues to be dominated by a lack of Grade A stock and a large supply pipeline.

In terms of performance, market wide rents and occupancy levels have been under pressure since 2016, with the trend continuing into 2018 amid increasing levels of supply and subdued occupier demand. Key prime schemes continued to perform better than the market average as a result of a lack of high quality stock. However as new schemes are released into the market this trend is unlikely to persist over the long term.

Against the backdrop of a highly elastic supply dynamic, we see rents for Grade B assets softening further in the short term where buildings that suffer from poor accessibility and parking arrangements will struggle for occupancy.

Although we have seen an improvement in business sentiment in 2018, we believe that any increase in demand will remain subdued in the short term, with rents and occupancy likely to remain under pressure as increased demand will be met with new supply. Vacancy rates can therefore be expected to rise placing downward pressure on rents. In this context, we expect landlords to continue offering incentives in order to maintain occupancy levels amid an increasingly competitive market.

Longer term, we see demand for office space picking up from current levels as economic reforms under the National Transformation Plan (NTP) and Vision 2030 start feeding through the wider economy, translating into an acceleration of growth in the non-oil private sector.

Moreover, the implementation of various urban regeneration initiatives including mixed use communities and large scale infrastructure projects, is expected to act as a catalyst for the real estate market.

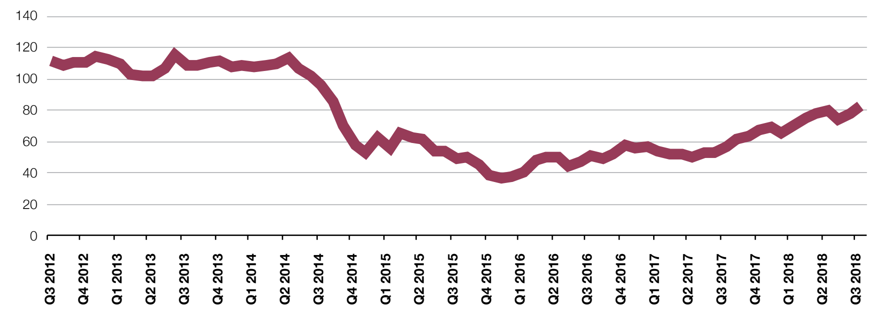
Furthermore, it is expected that the planned wave of privatisation will boost investment and foster growth in the business environment creating favourable conditions for the office sector.

FIGURE 1
Selected NTP targets in relation with the real estate sector

- Increase the real estate sector growth to 7% per year up from 4%
- Increase the private sector contribution from 40% to 65% of GDP with particular focus on the real estate sector
- x2 Double the real estate contribution to GDP from 5% to reach 10% by 2020

Source: Knight Frank Research

FIGURE 2
Brent Crude Oil, Spot (in USD)



Source: Macrobond

RAYA MAJDALANI
Research Manager

"The slowdown in the office market continued in 2018, as subdued occupier demand weighs on market wide rents and occupancy levels; while key prime schemes continue to perform better than the average market as a result of limited stock of high quality assets."

Macroeconomic overview

Saudi Arabia's real GDP growth slipped into negative territory in 2017, declining by 0.9% on the back of lower oil prices. This was further exacerbated due to fiscal tightening measures aimed at curbing spending and alleviating pressure on the fiscal position. There was a recovery in economic growth at the start of this year, with GDP growth projected to gather momentum reaching 2.2% through 2018 and 2.3% in 2019 according to IMF estimates.

The return to growth is being underpinned by a combination of favourable factors including a rebound in oil prices, a gradual acceleration in the growth of the non-oil economy and the government's shift away from a tight fiscal policy as announced in the 2018 budget. The expected pickup in GDP growth along with higher oil prices and ongoing fiscal consolidation efforts should drive the fiscal deficit to narrow gradually from 9.3% of GDP in 2017 to 4.6% of GDP in 2018 and then further to 1.7% of GDP in 2019.

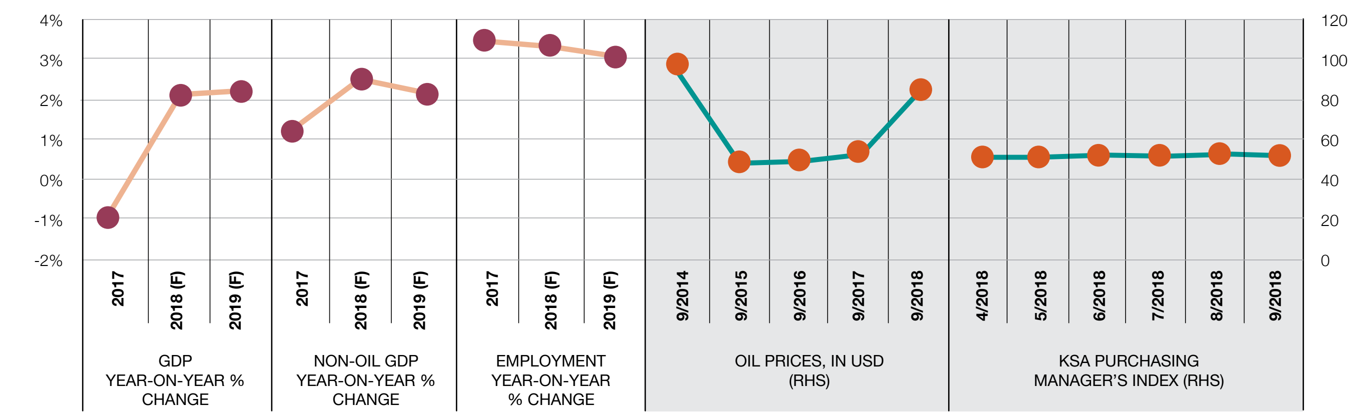
The non-oil economy tracker (Purchasing Manager Index, PMI) stood at 53.4 in September 2018 which is well above the neutral 50 level indicating an expansion in the non-oil sector. This PMI reading indicates a recovery of the index from its lowest level on record registered in April 2018 (51.4), although it is still below the 55.1 three year rolling mean. Structural reforms to decrease the Kingdom's reliance on the hydrocarbon sector and to support stronger non-oil growth looks set to remain a central element of economic policy over the coming years, in line with the Vision 2030 and the NTP. Non-oil GDP growth is expected to ramp up to 3.2% in the medium term well ahead of overall GDP growth.

Along with the recovery in oil prices, there was an improvement in business sentiment in 2018 year to date. The Tadawul All Share Index has recorded significant growth in the first three quarters of 2018 (c. 10% ytd), boosted by inflows of foreign funds in anticipation of inclusion in the MSCI and the FTSE Russel emerging market indices. Conversely consumer-facing sectors have faced difficult operating conditions throughout 2018 following the introduction of value added tax and the reduction of subsidies.

Looking at the labour market, employment growth is forecast to remain supported by the various initiatives aimed at boosting youth, women and Saudi nationals' participation in the workforce. In the short term this will be balanced by rising pressures on the expat labour market resulting from the impact of the expected ramp up in government fees and Saudization plans on non-Saudi employment figures.

While a substantial improvement in business conditions is yet to be seen, the outlook and sentiment for Saudi Arabia's economy remain cautiously positive. The increase in oil prices to $82.9 pb in September 2018 up from $56.7 pb a year earlier will help underpin economic growth this year. The restructuring of the economy in line with the Saudi Vision 2030 is likely to be a gradual process which requires some time to come into effect.

FIGURE 3
Key economic indicators



Source: IMF, Macrobond, Oxford Economics

Riyadh

Demand

Whilst 2018 has seen a number of high profile occupiers expanding or moving to upgraded premises, market wide demand over the past 12 months has remained subdued. This market sentiment has mainly been driven by the slowdown in the economy throughout Q3 and Q4 of 2017. Improved economic data throughout Q1 and Q2 of 2018 has yet to result in an increase in demand for office accommodation across the city.

However, this market dynamic has to be seen within the context of a lack of Grade A space which continues to underpin rents and occupancy levels in this segment. To this end good quality schemes such as Kingdom Tower, Faisaliah Tower and Business Gate maintain high occupancy rates, a trend that we see continuing in the short to medium term until King Abdullah Financial District (KAFD) hands over meaningful levels of stock which is estimated to be in Phase 2 post 2021.

In the short to medium term we see demand for Grade B office stock weakening considerably as occupiers look to upgrade their premises amid increasingly tenant friendly market dynamics.

Supply

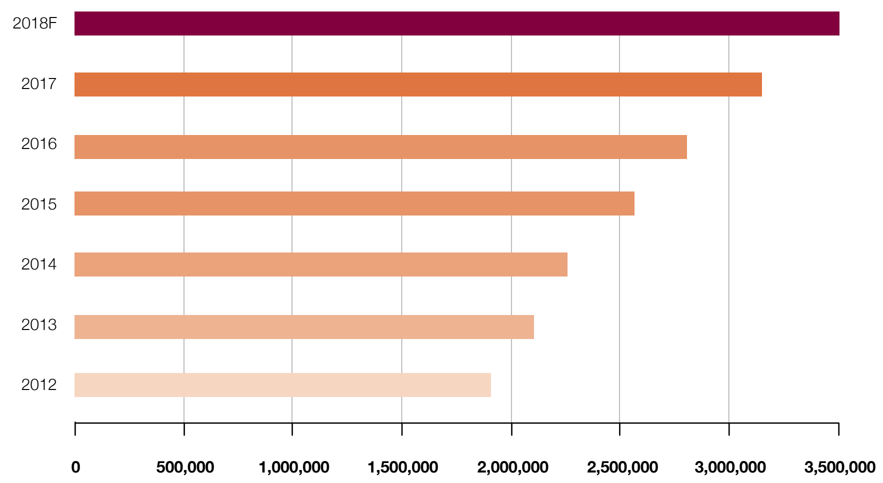
At the end of 2017, the total stock of office space in Riyadh stood at circa 3,100,000 sq m GLA, growing at a compound annual growth rate of 11% over the past 6 years. The existing office stock is characterised by a lack of quality assets with less than 30% of total stock being classed as local Grade A. Al Raidah Digital City (RDC, formally ITCC) continues to gain traction as a result of the restricted pipeline of Grade A space with occupancy standing at 95% following strong interest from both public and private occupiers.

Following a restructuring, the first phase of KAFD approaches practical completion though it is likely to be handed over in the coming 18 months. Phase 1 has been well subscribed which will smooth any major effect on achievable rental rates when it comes to the market. Looking ahead, Phase 2 will provide the majority of stock to the market which looks set to be released post 2021.

The total stock of office space in Riyadh is expected to increase to reach approximately 3,500,000 sq m GLA by the end of 2018, owing to the entrance of a number of notable projects throughout the year including: Cayan Mefic Center, Al Rajhi Bank Tower and the first part of the Business Front. (*Figure 4)*

FIGURE 4

Supply of office space in Riyadh, sq m GLA



Source: Knight Frank Research

Performance

Average rental rates remained flat across Grade A stock year-on-year while Grade B rental rates continued to come under downward pressure. In Q3 2018, Grade A average rents stand at SAR 1,550 per sq m per annum while Grade B average rents stand at SAR 775 per sq m.

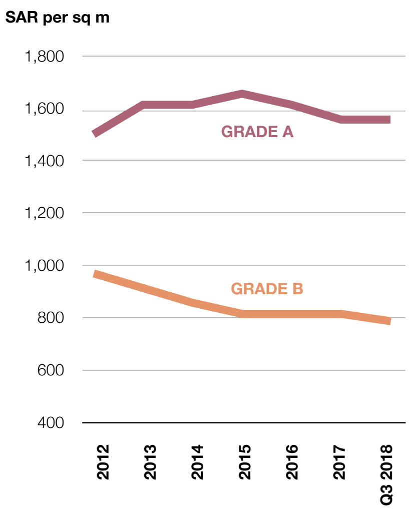
We expect rental rates of Grade A stock to remain underpinned by supply shortages in the short term while the Grade B segment will continue to see declines in rental rates as stock becomes more dated.

Occupancy in prime schemes remains high as the market has been characterised by a lack of Grade A space with key assets such as Kingdom Tower, Faisaliah Tower and Business Gate benefiting from frictional vacancy. Average vacancy rates in Grade A stock were relatively stable year-on-year at 12% while vacancy rates for Grade B stock trended slightly higher to reach 30%.

Looking ahead and as supply increases, we expect the market to become more occupier friendly. We see a two tiered market developing where buildings situated in better locations with attractive facilities will command premium rents while secondary assets will struggle to drive rental rates and occupancy levels. *(Figure 5)*

FIGURE 5

Riyadh office rents



Source: Knight Frank Research

Jeddah

Demand

Demand for office space has remained subdued since 2017 due to economic conditions. Office demand across the city has been focused on smaller offices as companies look to downsize their office space and avoid capital expenditure on customized fit out options.

We expect this trend to continue in the short term until we start seeing a substantial improvement in business conditions and as the reforms set out in Vision 2030 and the NTP feed through into the wider economic system. Jeddah continues to lack a well-defined CBD with key commercial projects being situated on arterial roads such as King Abdulaziz Road and Prince Sultan Road.

Supply

At the end of 2017, the total stock of office space in Jeddah stood at circa 1,000,000 sq m GLA, broadly segmented evenly between Grade A, B and C stock.

The total stock of office space in Jeddah is expected to reach approximately 1,100,000 sq m GLA by the end of 2018, owing to the entrance of a number of projects throughout the year including Ibrahiem Center and Randa Tower.

Looking ahead, there is a large amount of potential office space that could be released to the market, the majority of which is Grade A (60%-70%), while an additional 30% of stock is set to come online in smaller projects along major arterial routes.

A key prime scheme in the pipeline is Jeddah Gate, a masterplan development by Emaar on two sites located along King Abdullah Street and Abdullah Al Sulaiman Street. The development will offer c. 230,000 sq m of high quality office space within a mixed-use environment. Overall, we remain cautious about the timely delivery of scheduled projects within the specified timeframe and expect further delays given current market conditions. *(Figure 6)*

Performance

Average rental rates witnessed year-on-year declines across all segments of the market with Grade A showing a 4% decline and Grade B a 13% decline. In Q3 2018, Grade A average rents stand at SAR 1,150 sq m per annum, while Grade B average rents stand at SAR 775 sq m.

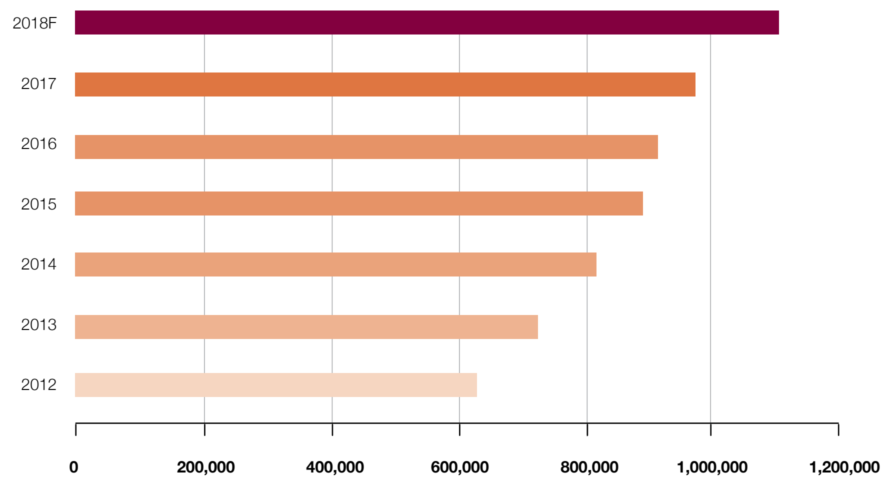
We expect rental rates to remain under pressure in the short term as the market absorbs new supply and demand remains weak. However, due to delays in handover any significant pressure on Grade A rental rates will be smoothed. We expect Grade B rents to come under downward pressure over the short to medium term as occupiers are given more choice as a result of increased supply and competition.

Average vacancy rates in Grade A stock increased year-on-year to reach 10% up from 5%, though certain key schemes have seen occupancy rates increase due to good quality facilities, amenities and parking arrangements. Conversely vacancy rates for Grade B stock trended substantially higher year-on-year to reach 16% up from 5% in 2016.

While a few select Grade A buildings continue to perform above market average, rents and occupancy rates are likely to soften further in the short term as supply outstrips demand for the foreseeable future. Schemes which have good floor plates and are well located within a mixed use environment will have the potential to outperform the rest of the market. *(Figure 7)*

FIGURE 6

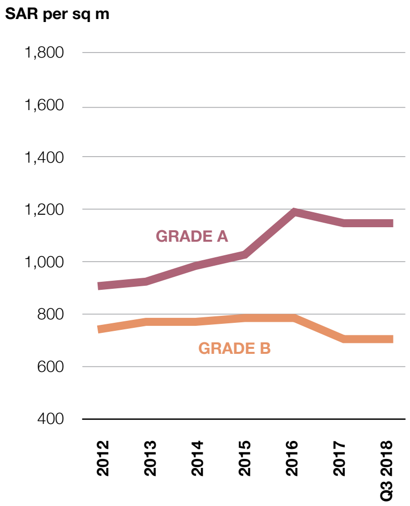
Supply of office space in Jeddah, sq m GLA



Source: Knight Frank Research

FIGURE 7

Jeddah office rents



Source: Knight Frank Research

Eastern Province

Demand

While demand for office space in the Eastern Province has been primarily driven by the oil & gas sector, more recently demand has stemmed from professional services catering to the mining and hydrocarbon sectors such as consulting and law firms. Nevertheless, public sector and family conglomerates continue to be a major occupier of office space.

Demand for offices has been muted throughout 2017 and 2018 as occupiers and investors adopt a wait and see approach, amidst a general slowdown in the wider economy. Should crude oil sustain its recent price rise, we could start seeing positive ramifications on the local economy and market conditions.

However large amounts of future supply will counteract any increase in demand which makes rental increases unlikely in the short to medium term. As a result, the majority of demand is for fitted out office units between 100 - 400 sq m as occupiers seek to avoid capex.

Supply

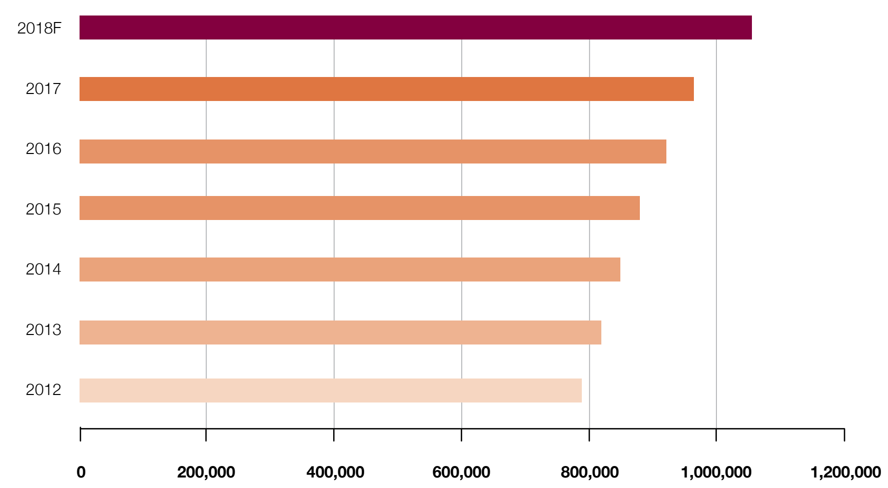
The supply of office space in the Eastern Province stood just below 1,000,000 sq m of GLA at the end of 2017. Approximately 30% of this stock is classified as Prime or Grade A with the majority of quality space being located in Khobar.

In comparison to other centres, there are no large scale master plan developments in Eastern Province that are set to deliver commercial office led schemes, which implies that the market will remain dominated by fragmented development along key roads in the short to medium term.

Our data and estimates show that the stock of office space is expected to increase this year to reach approximately 1,050,000 sq m of GLA by the end of 2018.

As this new supply comes online the market will continue to move in favour of occupiers who will be able to negotiate flexible lease terms such as elongated rent free periods as landlords seek to maintain occupancy rates. Property location will continue to influence occupiers' decisions to relocate along with rental rates as the market is becoming more price sensitive. *(Figure 8)*

FIGURE 8
Supply of office space in Eastern Province, sq m GLA



Source: Knight Frank Research

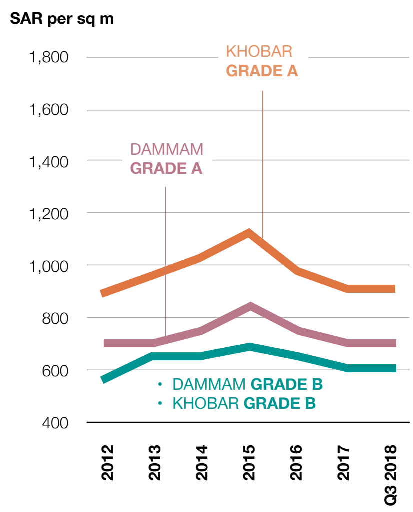
Performance

Average rental rates witnessed year-on-year declines across all segments of the market. Average rents for Prime and Grade A space in Khobar declined 8% year-on-year, while Grade B rents declined by a similar 8% across both Khobar and Dammam. In Q3 2018, Prime and Grade A average rents in Khobar stand at SAR 900 sq m per annum, while Grade B average rents stand at SAR 600 sq m across both Khobar and Dammam.

Vacancy rates in quality stock trended higher on a year-on-year basis to reach an average of 25% for prime and Grade A stock up from 20% a year earlier. Meanwhile Grade B stock also saw vacancy rates increasing to an average of 30% up from 25%. Given the structure of the market we see this trend continuing with Grade B stock expected to witness higher vacancy rates going forward as aging Grade A stock falls into this category.

The recent recovery in oil prices is positive for the local economy though it is unlikely to drive demand to a position where the market reaches parity given the weight of supply in the pipeline. It is key to note that the majority of future supply will be delivered in the Grade A segment which is likely to place pressure on rents and occupancy rates in the short to medium term *(Figure 9)*.

FIGURE 9
Eastern Province office rents



Source: Knight Frank Research, Flag Realty

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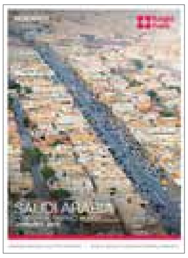

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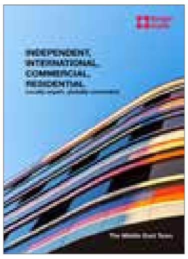

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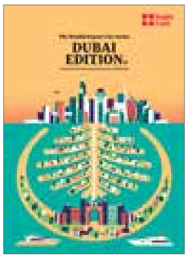

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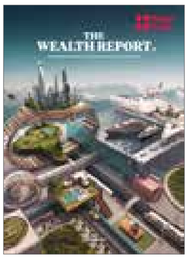

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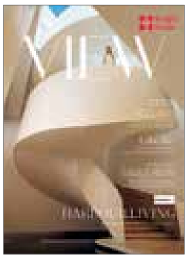

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