Real Estate Market Outlook: Regulatory Reforms & an Overall Stagnant View for 2015

Real Estate Outlook

The current stagnant state of the market as well as the uncertain future outlook might discourage capital investment in the sector. This will eventually discourage lenders to take larger risks by lending investors and consumers.

For the short term, the recent declines in real estate indicators (average price per sqm and number of transactions) lead us to believe that a bottleneck in the broader residential land and housing market is forming.

The bottleneck is further congested by the inability of new participants to enter the market due to inaccessible capital. The sharp drop in recorded prices is not sustainable and is set to adjust after the bottleneck clears in the medium to long run and affordability rises.

For our overall outlook, certain housing segments will experience declines in prices in 2015 with a marginally negative outlook on prices in the long term. The resurgence of residential real estate can only be driven by an upturn in available liquidity and /or a rise in relative affordability giving broader access to entry level home buyers.

In the long term, real estate developers have an opportunity to gain from an eventual surge in liquidity from both an increase in lending activity and a rise in affordability.

Rental yields are expected to exhibit an inverse move in the medium to long term where yields are expected to increase as prices of units decrease, effectively decreasing both rents and prices while increasing yields on real estate assets.

Sector Equities Took Sharp Declines Post Recent Changes in the Market

We further note that we do not expect changes in the real estate market to have a substantial effect on real estate equities earning power in the short term.

Real estate sector index declined 9.04% the day following the official announcement of land taxes. Sector equities gained 31% YTD at a PE of around 33x.

ROE for the sector stands at 6.44% by the end of 2014 and is expected to grow given the size of the companies in the sector with a positive future outlook.

We highlight that for current prices to be justified, earnings need to grow at above sector average levels.

We expect **Emaar Economic City** and **Jabal Omar** to post record earnings in 2015, growing 30% and 19% respectively.

Following a decline in EPS in 2014, we expect **Dar Al Arkan** to post growth in EPS this year of 12.5% contributed mostly from a decline in finance charges, however, we are cautious on the company's overall prospects.

Companies Under Coverage

Company	12-month TP (SAR)	Investment recommendation	Profitability (SAR in mn)			EPS (SAR mn)		PE (x)*		PBV (x)*	
			2014	2015E	Growth %	2014	2015E	2014	2015E	2014	2015E
Jabal Omar	71.5	Neutral	421.98	501.2	18.7%	0.45	0.54	104.4	140	4.7	7.2
Emaar Economic City	18.75	Overweight	379	493	30%	0.45	0.58	35.2	31	1.62	1.32
Dar Al Arkan	9.45	Neutral	574	646	12.5%	0.53	0.60	15.30	14.4	0.50	0.59

* 1 Data based on closing prices of 7 April 2015

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Reforms, Market Dynamics, and Broad Market Outlook

Current state of the real estate market is highly influenced by regulatory reform; future outlook is highly dependent on how market participants react to reforms and how the legislation will be enforced (enforcement mechanism).

The recent land tax law to be imposed on vacant land (white land) will change market dynamics and direct real estate investment towards development rather than the current state of investment for capital gains.

The 30% down payment mandate imposed by SAMA partially offset the potential surge in liquidity from mortgage lenders. Stricter lending standards triggered lower sales in both volume and value.

Currently, liquidity in the market remains as a potential issue.

Collateral, either land or buildings are expected to decrease in value over time, lenders might decide against taking risk in the sector in 2015.

The ministry of housing (MOH) led the government's recent efforts in easing what is deemed by many as a housing crisis in the kingdom. It is estimated that the ministry of housing's efforts in the market along with the Real Estate development Fund (REDF) will not have a direct short term impact on both land and housing prices along with rental rates in the kingdom.

The view that the distribution of housing units, land, loans, or a combination of land and a loan would eliminate a significant amount of consumers from the demand curve is partially flawed; reading into the available information would reveal an alternative view.

Given the regulatory framework of the MOH's offers, we believe that the first few batches of land and unit awards will be to consumers who were theoretically not in the market for new housing or land (low-income segment). As a result, demand for mid-level units and above along with land in the Saudi market would not be impacted by the MOH's offers in the short term.

Moreover, the ministry will also offer loans; these loans will only contribute to higher demand for housing. If we take into consideration the number of families accepted in the housing program while assuming a certain percentage live in rental units around the kingdom, we can reach a tentative inference that the first impact would be on low to mid-level rental housing units.

A certain percentage of these units will vacate, effectively lowering demand compared to supply and eventually lowering rental rates.

The expected shift in yields and prices (residential real estate) would drive investment activity towards yield generating properties in the mid to long run.

Land Fees (tax) set to Change Market Incentives and Direction

Another catalyst currently having an effect on real estate market is the imposition of a form of tax on empty unused land within municipalities (white land) around the kingdom. Such a policy would be ultimately beneficial for the general public if implemented appropriately.

Fees on vacant undeveloped land would discourage the investment in land for capital gains.

Anecdotal and academic evidence point towards a decline in land value after the implementation of land value taxes. We further note that certain studies might not fully apply to the Saudi market where land ownership distribution is substantially different and prior property taxes are non-existent. Previous land value tax legislation were mostly part of a total tax reform, making it difficult to isolate the effects of land value tax alone.

Policies to limit speculative behavior in the market are necessary for the overall goal of the legislation to take place. Speculative behavior would be encouraged in the event where fees are only directed at holding land for a specific time period.

The most probable case where tax can be passed on to the end buyer is when taxes are implemented on capital gain after the transaction takes place. Taxing on annual basis would discourage passing taxes to end buyers.

Taxing vacant land as well as capital gains on land investment would discourage investment in land for the purpose of price appreciation, encourage purchasing for development purposes, discourages urban sprawl (building housing on city outskirts) and discourages speculation while lowering land prices, limiting the risk of creating real estate bubbles.

Tax or fees on land should be high enough to discourage holding land and investment for capital gains without causing land abandonment.

A moderate approach to the above point is to implement land tax while offering incentives for current land owners to develop land holdings.

Lower land prices, if applicable, would open a window for developers as new entrants to acquire scalable land at lower prices for medium to large projects effectively increasing margins in the process. The attractiveness of the market for developers usually suffers in transitional phases like these.

Given the above forces, we might find changes in prices of land and units to move at different paces.

The ability of real estate owners and developers to absorb changes in demand and supply is an important factor to consider in the current state of the market. The extent to which owners and developers are willing and able to withstand shifts in demand and changes in regulation (i.e. taxes) would be a factor in determining how long prices will take to adjust in accordance with supply and demand.

Oil, an Additional Catalyst

The decline in oil prices triggered expectations of an even slower year for real estate. Two important factors to consider here are the lack of data and studies on the effect of lower oil prices on the real estate market and the maintenance of government expenditure at levels close to 2014's expenditure. In a scenario where oil prices remain at current levels and government overall expenditure starts to decline we believe real estate prices (input and output), all else equal, should experience a slight decline.

Data Breakdown

Examining data from the ministry of justice (MOJ), the total number of residential transaction in the major cities appear to have experienced a YoY decline of around 33.5% from Q2-1435 to Q2-1436. The same indicator witnessed a decline on a quarterly basis equivalent to 15.02% QoQ.

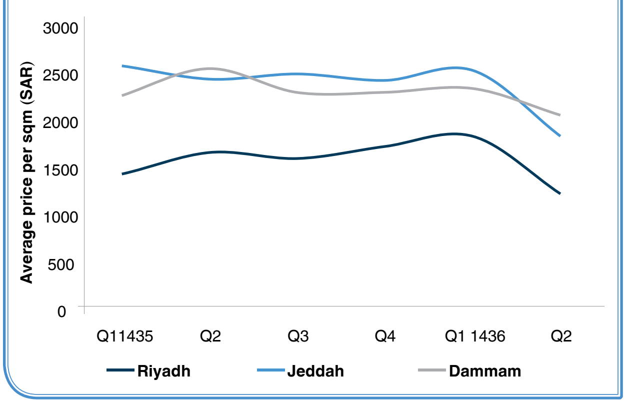
The same pattern is seen in the total value of residential deals, where a 38% YoY decline was recorded for Q2-1436 alongside a QoQ decline of 24.38% for the same period.

Average price per Sqm experienced quarterly decline in all three major cities average price per sqm for land in Riyadh declined 26.88% YoY, followed by decline of 25.10% and 19.60% in Jeddah and Dammam respectively.

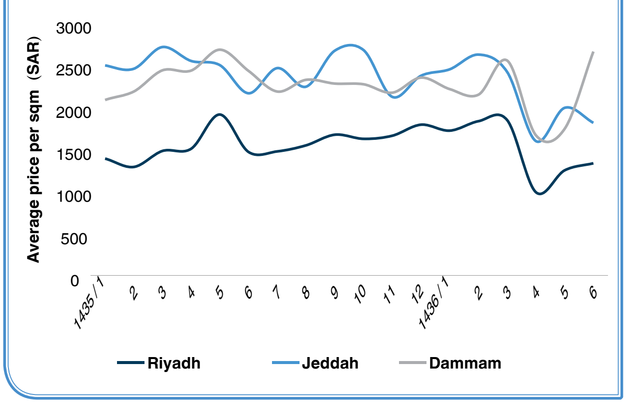
We should highlight that these declines accompany a decline in total number of transactions indicating that the sharp drop in recorded prices is not sustainable and are set to adjust after the bottleneck clears.

Clearing the bottleneck can only be fueled by liquidity, in the form of credit availability, and a rise in affordability. Only then will the market adjust to fair and long term sustainable values with less volatility.

Average Price per sqm on a Quarterly Basis:

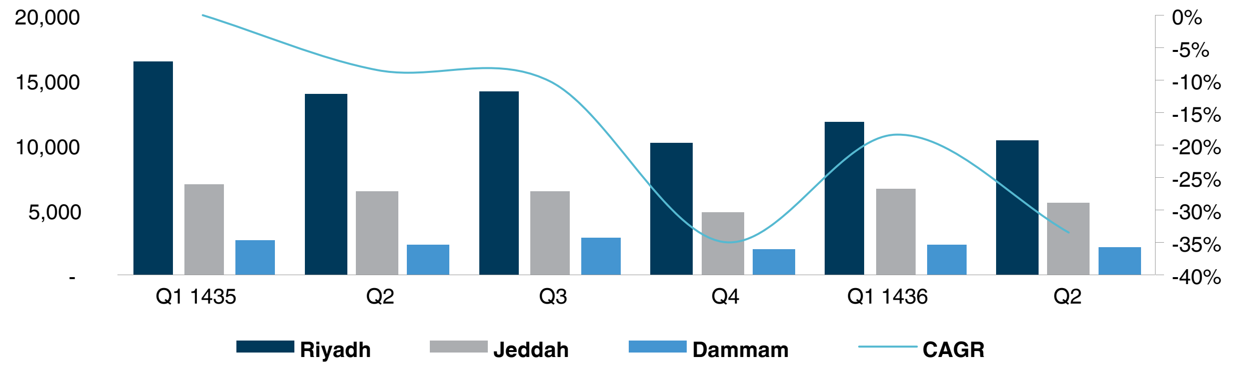


Average Price per sqm on a Monthly Basis:



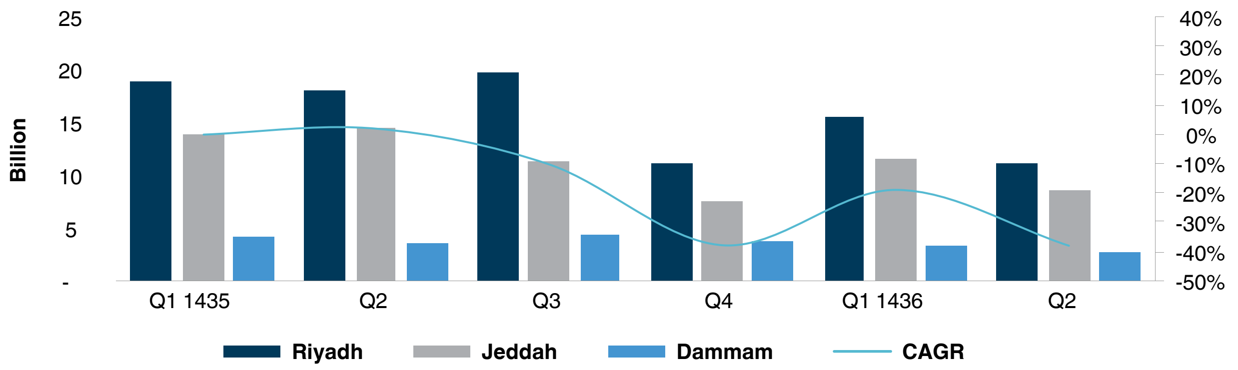
.Source: MOJ, Al Jazira Capital Research, *Prices were computed on simple average basis in order to realistically reflect price movement over time

Total Number of Residential Transactions:



Source: MOJ, Al Jazira Capital Research

Total Value of Residential Deals:



Source: MOJ, Al Jazira Capital Research

Real Estate Sector Index Key Data [1]

	Price	PE	PB	ROE	YTD
Jabal Omar	78.71	122.60	7.78	6.10	49.90%
Emaar Economic City	13.52	30.42	1.41	4.60	13.52%
Dar Al Arkan	8.62	16.58	0.53	3.33	6.03%
Makkah Construction & Development	101.58	51.30	1.89	4.41	29.14%
Taiba Holding	42.79	5.28	1.61	32.44	5.14%
Arriyadh Development	21.64	14.96	1.69	11.17	6.08%
Knowledge Economic City	22.50	-	2.42	-	32.90%
Saudi real Estate	35.79	15.43	1.24	8.25	8.63%
Real Estate Sector	7804	33.89	2.02	6.34	31.54%

Source: Bloomberg, * Exceptional profit

[1] Data based on closing prices of 7 April 2015

ALJAZIRA CAPITAL الجزيرة للأسواق المالية

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Dar Al Arkan: Modest Recovery in 2015 following a Decline in Net Income. S&P outlook downgrade

Our updated target price is SAR 9.45; we remain neutral on the stock. Based on our earnings outlook, forward P/E multiple and P/B stand at 15.7x, and 0.56x respectively.

Dar Al Arkan posted annual earnings for 2014 at the lower end of expectations. Revenue for the year was at SAR 3,056 mn while net income stood at SAR 574 mn. EPS ended the year at SAR 0.53, a 16% decline YoY.

The company recorded its lowest ROE to date at 3.3%. We believe the company is unable to fully utilize the large asset base under management.

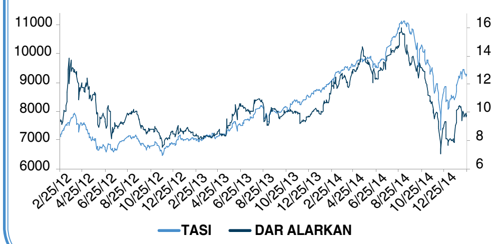
We expect 2015 to be a marginally better year for the company, 5.2% expected growth in revenues and a larger growth rate in the bottom line by about 12.5% mainly due to **lower finance charges and a higher top line**.

The company is expected to go through 2015 and 2016 depending fully on developed land sales and lease income from properties under Dar's portfolio. The company is expected to operate leased properties at higher occupancy rates this year.

Dar Al Arkan paid the matured portion of SAR 1,687 million sukkuk on February 2015. This will alter the company's debt ratios, putting net debt to EBITDA at 4.0x from a level of 4.5x at the end of 2014. Dar Al Arkan is expected to take on further debt during the year in order to maintain a healthy cash position and fund further land development.

New Recommendation	'Neutral'
Old recommendation	'Neutral'
New 12-month price target;	SAR 9.45
Old 12-month price target	SAR 13.70
Current Price:	SAR 8.62
Upside / (downside):	7.77%

Price Chart



Key information

Reuters code:	.SE
Bloomberg code:	AB
Country:	Saudi Arabia
Sector:	Real Estate
Primary Listing:	Tadawul
M-Cap:	SAR 10,530 mn
52 Weeks H/L (SAR):	16.15 / 6.80

Risks to consider

Downside risks stem from the constant delays in scheduled projects. We also have medium term concerns on whether the company is able withstand a drop in land prices and possible effects on margins given the ongoing developments in the real estate market and the company's dependency on land sales.

We should note that Dar Al Arkan is in a position to leverage its land bank and development expertise to benefit from an expected surge in real estate development in the long term.

Dar Al Arkan made efforts to increase its recurring income. However, the current contribution makes less than 5% of the revenue mix and is not expected to increase dramatically in the medium term without acquisitions or development by the company.

Rating Agency S&P kept Dar Al Arkan's corporate credit rating at B+ and revised rating outlook from stable to negative.

Key financial data

	2013	2014	E2015	E2016
Revenue	2,931	3,056	3,216	3349
Growth (%)	**(17.6%)**	**4.3%**	**5.2%**	**4.1%**
Net Profit	681	574	646	684
Growth (%)	**(31.1%)**	**(15.7%)**	**12.5%**	**5.9%**
EPS	0.63	0.53	0.60	0.63
ROE	4.1	3.3	3.5	3.62
ROA	2.8	2.2	2.3	2.7
PE (x)	13.25	15.30	14.4	13.73
PB (x)	0.50	0.50	0.59	0.61
EV/EBITDA (x)	13.20	11.70	17.14	15.88

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Emaar Economic City: Favorable view, Exceptional Years Ahead.

We update our recommendation to "Overweight" with an updated target price of SAR 18.75.

Emaar Economic City posted 2014 annual results showing 27.7% growth in revenues and 38% growth in net income (EPS SAR 0.45). The company is expected to post further growth in 2015 and 2016. We expect the company to post record earnings for 2015 driven mostly by higher residential sales.

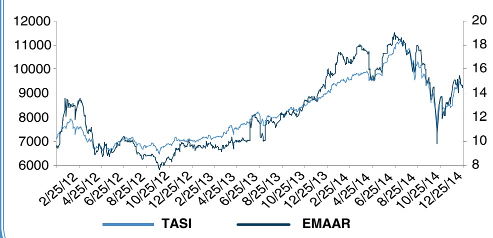
We estimate annual revenues for 2015 to grow 122% to stand at SAR 2367 million while net income is estimated to end the year at SAR 493 million recording 30% growth YoY. We believe Emaar will continue growing in the following years recording stable growth rates and lesser quarterly deviations post 2016.

Our favorable view of Emaar Economic City is driven mainly by the company's ability to leverage the industrial valley and available residential land.

Financial statements show a healthy liquidity position that would enable Emaar to manage its relatively large debt position. The first installment of the SAR 5 billion loan by the ministry of finance is due on June 2015 with a current portion of SAR 753mil. We believe the company's attractive cost of debt along with its sizable future development plans and current project pipeline would enable it to manage its long term debt position.

New Recommendation	**'Overweight'**
Old recommendation	**'Neutral'**
New 12-month price target;	**SAR 18.75**
Old 12-month price target	**SAR 16.06**
Current Price:	**SAR 13.50**
Upside / (downside):	**38%**

Price Chart



Key information

Reuters code:	.SE
Bloomberg code:	AB
Country:	Saudi Arabia
Sector:	Real Estate
Primary Listing:	Tadawul
M-Cap:	SAR 12,665 mn
52 Weeks H/L (SAR):	19.35 / 9.75

We should note that at the end of Q4 - 2014 the company has signed a loan facility with a commercial bank for SAR 1,250 million and an Islamic murabaha finance facility for SAR 2000 million in the same quarter.

Excluding the loan facility, the company's Net Debt / EBITDA by the end of 2014 stands at around 3.95x. We expect the company to maintain this multiple for the next two years as it reaches targeted capital structure.

Emaar's substantial growth in the coming years is accompanied by high capex for 2015 and 2016 which would marginally squeeze free cash flow for the period.

We don't expect the company to pay dividends in the short and medium term given the scale and requirements of the projects in hand.

Emaar economic city is currently trading at 30.2x PE, at our targeted price of 18.75 we estimate a forward 2016 PE of 13.3x.

Key financial data

	2013	2014	E2015	E2016
Revenue	833	1064	2367	4580
Growth (%)	**53%**	**27.7%**	**122.4%**	**93.5%**
Net Profit	273	379	493	1201
Growth (%)	**44%**	**38.8%**	**30%**	**143.6%**
Profit Margin	32.8%	35.6%	20.82%	26.2%
EPS	0.32	0.45	0.58	1.41
ROE	3.50	4.6	5.7	12.1
ROA	1.90	2.3	2.3	4.3
PE (x)	26.10	35.2	31	12.7
PB (x)	0.91	1.62	1.32	1.06
EV/EBITDA (x)	22.66	31.53	22.72	11.06

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الجزيرة كابيتال

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Jabal Omar: High Growth, Attractive Fundamentals, and Set to Record its Best Year Yet. Difficult to Overlook Current Overvaluation.

New Recommendation	**'Neutral'**
Old recommendation	**'Neutral'**
New 12-month price target;	**SAR 71.5**
Old 12-month price target	**SAR 49.9**
Current Price:	**SAR 78.71**
Upside / (downside):	**(9.1%)**

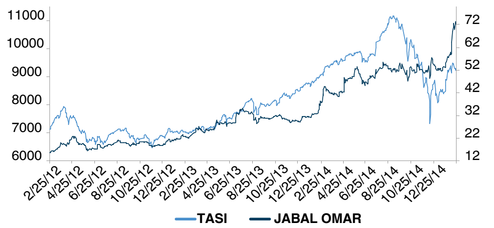
We update our recommendation for Jabal Omar to "Neutral" with an updated price target of SAR 71.5.

Jabal Omar posted Q1-1436 earnings. Net income stood at SAR149.30 mil compared to a loss posted on the same quarter last year of SAR -2.35 mil. Unit sales had the largest contribution to Q1-1436 revenues at 75%, followed by commercial lease and hospitality at 13.2% and 11.6% respectively.

We believe the company is set for a record year in 2015. We estimate revenues for the year to record SAR1,122 mil and net income at SAR 501.2 mil, a 19% growth in net income.

This estimate is backed by the company's announcement that it auctioned 23 units in the S1 area this year at SAR 350.5 mn averaging SAR 15.24 mn per unit. The company auctioned 20 units last year at SAR 783.9 mil, averaging SAR 39.19 mil per unit and SAR 132,150 per sqm. Jabal Omar has a total 204 Residential units under development, 86 of which are part of phase 1 at an average space of 175sqm per unit.

Price Chart



By Q1 2015 the company announced 90% completion of phase 1 which includes 4 podiums, 10 towers, and 86 units (villas and apartments). Operational part of phase 1 currently consists of Hilton suites and S1 commercial area. We don't expect the company to announce material delays in the project.

Key information

Reuters code:	.SE
Bloomberg code:	AB
Country:	Saudi Arabia
Sector:	Real Estate
Primary Listing:	Tadawul
M-Cap:	SAR 64,593 mn
52 Weeks H/L (SAR):	33.80 / 77.25

Jabal Omar is is also expected to add three hotels to its operational income by the end of the year with a total of 1526 rooms and suites added. 426 of which are expected to be added by H1 of this year. The S2 commercial area will be operational this year and is expected to add to the company's top line as early as Q1.

Debt position has improved recently. Jabal Omar restructured its debt with more favorable terms in Q1- 2015. The new terms allow for a longer grace period and extended loan duration from 8 to 12 effectively lowering total annual finance charges. A new added clause permits the company to pay dividends in the event of having surplus earnings.

A stagnant real estate market does not affect Jabal Omar, the company's earnings are mainly driven by hospitality indicators.

The company is currently trading at around 122.6x trailing PE and a 2016 forward PE equivalent to 91.5x. We should note that 81.7% growth in 2016 EPS can hardly justify PEs at that level. However, we should note that companies with abnormally high growth profiles compared to the market command high valuation. To put things into perspective, forward PEG[2] at our target price of SAR 71 stands at around 1.05x suggesting that the forward look of the company at our target price is justified given potential growth

Key financial data

	2013	E2014	E2015	E2016
Revenue	45.59	731.17	1122	1601
Growth (%)	-	**1500%**	**53.4%**	**42.6%**
Net Profit	(32.53)	421.98	501.2	766.9
Growth (%)	-	-	**18.72%**	**53%**
Profit Margin	-	58%	44.65%	47.9%
EPS	(0.03)	0.45	0.54	0.825
ROE	-	4.54	5.11	7.24
ROA	-	2.27	2.70	4.08
PE (x)	-	104.4	140	91.5
PB (x)	3.00	4.7	7.2	6.6
EV/EBITDA (x)	-	112.3	125.1	81.2

[2] PE / Expected growth

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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.

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