Financing Bricks and Mortar

Opportunities for private real estate debt
in the United Arab Emirates and Kingdom of Saudi Arabia

A paper by JLL and Clifford Chance

Key Findings

There has been a **major growth** in the size of the global private debt market (that is, debt not issued by commercial banks) over the past decade. It has increased by *400%* since **2006** to around *$638 billion* as at the end of **2017**

North America dominates the private debt space with close to *60%* of capital deployed, followed by Europe with *25%*

Key sources of private debt include Public & Private Pension Funds, Foundations, Endowments and Insurance Companies

- Despite the trends mentioned above, private debt is rather limited in the Middle East, with the vast majority of debt being provided by commercial banks. Challenges with respect to foreclosure and bankruptcy laws, lack of market data and understanding of risk and reward metrics have been some of the key reasons for its limited use in the region.

- This situation is expected to change over the next decade, with alternative funding sources including fund managers, pension funds and insurance companies actively reviewing this investment style. Improvements in market transparency and regulation are creating a more attractive environment for this to occur. We expect that the majority of this capital will find its way into real estate.

- These new sources of debt are expected to respond to the constraints of the present arrangements, with limited competition to the commercial banks in respect of real estate lending.

- We expect that over time, these new sources will offer alternatives to:-

  - Tier 2 & 3 developers who currently find it difficult to obtain debt facilities from commercial banks.

  - Institutional investors who are seeking a cash on cash yield through interest only finance, a phenomenon very common in developed markets.

- While this competition may not significantly reduce the cost of borrowing, it should encourage conventional banks to become more flexible and accommodating to the requirements of borrowers.

- The emergence of diverse sources of debt will be a positive for a maturing real estate market, providing greater competition and more options for real estate developers and investors.

- Coupled with alternative financing structures such as sale & leaseback, build to suit and sale & buyback, the growth of private debt will attract more capital to real estate, primarily in the more advanced regional markets such as Saudi Arabia and the United Arab Emirates.

Foreword

Historically, commercial bank lending has been the major source of debt for real estate developers and investors in the Middle East as there has been an absence of alternative sources of debt. **The growth of this alternative sector, private lending (defined here as non-bank debt), forms the focus of this paper.**

The insignificance of this market is reflected in a current lack of official data on private lending in both the UAE and Saudi Arabia, the two largest capital markets in the region. Much of the discussion on the current market is therefore, by necessity, couched in qualitative rather than quantitative terms. Given the lack of quantitative data, we have undertaken interviews with approximately 30 players (both lenders and borrowers) based in either the UAE or Saudi Arabia in writing this paper. While these discussions were held on a confidential basis, we would like to express our appreciation to these parties for sharing their insights on this emerging funding class.

We believe that the next decade will see major growth in the availability and use of private debt, with the majority benefitting real estate. Without doubt this will be a positive sign of a more mature and competitive real estate capital market in the Middle East region.

An active, competitive and vibrant debt market is as important to the real estate sector as the amount of equity. It not only increases the pool of capital available but also increases the opportunities for medium to low risk investors to access the real estate sector.

This paper aims to provide a better understanding of the private real estate debt market in the UAE and KSA by addressing the current condition of the market and **giving insights on its potential growth and the opportunities it will present to both lenders and borrowers.**

This paper is co-authored by JLL and Clifford Chance. We trust it provokes interest among both potential lenders and borrowers and encourages an increased debate on alternative sources of real estate funding. As this is a very nascent market in the region, we do not claim to have all the answers and we welcome comments or suggestions on the issues raised in this report.

Gaurav

Gaurav Shivpuri
Head of Capital Markets – MENA

Role of Debt in Real Estate Capital Stack

While debt should be an integral part of the capital stack for real estate investors, due to cultural reasons, the Middle East has historically seen less use of debt than more mature overseas markets. This is one of the reasons why the creativity and flexibility of the debt market in the region remains limited.

While the composition of the capital stack clearly varies significantly, both between investors and across specific investment opportunities, we estimate that debt currently comprises no more than 10-15% of the capital stack of the overall real estate market, excluding undeveloped lands.

Characteristics of debt & equity investments

Potential Return & Risk

Low → High

Senior Debt	Subordinate Debt	Mezzanine	Preferred Equity	Common Equity

	Debt	Equity
Order of Claim	Senior	Junior
Ownership Rights	None	Exists
Life	Finite	Infinite
Examples of Public Securities	Bills, Bonds, Sukuks, Debentures	Shares
Examples of Private Securities	Loans	Shares
Source of Profit	Interest	Dividend and Capital Gain
Risk Exposure	Low (first in line)	High (residual claimants)

Source: JLL

The attraction of debt is that it allows investors to reduce the level of their own equity, while boosting returns. While these returns will clearly vary between asset classes and cities, the following is our view of the typical returns that investors currently expect from different components of the capital stack.

Typical IRRs from different components of the capital stack in the GCC

	Core	Core Plus	Value Add	Opportunistic
Equity	9% -10%	11% -12%	14% -16%	20% +
Mezzanine	-	-	12% - 14%	16% - 18%
Junior Debt	7% – 8%	7% – 8%	9% – 10%	9% – 11%
Senior Debt	4% - 5%	4% - 5%	5% - 6%	6% - 7%

Source: JLL

We expect that private debt will initially enter the senior debt space in core assets as investors go into lower risk opportunities before going up the risk curve.

Private debt

Senior debt	Most senior claim	Lowest to risk to lender lowest interest rate	Eg. Bank loans (usually most senior)
Mezzanine debt	Claim on debt	Risk to lender interest rate	Less senior bank loans Mainly used to finance short to medium term company growth, when other forms of debt are not viable
Venture debt			Venture debt
Distressed debt	Least senior claim (more senior to equity)	Highest to risk to lender Highest interest rate	Distressed debt

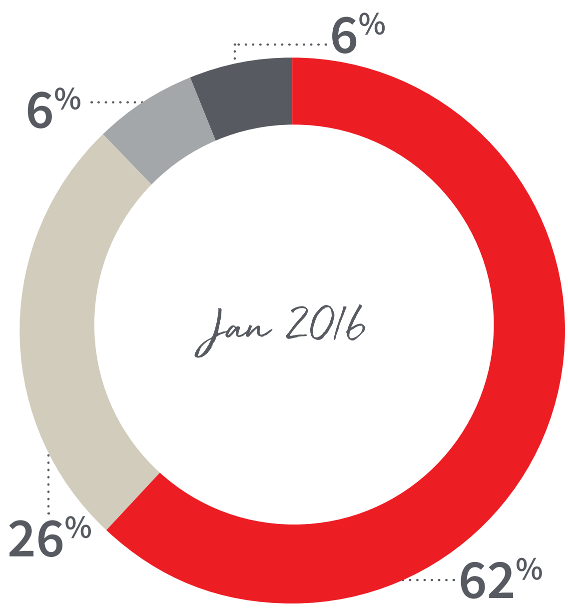
Source: JLL

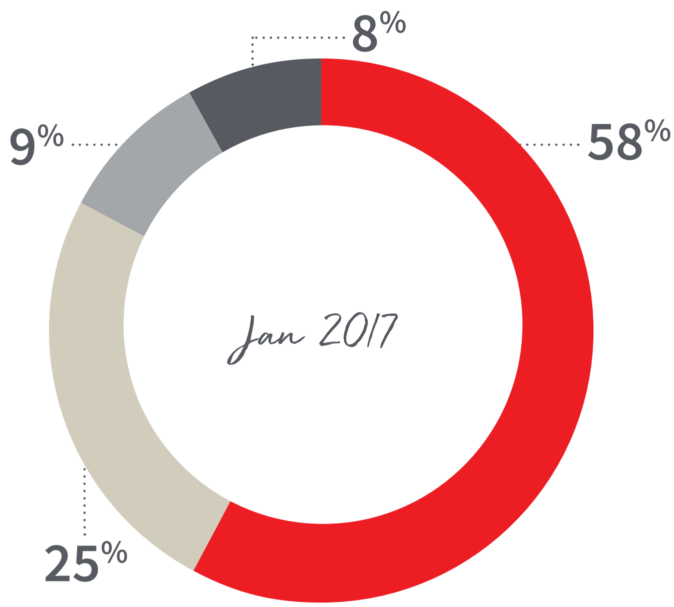
Global *Growth* of Private Debt

The global market for private debt has increased by approximately 400% since 2006 to around $638 billion by the end of 2017. In addition, another $220 billion of "dry powder" is currently available. The current market is dominated by capital raised in North America, which accounts for almost 60% of the global total. In comparison the markets in Europe (25%) and Asia (9%) are much smaller.

While the rest of the world (including the Middle East) currently accounts for just 8% of the total private debt, there is a growing interest in this sector from investors, particularly in the GCC.

Institutional private debt investors by location



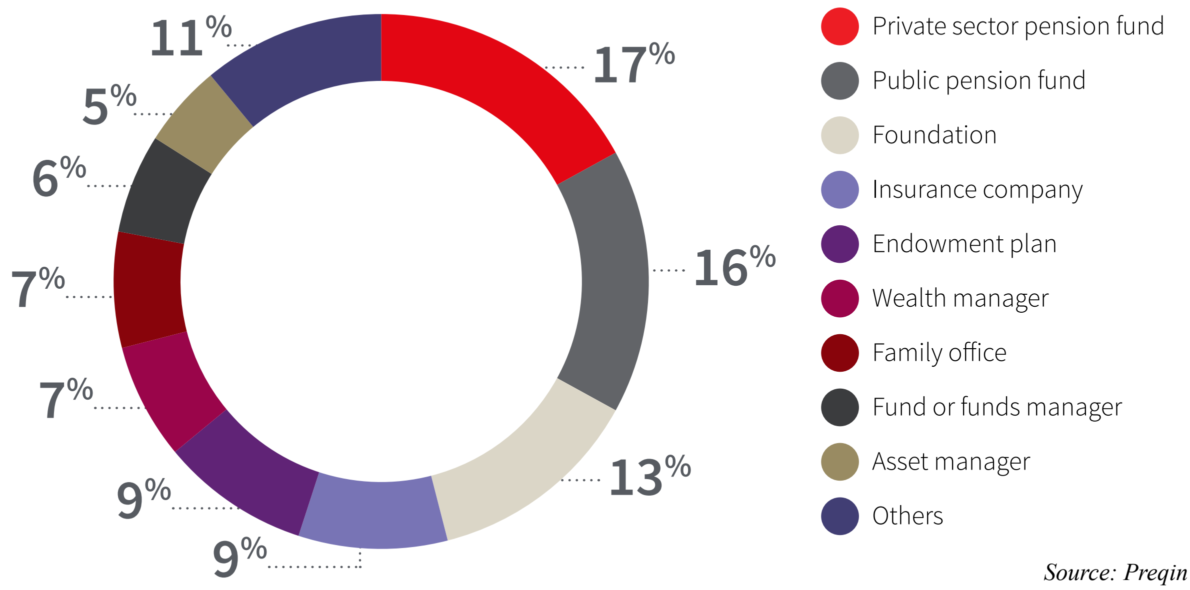


North America | Europe | Asia | Rest of the world

Source: Preqin private debt online

The global market for private debt is dominated by 'institutional' investors that account for around 85% of the capital currently deployed. Pension funds, foundations and insurance companies are the major players in the institutional sector of the market. The major players in the private wealth sector (15% of the global total) include wealth managers and family offices.

Institutional investors in private debt investor type



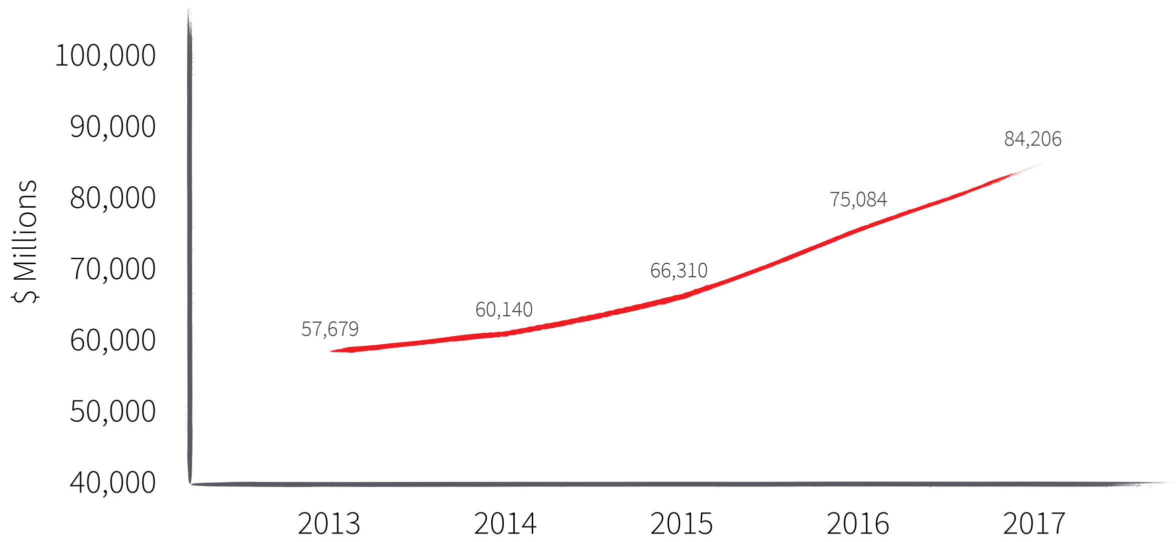
Source: Preqin private debt online

Real Estate Debt in the Middle East

Debt is an integral part of real estate investment and development, and the Middle East is no different, albeit the quantum is lower than most developed markets. The reasoning is steeped in culture and tradition, although we are beginning to see that institutional investors in the region are beginning to judiciously use debt to improve equity returns and ensure their available equity goes further.

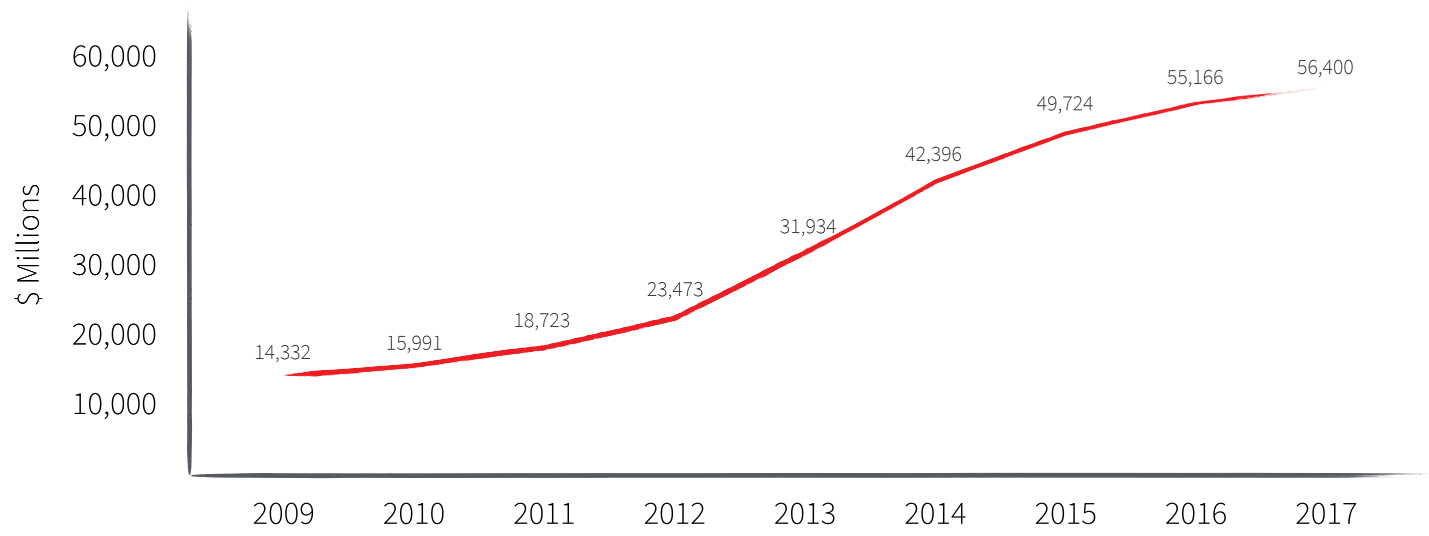
Most, if not all, of the real estate debt in the Middle East is currently sourced from conventional banks, given that there has been limited availability of private debt. Nor has the legal set up allowed for non-banking entities to take charges over the assets. Historically this debt was issued with recourse to the promoter and 'name lending' has been a big part of real estate lending in the region. Additionally to debt, since the advent of the "freehold law" in Dubai in 2006, developers in the UAE have used off-plan sales as an alternative means to fund their projects.

Bank lending to real estate in the UAE



Source: Central Bank of the UAE

Bank lending to real estate in Saudi Arabia



Source: Saudi Arabian Monetary Authority (SAMA)

> *“We estimate that around 10% of the $51 billion of private debt that was raised outside of the three main global markets of USA, Europe and Asia Pacific in 2017 could have been lent to the real estate sector in the GCC. This would equate to around $5.2 billion, which is just 3.8% of the total of $136 billion of bank lending to real estate in the two major markets in the GCC (UAE and KSA).”*
>
> *Gaurav Shivpuri*

There is no official data available on the level of non-bank lending to real estate in either the UAE or Saudi Arabia, indicating the undeveloped nature of this sector of the market.

To compensate for the lack of official data on the size of the private debt market, we interviewed around 30 participants (lenders and borrowers) in the private debt market based in the region.

The major conclusion from discussions with potential borrowers and investors was the need for a range of new products that are not widely available in the marketplace today. Two major attractions of private debt were recognised:

1. Widespread availability to smaller and less well established borrowers who currently struggle to secure traditional bank debt without providing a high level of collateral as security.

2. More flexible loan terms.
Investors recognised that private debt is likely to cost more than that available for commercial banks, but felt this would be offset by the more flexible and tailored packages and more alignment of risk between the borrower and the lender.

The conclusion from discussions with potential providers of private debt was that the market was now sufficiently mature and the legal framework sufficiently robust to allow for the development of more sophisticated debt instruments.

A range of fund managers and insurance companies expressed their interest in debt instruments to meet their allocation to real estate without having to take operational and business risks.

Private Real Estate Debt Markets: UAE & KSA

The views of potential borrowers and lenders of private debt are summarised in the following tables:

Borrower's view

Developers	Private Family Groups	Real Estate Funds
Development financing is generally easier for large developers with established track records	Access to conventional debt funding is largely restricted to private family groups with a long-standing established reputation	Real estate funds typically require debt in order to leverage their positions and generate attractive returns to their investors
Unlike upper tier developers, smaller developers with limited track record find it difficult to obtain financing unless providing sufficient additional security including cross collateral and corporate / personal guarantees	Large private family groups typically secure general credit facilities rather than on a project basis	Unlike developers and private family groups, the funds nature of business does not allow the provision of security from outside the fund structure
Aside from the borrower's profile, lenders will only consider funding projects that are well located with sound market fundamentals	Due to liquidity pressures, smaller private family groups are increasingly finding it difficult to secure conventional facilities unless they provide high levels of protection	Given the above-mentioned limitation, coupled with the conventional banks' risk appetite, funds opt for lower LTVs to provide lenders with sufficient comfort
Most of the developers seek out financing from conventional means	Most private family groups are seeking funding from commercial banks	Most funds seek their real estate debt from commercial banks
Smaller developers with limited access to conventional capital are now considering alternative sources		

Source: JLL

Lender's view

	Commercial Banks	Capital Leasing Firms	Debt Funds	Pensions and Insurance
Typical Borrowers	Various	Corporates and private family groups	Developers and private family groups	Active real estate investors in North America and Europe, on the real estate in the Middle East
Ticket Size per Investment	Depending on the borrower, asset details and approved exposure	Up to USD 30 million	Up to USD 100 million	
Loan to Value	Up to 60%	Up to 70%	Up to 60%	Invest in a wide range of asset classes including fixed income, equities and real estate
Amortisation	Straight line preferred, limited flexibility on balloon arrangements	Straight line preferred, can accommodate different balloon structures	100% bullet	
Interest Payment Method	Cash	Cash	Cash and payment-in-kind (PIK)	Real estate exposure can be both direct and indirect either through equity or debt placements
Tenor	5 – 10 Years	3 – 7 Years	2 – 3 Years	
Security	Asset collateral / cross collateral and corporate / personal guarantees	Asset collateral and corporate / personal guarantees	Asset collateral and corporate / personal guarantees	Depending on their asset allocation strategy, regional pensions and insurance companies can offer different debt structures
Commentary	In times of liquidity pressures, conventional banks adopt conservative approaches to lending. Prefer lending to private family groups with strong financial positions.	While capital leasing firms could offer flexible facility structures, they offer limited ticket sizes and mostly focus on lending to private family groups rather than financial institutions.	There are a handful of real estate debt funds in the region, focused on providing short-term development finance facilities with either senior or junior claim positions. Few non-debt-focused fund managers offer alternative arrangements including sale, lease and buyback structures on an opportunistic basis.	

Source: JLL

Challenges & Constraints

1. Legislative constraints

While there are few specific laws relating only to non-bank debt, this market is of course subject to more general laws and regulations. One major regulatory constraint on both bank and non-bank lending to real estate in the UAE and Saudi Arabia are those relating to foreclosure and bankruptcy. In these jurisdictions it has been, and continues to be, difficult for lenders to force non-performing borrowers into bankruptcy or to obtain title over real estate assets held as security for loans.

Generally speaking, all companies offering debt (banks and non-banks) are required to obtain operating licenses from the relevant regulatory bodies for financial services. Foreign lenders are also required to obtain a license from these regulators to operate in both the UAE and KSA. Additional licenses are required to hold certain types of security e.g. mortgages.

This situation is slowly changing and new bankruptcy legislation in the UAE aims to give lenders additional remedies with respect to non-performing loans. The regime is still largely untested and it is probably too early to assess the full extent of this new law in promoting the growth of non-bank debt in the real estate market.

A related area of the law that applies equally to all real estate investors is mortgages. In the event of default and the failure of other remedies, a lender may elect to enforce the mortgage. The UAE court can authorise the auction sale of the property with the proceeds of this sale being used to repay the outstanding debt. The enforcement process is however relatively protracted and it could take more than twelve months for a borrower to receive repayment of their debt.

The mortgage law in Saudi Arabia has not been fully implemented meaning that mortgages have generally not been available as a form of security to lenders in the KSA market. However the authorities in KSA have recently issued directions which are intended to clarify the mortgage registration process and increase implementation of the mortgage law.

2. Lack of understanding

One of the greatest challenges with any new product is the lack of understanding of the benefits and the absence of a clear track record that the proponents of the product can point to. This is certainly the case with private debt for real estate investment in the region at the current time. The market generally understands traditional bank lending and while the constraints and limitations of this source of capital are acknowledged, there is far less understanding of how these can be overcome by the increased use of non-bank lending.

With private debt now playing such a major role in the real estate capital stack globally, this lack of understanding can only be a temporary constraint. The increased globalisation of the real estate capital markets will ensure that experience gained in other regions will quickly become available in the Middle East, thereby reducing the current lack of understanding of the benefits that private debt can bring to the table.

3. Absence of specialist non-bank lenders

The past decade has seen a significant increase in the number of specialist lending institutions, with some of these being spun off by local and international banks that recognise the increasing sophistication of the local financial markets.

Particularly notable has been the growth in the number of specialised asset managers focussing on opportunities in the real estate sector. Some of these fund managers have now diversified their product offerings away from simply taking an equity stake to now also offering an increasing range of debt products as they seek to diversify across the entire capital stack.

4. Limited institutional investor base

The global distribution of the private debt investor base is largely institutional, whereas the Middle East is dominated by private investors, whose understanding and appetite for such a product remains limited.

As the investor base in the Middle East begins to institutionalize, we expect the appetite for debt instruments to increase, as witnessed globally.

5. High returns on equity

Historically, real estate development/investment in the GCC has generated strong returns backed by growth in population and demand. These high returns have resulted in capital flowing in the form of equity, rather than seeking lower risk/return approaches.

The above combined with a low interest rate environment, especially since the Global Financial Crisis, has meant that return on debt has remained conspicuously low. However, as the interest rates begin to rise in the United States, and respectively in the GCC, we expect that the spreads between equity IRRs and debt returns will compress, drawing more investors to this asset class.

6. Lack of demand

For any product to succeed there has to be demand for it. Historically, banks have provided debt to real estate largely at the corporate level. This has resulted in higher LTVs and at lower costs, given that the coverage of the loan was more than just the real estate asset. Most borrowers also did not see leverage as a means to enhance their equity returns and preferred to pay back the loan as soon as they could. The amount of liquidity in the banking system meant there was ample debt capital available for the amount of real estate development that was taking place. Given this, most borrowers were not looking for any alternative or more flexible structures, especially if these were offered at slightly higher rates, resulting in no supply of this product.

In conclusion, while there remain challenges and constraints to overcome, the real estate markets are maturing quickly in both the UAE and Saudi Arabia. This maturity is resulting in more sophisticated players with global experience of alternative financial structures such as private debt financing that are not currently widespread within the region. Most of the above constraints are therefore reducing in significance and are considered unlikely to inhibit the expected growth of the private debt market over the next 5 to 10 years.

Looking *Ahead*

A total of $81 billion (AED300 billion) of bank debt was lent to the real estate and construction sector in the UAE in 2017, with banks in Saudi Arabia lending $55 billion to the real estate sector alone. A 10% market share would suggest private debt could reach levels of between $10 and $15 billion.

Potential size of market

Developers and investors will continue to seek debt for the construction or purchase of real estate investments. With constraints on traditional lending by the commercial banks, it is not unreasonable to assume that 10% of the total real estate debt market could come from private providers within the next 5 years.

Sources of private debt

Overseas experience suggests that the majority of private real estate debt will initially come from institutional players such as pension funds, insurance companies and fund managers. These investors recognise that with the region facing a low growth environment and capitalisation rates not expanding enough on the back of interest rate rises, taking exposure to real estate though debt instruments, offers them a balanced reward for the risk.

Endowments in Saudi Arabia are also likely to be active lenders in the private debt market over time as they have a long-term view on their investments and are attracted by the lower risks and management costs offered by investing in completed real estate projects.

Collective investment vehicles will also emerge over time, as investors see debt as an alternative for investing directly in real estate, with many of these vehicles being floated by existing and new asset management companies. These vehicles are likely to be more creative than the endowments and pension funds as they will be seeking higher returns for their investors. These funds will therefore probably target more opportunistic/ development projects and will back tier 2 & 3 developers that may currently struggle to borrow from traditional banks for their projects.

Cost of debt

Given the more flexible and tailored nature of private debt vehicles, there is a general recognition that these instruments will be priced at a premium compared to more traditional bank lending on real estate.

Potential borrowers

To begin with, we expect the majority of demand for non-bank debt funding will emanate from those real estate investors seeking longer term lending, at lower loan to values on an interest only basis.

The more creative and tailored nature of private debt finance will help these investors achieve better cash on cash dividend returns than traditional bank lending.

Most of the large real estate investors in the region have access to sufficient bank debt in the form of relationship lending. The majority of private lending is therefore likely to target smaller and less well established developers.

While these tier 2 & 3 developers will ultimately be keen to access private debt, we expect this to emerge in the second stage of the evolution of the private debt market in the region.

Interbank lending rates within the region are currently in the order of 2.5% and a margin of 250 - 300 bps for real estate is considered appropriate, bringing bank lending on real estate to between 5% and 6%. We estimate private debt would be priced between 100 -150 bps above conventional bank lending, suggesting private senior debt could be priced in the range of between 6% and 7% on core transactions.

Uses of private debt

While private debt could be used to fund new development, the generally over supplied nature of real estate markets in the UAE and Saudi Arabia at the present time suggests that the majority of private debt is likely to be used to fund the purchase of existing income producing assets in the short-term.

While much of the initial private debt is likely to be invested in 'core assets' (existing income producing projects) declining returns in more traditional asset classes such as offices, retail and residential, is likely to result in an increased level of investment in 'alternative' asset classes such as education, healthcare and student housing over the next 5 years. Some of the increased pool of private debt is also likely to be directed into infrastructure rather than real estate projects.

Potential structures

The table below depicts the typical structures that are prevalent across the funding options to investors and developers. As witnessed, over the past decade the sale & leaseback structure has emerged out of the shadow of conventional debt funding and we expect the same to evolve towards the private debt in the coming decade.

The key differential between the two ends of the spectrum is the risk and reward dynamics of a conventional bank vs. private debt provider, which drives the acceptable terms to each.

In addition, the private debt business will be more creative and will play across the capital stack including senior debt, junior debt and mezzanine and preferred equity, pricing each according to the amount of equity committed, the investment style and operating risk. This is going to create a more vibrant real estate investment landscape allowing investors to cherry pick risk and returns.

Financing structures

	Traditional		Alternative	
	Mortgage	Rent-to-Own	Sale, Lease and Buyback	Private Debt
Interested Lenders	Commercial Banks	Islamic Commercial Banks, Capital Leasing Firms	Pensions Funds and Asset Managers, Private Families	Insurance, Pensions, Foundations and Debt Funds
Loan to Value	50-70%	Up to 70%	Up to 100%	Up to 50%
Amortisation	Straight Line (Limited Flexibility)	Straight Line (Ijarah), Limited Flexibility (Capital Lease)	Interest Only (Rental Yield)	Flexible Arrangements (Interest Only / Balloon Structures)
Investment Style	Core, Core+, Value Add, Opportunistic	Core	Core	Core, Core+, Value Add
Interest / Profit / Rent Payment	Cash	Cash	Cash	Cash and PIK (Toggles can be Accommodated)
Tenor	5 – 10 Years	5 – 10 Years	Flexible Arrangements	Flexible Arrangements
Security	Asset collateral / cross collateral and corporate / personal guarantees	Asset collateral / cross collateral and corporate / personal guarantees	Flexible Arrangements	Flexible Arrangements

Source: JLL

JLL added value

As a trusted real estate partner in the region, JLL adds value as a commercial and technical advisor to both the public and private sectors. JLL often works in consortiums, working closely with legal and other technical specialists to provide clients with one-stop-shop solutions in relation to large and complex projects.

JLL has advised many private sector clients in relation to complex real estate developments in Saudi. This assistance has ranged from evaluating PPP opportunities, raising finance, assistance during bid preparation and project and construction management skills during the construction stage. JLL was recently appointed by an international consortium to assist in deal evaluation for a project in partnership with the Ministry of Housing in KSA.

JLL has also collaborated with various public sector bodies and government agencies across Saudi. Our role in such engagements has varied from acting as a commercial and technical advisor to an end-to-end development manager. We recently advised a large public sector entity in respect of a major BOOT, including the preparation of a commercially viable PPP deal, managing the RFP process and assisting the client until project award.

About Clifford Chance

Clifford Chance is one of the world's leading international law firms and has been advising in the Middle East for over 40 years, with over 30 Tier One directory rankings achieved in the region in 2017, and more award winning first-of-a-kind deals than any other firm.

Clifford Chance has a cooperation agreement with Abuhimed Alsheikh Alhagbani Law Firm (AS&H) in Saudi Arabia and works closely with AS&H on a number of complex and innovative mandates covering a wide range of practices. In the UAE our team of over 80 lawyers advises clients on domestic, regional, and international matters and have delivered many first-of-a-kind deals. Our offices in Abu Dhabi and Dubai are permanently staffed by over 80 lawyers. We base lawyers in the UAE, rather than bringing in out-of-region lawyers to resource complex transactions, because we believe that clients get the best results from teams who are familiar with the region›s laws, languages, and business processes.

Clifford Chance Real Estate practice:

Clifford Chance offers an exceptional real estate practice, with experienced on-the-ground resource in the United Arab Emirates and Saudi Arabia. Our regional real estate team have led on numerous complex landmark projects and transactions, and regularly advise clients throughout the entire life cycle of a real estate project, from initial financing and development, through to sales, lettings and divestment. Our real estate practice is truly global by nature, and draws on the expertise of specialist lawyers from around the Clifford Chance international network. We have more tier 1 rankings in Chambers & Partners Europe and Chambers & Partners UK 2018 combined for Real Estate, Real Estate Finance, Construction, Planning and Environment than any other firm.

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