Real Estate Market Outlook:

Current state of the real estate market is highly influenced by regulatory reform: Future outlook is dependent on how market participants react to reforms and how enforcement takes place (effectiveness of enforcement mechanism). The NTP (National Transformation Plan) and 2030 vision outlined real estate initiatives and indicators in an effort to reshape the industry. Noteworthy initiatives and targets include raising institutional contribution to real estate development (from 10% to 30% by 2020) along with pushing real estate financing as a percentage of non-oil GDP from the current point of less than 10% to 15% by 2020. Such initiatives have the potential of backing institutional investment to rise and fill market gaps as market transparency improves.

NTP Real Estate initiatives aimed at shaping the investment landscape:

Initiative	Current Base	Target	Benchmark	
			Regional	International
Real Estate Contribution to GDP	5%	10%	13%	20%
Average multiple of unit price to Annual income	10x	5x	6.7x	3x
Percentage of units built or executed by licensed developers	10%	30%	NA	NA
Percentage of Real Estate loans to non-oil GDP	8%	15%	16%	75%
Average days for issuing development licenses	7	1	44	26

Source: 2030Vision, AJC, MOH

SAMA adopted a macro prudential approach to real estate financing by setting LTVs (Loan to Value) at 70%: Stricter lending standards reflected in a lower LTV ratio mandated by SAMA on lenders have had its toll on the level of liquidity in the market. Such measures are usually taken to curb real estate prices and avoid credit bubbles. LTV is estimated to remain at current levels. As real estate markets exhibit a level of transparency in a more regulated market, LTV classifications might be introduced and used as a tool to direct/incentivize investment towards specific market segments.

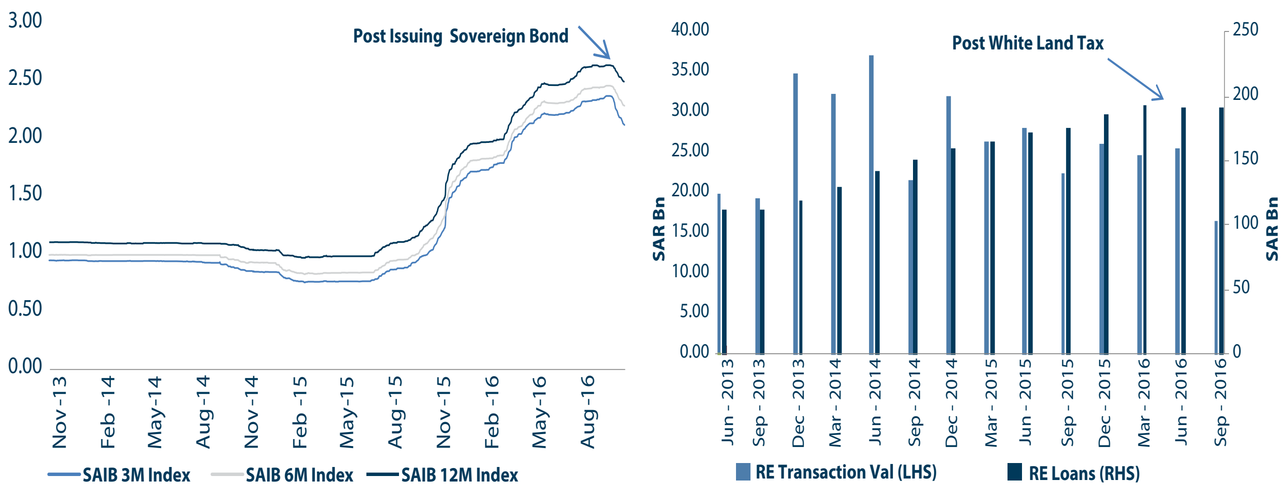
Tax on vacant land (white land) set to change market dynamics and approach towards real estate investment: It is relatively early to speculate on how the investment landscape post land tax will look, given that the regulation will take place in four phases, the last being all inclusive. The real estate investment landscape is expected to shift away from raw land and divestment and lean towards income generating assets; we have seen this take place in 2016 through the growing level of investment in income generating assets through private placement funds compared to the previous years. Sale and lease back deals (asset stripping) are expected to rise compared to previous years, fuelling the availability of income generating assets in the process. Data shows that the first 9m of 2016 witnessed a rise in real estate funds with a focus on income generating assets; with more than 70% of real estate funds initiated being under income classification.

The introduction of REITs will prompt institutional investment in different income generating real estate sub sectors on the medium and long term: As REITs mature in terms of size and market coverage as an asset class; yield and performance data would make a reasonable reflection of real estate sub-markets as a whole. Riyad Capital's Riyadh REIT is the first to get full approval towards listing on Tadawul; Tadawul's REITs index is expected to add a level of transparency in terms of required returns on real estate investment.

Challenging market conditions; a combination of declining purchasing power and rising interest rates: Broadly, the combination of declining purchasing power and rising interest rates reflects negatively on housing; credit driven markets are sensitive to changes in interest rates and the broad credit environment. A general decline in housing prices usually follows declines in purchasing power in order to accommodate lower purchasing power. Rising interest rates are followed by rising cap rates (i.e. a higher required rate of return on real estate), which tends to be at the expense of lower real estate values rather than on higher rents. However, real estate prices tend to be sticky in nature and require significant time to adjust. We should note that the timing of such cycles is unknown; there isn't enough recorded data to document previous cycles and tentatively predict and forecast future ones. We should also note that the previous view on rising cap rates at the expense of lower real estate values is abstract, in the sense that data on rent and rental yields have yet to be available in the kingdom.

Finally, relatively low levels of debt in the market (compared to regional debt levels) could partially mute the effects of rising interest rates on real estate values.

As the amount of debt in the market increases in a more regulated form (Mortgage to GDP), the market is expected to react in a more definitive manner to changes in interest rates.



Source: Bloomberg, AJC

Varying levels of uncertainty in sector outlook, lack of data adds a layer of risk to sector investment: For the short term, the recent and ongoing declines in recorded real estate MOJ indicators (average price per sqm and number of transactions) might pave way to a potential scenario that a long term bottleneck in the broader residential housing market is forming, where supply at a range of price points that align with consumer affordability levels might experience shortage for a period of time before balancing.

In the long term, real estate developers have an opportunity to gain from an eventual flow in liquidity from both an increase in lending activity and a rise in affordability (eventual market adjustment to affordable values) effectively taking advantage of relatively lower and potentially distressed input prices throughout the cycle.

For our overall outlook, certain housing segments will experience declines in prices in the short to medium term led by distressed assets. The resurgence of residential real estate going forward can only be driven by an upturn in available liquidity and /or a rise in relative affordability giving broader access to entry level homebuyers.

The broader view shows that the ongoing rebalancing might turn out to be quite healthy for the real estate market, effectively setting an improved and transparent investment environment.

A note on data, recorded prices and indices: It is a common oversight to narrow real estate markets down to land transaction activities and values in major cities in an effort to gauge investment attractiveness or investment environment and conditions. Different indices methodology would paint a different picture. MOJ's (Ministry of Justice) current indices give a relatively distorted view of real estate prices. The current methodology relies completely on recorded transactions, which provides data on what has been sold and purchased regardless of outstanding or prevailing market prices, in effect; this ignores market value of outstanding unsold units. Given the stickiness of real estate prices over time, MOJ's current indices are not an accurate reflection of prevailing prices or values, rather, it is a good indicator of market demand direction. The index exhibits a clear sales selection bias. The MOJ announced plans to update indices methodology.

Real estate equities have outperformed the market; not a complete reflection of the state of the sector. We update our recommendation for sector companies under coverage to "Neutral".

Dar Al Arkan: Current credit and real estate conditions do not support a positive outlook on the company. Debt repayment to take place at the expense of investment in future projects. Fees on land bank pose significant long term risks. Government contracts remain as the only short to medium term positive catalyst. We are "Neutral" on Dar Al-Arkan with a PT of 5.10 per share. AJC estimates puts Dar Al Arkan in a positive position with regards to the company's ability to repay outstanding debt. Positive cash flows are critical for maintaining a favorable debt paying position; cash conversion along with realizing receivables is vital in the quarters ahead. Outstanding debt is at SAR 5.0bn (SAR 3.17bn in Sukuk and SAR 1.9bn in murabaha after the recent repayment of SAR 1.12bn in Sukkuk on the 25th of November). The company's cash position will stand at around SAR 440mn post Nov-2016 repayment, while receivables are at around SAR 1.7bn (we should note that receivables turnover have been on a downward trajectory and currently stands at 1.02x. We should also highlight the recovery of SAR 572mn in receivables during 1H-2016 effectively cushioning the company's cash position prior to the Sukuk repayment). Post Nov-2016 repayment, D/E stands at 0.27x while TTM Net-Debt/EBITDA stands at 5.18x, which is a crucial indicator given that the company relies on a declining real estate market where forward EBITDA is likely to weaken. Forward Net Debt to EBITDA and D/E are estimated to decline on the back of lower debt post Nov-2016 repayment.

We update our PT to SAR 5.1/share with a "Neutral" recommendation. Based on our earnings outlook, FY2016 forward TTM P/E and P/B stand at 27.2x, and 0.29x respectively, a 70% discount to current book value. FY2016 EPS is estimated at SAR 0.20 per share (a 39.4% drop YoY) FY2017 is expected to be in line with FY2016, forward bottom line improvements would be a result of lower Sukkuk charges and SG&A cuts. Assuming current revenue mix, sales are estimated to post CAGR (FY2016 – 2018) of - 4.7% for the period.

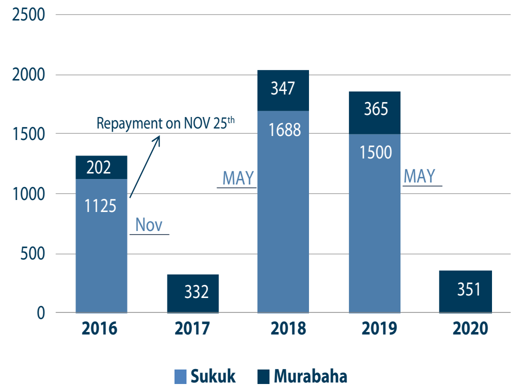
Emaar Economic City: Favorable view hinges on the company's ability to develop recurring income asset base. MOU with the Ministry of Housing. Forward liquidity remains a concern. We update our recommendation to "Neutral" with unchanged PT of SAR 15.6 per share: The company recorded a loss of SAR 32mn for the 9m-2016. Sales remained healthy for the period, growing 9.3% YoY, and standing at SAR 695.1mn for 9m-2016. Recurring income is estimated to grow steadily, supported by growth from the Industrial Valley lease portfolio in the short to medium term. Residential development remains as EEC's largest segment, contributing around 50% of total revenues, followed by revenues from the industrial valley (including divestment and Leasing) at around 32%. Emaar has significant room for growth supported by the passing of off plan sales regulation for real estate developers. However, we should note that further growth in residential sales hinges on consumer demand for housing, which is estimates to remain stagnant in the short term. Further development will require substantial funding, adding to Emaar's LT Debt of SAR 7.1bn current TTM Net Debt to EBITDA stands at around 26.5x (requiring significant growth in forward EBITDA to justify leverage levels) while Debt/Equity stands at 0.83x. SAR 5.0 bn of LT debt is due to the ministry of finance with a fixed rate and an extended grace period, effectively limiting interest rate exposure.

Key Sector Equities Data

Market Cap (SAR mn)	65,980
YTD %	6.5%
TTM PE	46.4x
PB	1.68x
ROE	3.63%
ROA	2.39%
D/E	0.42x
Sector companies	9

Source: Bloomberg, AJC, *prices as of 22nd Nov 2016

Dar Al Arkan Debt Maturity Schedule (SAR mn)



Source: Bloomberg, AJC

Valuation: Our valuation for sector companies is derived using SOTP approach: i) 5-year DCF applied to cash flow generating activities. ii) NAV with an applied liquidity discount. Upside risks to sector valuations include: i) a finalized deal with the MOH regarding land participation or land and units. ii) If sector companies able to sell land parcels and units at a higher pace,; cash flows are the priority at this stage. iii) Off plan sales would help in cushioning cash flows and restore investor confidence in project execution.

Companies Under Coverage	Recommendation	PT (SAR)	Upside / (Downside)	EPS		Forward PE	
				FY2016	FY2017	FY2016	FY2017
Dar Al Arkan	Neutral	5.1	-6.40%	0.20	0.18	27.2x	30.2x
EEC	Neutral	15.6	2.30%	0.13	0.47	117x	32.4x

Source: AJC, Bloomberg, Tadawul

*Prices as of 22nd of Nov 2016

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RATING TERMINOLOGY

1. Overweight: This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. Underweight: This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. Neutral: The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. Suspension of rating or rating on hold (SR/RH): This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

Disclaimer