Saudi Arabia Real Estate Market | 2018 End of Year Note

Looking at the real estate market performance in 2018, the general trend for Saudi Arabia is that most sectors have remained subdued as highlighted by lower activity levels, while occupancy levels have been under pressure across most asset classes leading to a gradual softening of rents.

While we see this current situation prevailing in the short term, we remain optimistic for the longer term due to the various government initiatives aimed at stimulating the real estate market whilst encouraging the private sector to take a key role in this process, as part of the recently introduced strategic reforms.

The approval of regulations for the use and listing of REITs in Saudi Arabia is a case in point, as it signals an important step in the government's drive to boost private sector participation in the sector and increase transparency in real estate markets where visibility around asset performance, ownership and legislation are key to attracting capital to the sector.

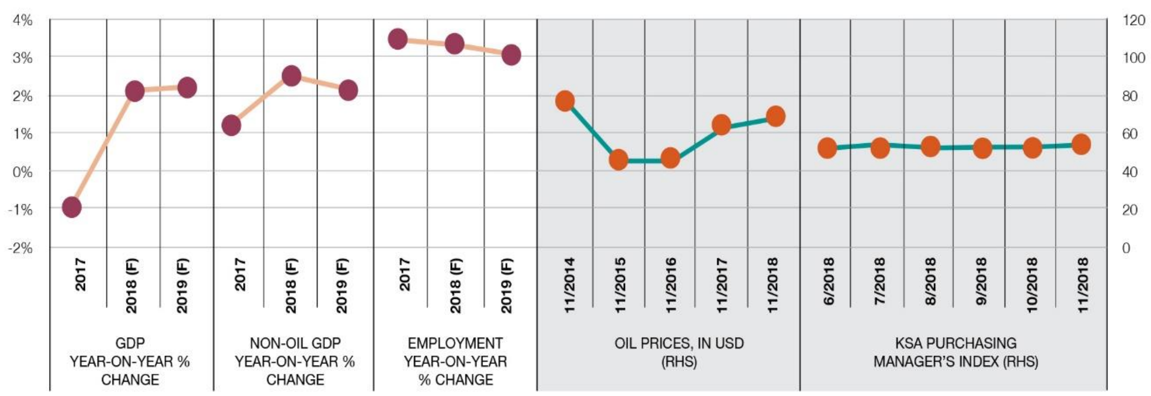
Moreover, the implementation of various urban regeneration initiatives including mixed-use communities and large-scale infrastructure projects is expected to act as a catalyst for the real estate market. The Riyadh Metro is one of the key infrastructure projects that is being implemented and which is set to dramatically alter the dynamics of both residential and commercial real estate markets when delivered.

Macroeconomic Overview

2018 overview

There was a recovery in economic growth at the start of this year in Saudi Arabia as GDP growth gathered momentum, with expectations to reach 2.2% in 2018 and 2.3% in 2019 according to the IMF latest estimates following a deceleration in 2017. The return to growth has been 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 and the 2019 preliminary budget. The Purchasing Manager Index (PMI), a non-oil economy tracker, stood at 55.2 in November 2018, which is well above the neutral 50 level indicating an expansion in the non-oil sector and a significant recovery of the index from its lowest level on record registered in April 2018 (51.4). Nevertheless, the indicator remains low by historical standards despite the rebound in oil prices this year.

Key economic indicators



Source: Knight Frank Research, IMF, Macrobond, Oxford Economics

Outlook

GDP growth is expected to remain on a positive trajectory over the coming years, averaging 2.2% over the next five years according to the IMF estimates. Generally, the outlook and sentiment for Saudi Arabia's economy remain cautiously positive and the recovery in economic growth that occurred in 2018 is yet to translate into a substantial improvement in economic conditions.
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 government fees and Saudization plans on non-Saudi employment figures.
In line with the Vision 2030 and the National Transformation Plan (NTP), the restructuring of the economy 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, yet this is likely to be a gradual process, which requires some time to come into effect.

REITs in focus

2018 Overview

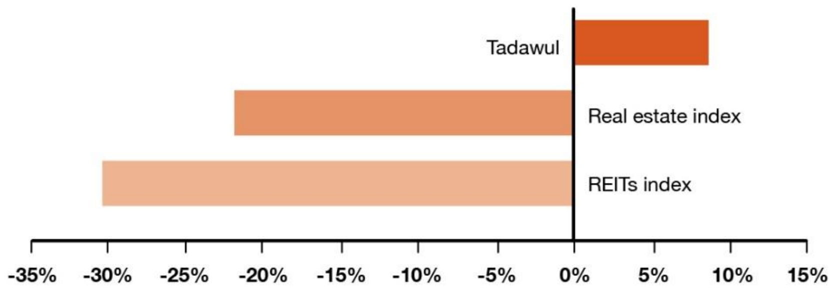
Since our last review in May 2018, the REIT market in Saudi Arabia has continued to expand and now surpasses USD 3 billion in terms of market capitalization, compared to just over USD 2 billion in Q1 2018. Four additional REITs were listed on the market, taking up the total number of listed REITs on the Tadawul to 16 at the date of writing compared to 12 at the end of Q1 18. From a regulatory perspective, the Saudi Arabian Capital Market Authority (CMA) has recently approved a number of amendments to initial regulations governing REITs, including the increase in the minimum capital requirement for new funds from SAR 100 million to SAR 500 million. A strong and evolving regulatory framework, which has proven to be favourable in more mature jurisdictions, will remain a key objective in the development of the REIT market in Saudi Arabia.

Looking at the asset allocation of existing REITs, the vast majority of REITS have their investments spread across multiple real estate asset classes, which is in part due to a lack of maturity in the market and a constrained pipeline of institutional grade assets. Looking at market performance, we noted in our previous Q1 18 review the fact that most REITs had already pared back early gains and were trading below listing price. Over the course of 2018, price moderation continued as highlighted by the REIT index dropping by just approximately 30% Ytd in the context of a weakening real estate backdrop translating into a drop in the real estate index on the Tadawul by just over 20% Ytd. On a positive note, the Tadawul all share index is up by almost 10% Ytd and looks set to register healthy gains for the full year 2018, supported by a buoy investor sentiment driven by the expected inclusion in the MSCI and FTSE Russel EM indices and by the overall improvement in macroeconomic conditions in 2018.

Thematic vs. diversified investment approach as at Q4 2018

Source: Knight Frank Research, Tadawul

Ytd performance: REITs index vs. real estate index vs. Tadawul all share index*



**Note: Ytd variation as at 09/12/2018*

Source: Knight Frank Research, Tadawul

Outlook

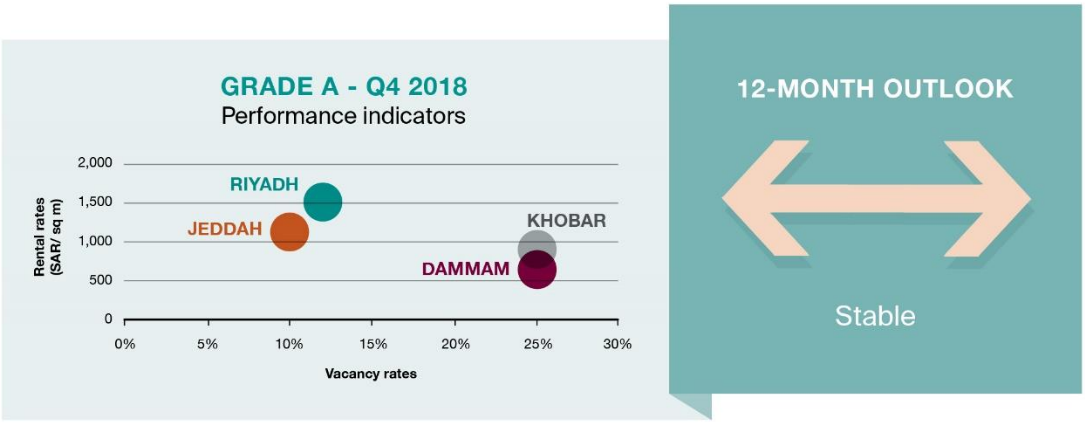
In 2019, we expect the pace of REITs listings to moderate as indicated by fewer numbers of approved REITs in the pipeline. Going forward, the greater choice of available REITs is likely to drive prices towards fundamental valuations, as investors increase their focus on fundamentals including income generation and dividend yields as more performance information becomes available. This will be particularly important for investors looking to adopt a longer term investment approach. With an increase in the number of listed REITs, we expect the level of competition to increase in the market, which would translate into a greater focus on the adoption of best-in-class practices in terms of quality of the underlying portfolio, asset management and corporate governance. Moreover, it is likely that we will start seeing the emergence of more thematic REITs as the market gains in maturity enabling investors to gain exposure to specific real estate sectors.

Office Market

2018 overview

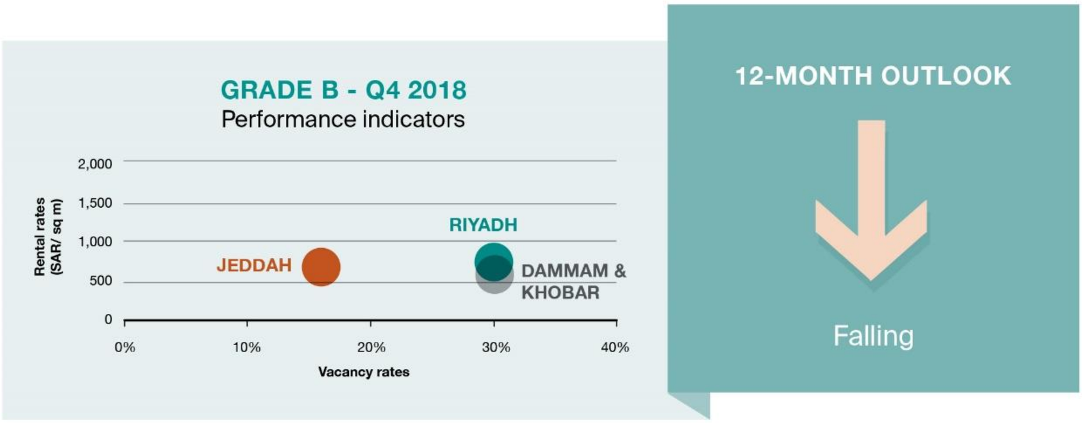
Whilst there have been a number of notable commercial office transactions throughout 2018, as key occupiers both from the public and private sector look to expand or move to upgraded premises, the market continues to be dominated by a lack of Grade A stock and a large supply pipeline. In terms of performance,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

Grade A - Q4 2018 Performance indicators + 12 month direction



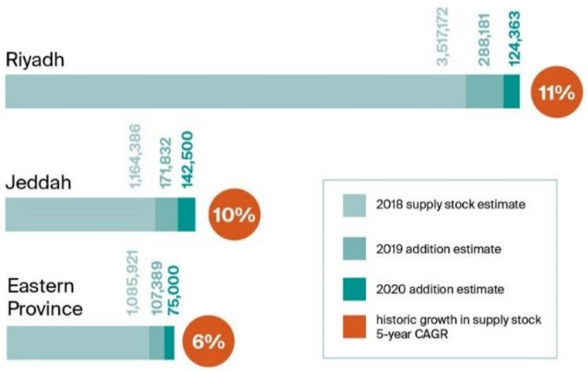
Source: Knight Frank Research

Grade B - Q4 2018 Performance indicators + 12 month direction



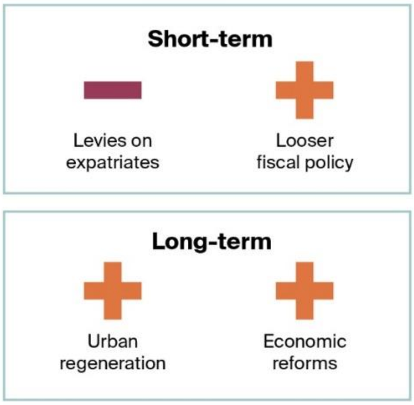
Source: Knight Frank Research

Supply stock of office space, sq m GLA



Source: Knight Frank Research

Policy impacts on the office market



Source: Knight Frank Research

Outlook

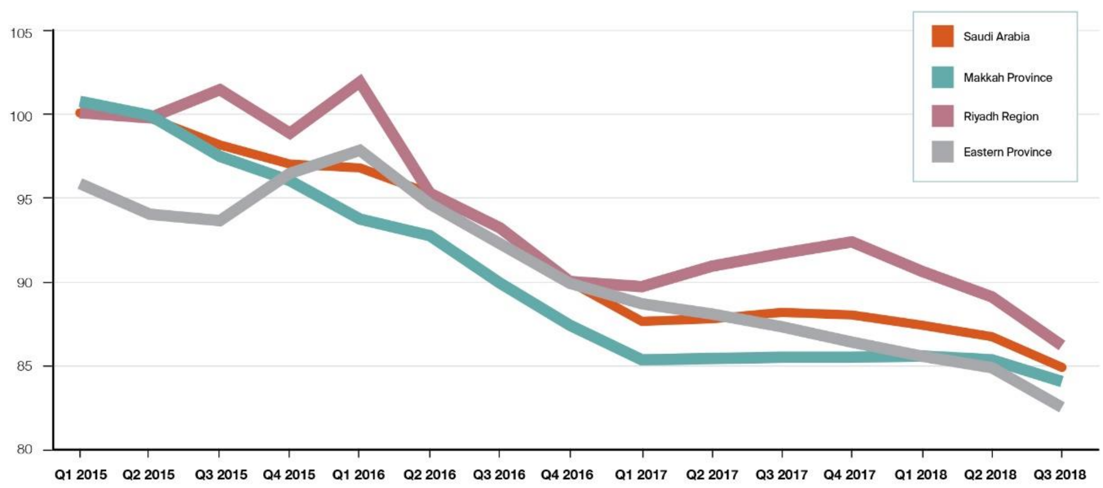
Although we have seen an improvement in business sentiment in 2018, we believe that any increase in demand for office space will remain subdued in the short term, with rents and occupancy likely to remain under pressure as increased demand will be met with new supply. Vacancy rates can therefore be expected 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.

Residential Market

2018 overview

The residential market has for some time been softening as highlighted by lower levels of transactions and a correction in sales prices across major cities in Saudi Arabia. This trend was mainly triggered by the deceleration in economic activity that started in 2016 and is exacerbated by a combination of more inherent factors namely the lack of affordability, a supply shortage in the mid-to-low end of the market as well as the lack of suitability of the existing stock. The slowdown in the residential market continued in 2018 as highlighted by lower transaction volume and prices.

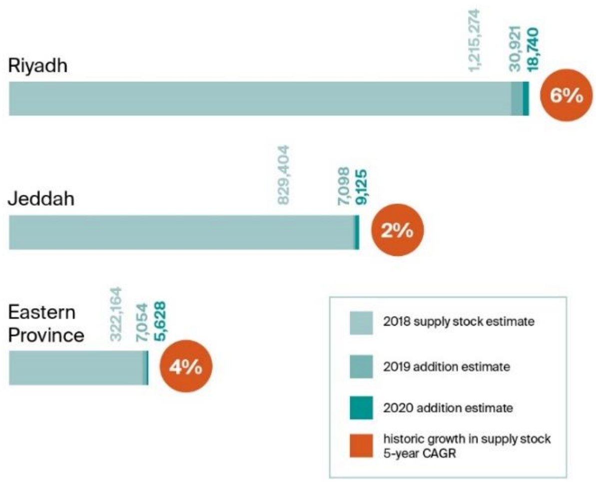
Residential price indices in key regions



Note: base year = 2014

Source: Knight Frank Research, GASTAT

Supply stock of residential units, number of housing units



Source: Knight Frank Research

Outlook

While we see this current market conditions prevailing in the short term, we remain broadly positive as a result of government initiatives looking to address key challenges restraining the residential sector in Saudi Arabia including high land prices, supply/demand imbalances and affordability among others. Regulatory efforts such as the white land tax, the large housing schemes and the mortgage law, display clear intent from the government to engage with the issues facing the residential market in the kingdom. While efforts are slowly filtering through, we see these initiatives as a step in the right direction for a more active real estate market over the coming years.

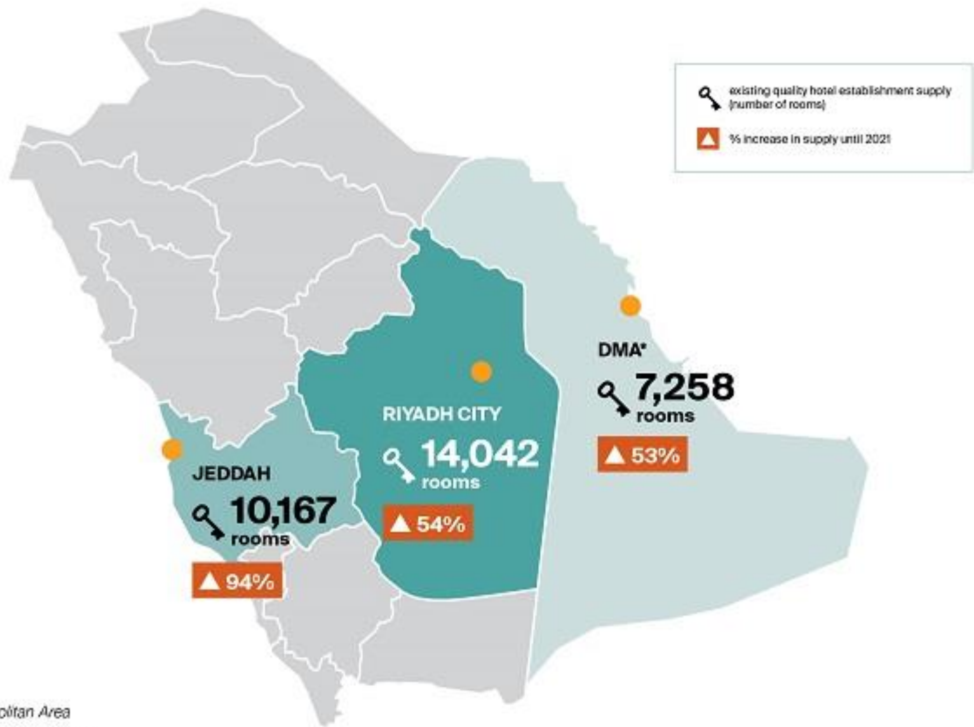
Hospitality Market

2018 overview

In line with the wider region, the performance of the hospitality sector in Riyadh and the Dammam Metropolitan area (DMA) within the Kingdom of Saudi Arabia continued to soften in 2018. A fall in corporate demand was widely cited as the primary issue in both Riyadh and the DMA, although in the latter of the two markets, leisure demand also became more price sensitive. In DMA, the vast majority of corporate demand is inexorably linked to the hydrocarbon sector (which has faced its own challenges in recent years), which, against the backdrop of recent hotel supply deliveries, has created a challenging operating environment. Over the last year, the Fraser Suites and Fairmont Business Gate came to market in Riyadh, while the Hilton Garden Inn and Park Inn by Radisson Industrial City opened in DMA.

By contrast, Jeddah's hotel market saw a return to form in 2018, after two years of weak performance correlated to significant supply deliveries in 2016. Strong performance during the summer months saw this situation reversed, with the city once again exhibiting YTD RevPAR growth as of November. Hotels that came to market during this period included the Centro Salama, Radisson Blu Corniche, Galleria Hotel by Elaf, and Mövenpick Hotel and Hotel Apartments Al Tahlia.

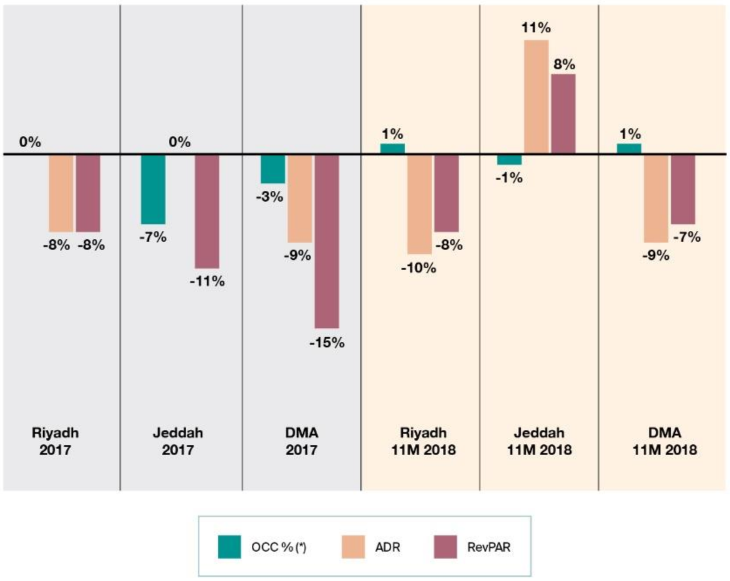
Existing and upcoming quality hotel establishment supply



Note: Dammam Metropolitan Area

Source: Knight Frank Research, STR

KPI's YoY Performance



*Note: percentage point

Source: Knight Frank Research, STR

Outlook

Despite the recent downward pressure in RevPAR levels in many markets within the Kingdom in recent years, we expect the hospitality sector to recover in the short to medium term, as various diversification efforts, infrastructure projects and tourism initiatives come online. As always, there is the spectre of a significant supply pipeline; however, historical precedent indicates that there is typically a low materialisation rate within the Kingdom, which will smooth out this impact.

From the perspective of creating a viable destination, the development of megaprojects such as the Red Sea Project, Amaala and Al Qiddiyah will be a great barometer of how successfully the government can create a viable leisure-based destination capable of attracting inbound visitation. From a legislative perspective, the introduction of the tourist visa, but more specifically the implementation of the 'Sharek visa' is a positive step toward having the correct legislative framework with which to make this happen.