REAL ESTATE FINANCE IN THE GCC

An overview of the GCC real estate finance ecosystem from a development perspective

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As GCC real estate markets continue to mature – with increasing transparency and continued improvement in government regulations – the GCC's real estate development finance market is expected to witness wholesale changes over the next decade.

GCC real estate development finance markets are at an inflection point in their maturation lifecycle, expected to move swiftly from a characteristic emerging market dynamic to a developed market dynamic in the next 5 to 10 years. Driven both by necessity (a continued high quantum of development activity) and by government strategy (continuous efforts to increase transparency, investor protection, and to facilitate the introduction of more complex financial mechanisms), the effects of this maturation process for GCC real estate developers will be significant.

Historically, GCC real estate developers were mostly categorized as family Small and Mid-size Enterprise (SME) businesses developing small projects. In this historic situation, GCC real estate development projects were financed by developer equity, often derived from owner capital, family wealth, or income from other businesses. This is in stark contrast to international standards in mature markets, where developer equity as a finance mechanism can be as low as 3% of the overall project development cost, and in almost all cases does not exceed 20% of the total project development cost.

As GCC markets matured, led by the UAE's development boom in the 2005-2008 period, bank finance as senior debt development loans began to replace developer equity as the primary real estate development funding source for new projects. This maturation process was in-line with international standards for mature markets, where bank financing is utilized almost exclusively as the primary development finance mechanism. Assuming that GCC markets follow the maturation curve seen in more developed markets, alternative finance mechanisms for real estate development will likely become just as common as senior debt loans.

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EXAMINATION OF ALTERNATIVE FINANCE MECHANISMS

The primary alternative finance mechanisms utilized in developed markets are mezzanine finance and private equity (PE) finance – both of which could see a significant rise in market share in the GCC over the coming decade.

- **Mezzanine Finance**
  Mezzanine finance is a flexible mechanism utilized by developers in more mature markets as "bridge financing" to fill the gap between developer equity and the maximum amount that banks provide as senior debt. In international mature markets, bank finance for real estate development projects typically does not exceed a 75% LTV (loan to value) ratio, leaving 25% of the total project cost to be filled by other finance mechanisms. Mezzanine finance fills this gap by providing a hybrid debt/equity solution to developers, allowing them to fund projects without investing significant developer equity. Typical deal structures in international markets combine a debt mechanism with an interest rate and repayment schedule, and an equity mechanism which extracts a profit-share from the project net revenues.

EXHIBIT 1
The Evolution of Financing Structures in Real Estate Projects

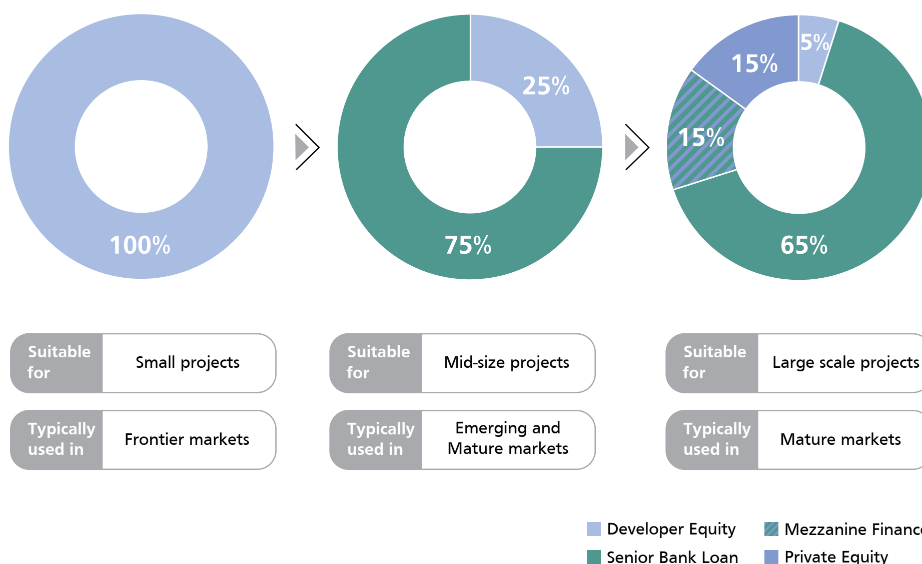
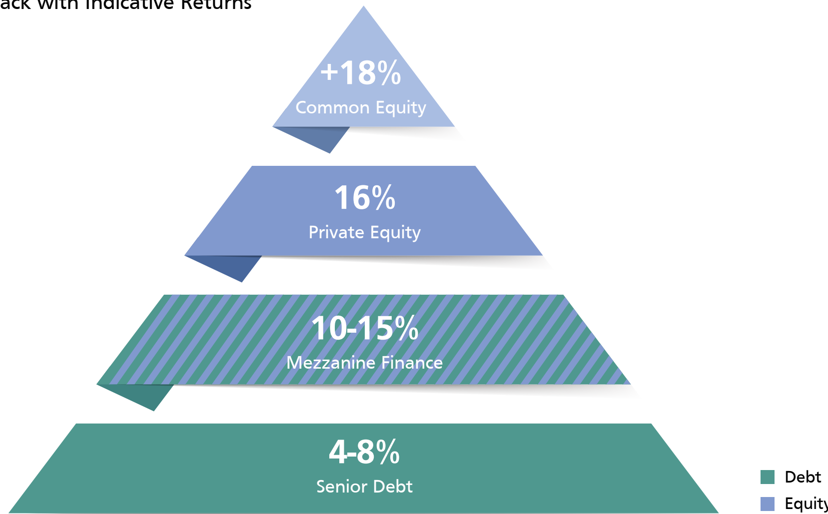


EXHIBIT 2
Capital Stack with Indicative Returns



Mezzanine investment mechanisms carry a higher risk profile than senior debt loans and are typically structured as investment funds. The global mezzanine market reached USD $23-Billion in 2020 as per Pensions & Investments' annual survey. However, mezzanine finance is not a common development finance mechanism in GCC markets. While statistics for GCC markets are unavailable, anecdotal evidence shows a limited number of active mezzanine funds in GCC markets, with a usage rate of less than 10% of total development projects.

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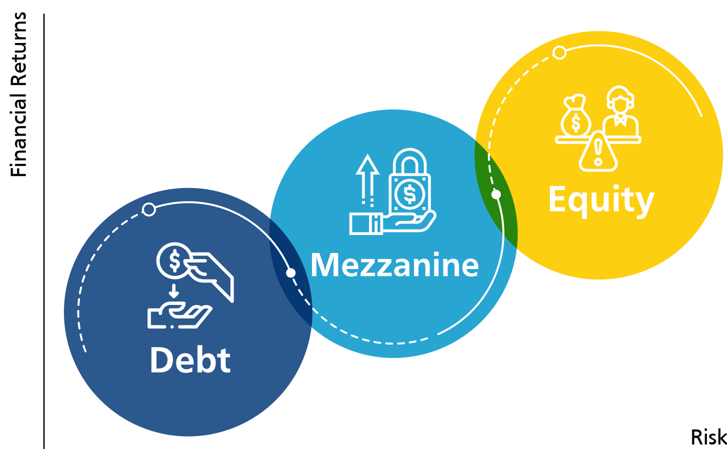
EXHIBIT 3
Mezzanine Finance – Risk vs. Financial Returns



- **Private Equity**
Private equity (PE) finance provides a structured equity investment into a real estate development project, again reducing the amount of developer equity required to fund a project. PE funds typically provide at-risk capital for development projects in a Joint-Venture (JV) structured deal and realize returns through a share in the end-profits of the completed project. PERE (private equity real estate) funds are high-risk investments and like mezzanine mechanisms, are typically funded and structured in an investment fund format. Developers utilize PE finance both as a risk management mechanism, as well as a source of funds to deliver larger projects where developer equity is insufficient.

As a risk management tool, PE funds share development risk with the developer by investing at-risk capital into the project, reducing the developer's financial exposure. As a source of finance, PE funds allow developers to deliver larger projects in cases where the developer does not have sufficient equity to meet the bank's LTV requirements for senior debt. Private equity finance for real estate development projects has grown rapidly in mature international markets in the past 20 years. Global private equity investment into real estate development projects reached USD $222-Billion in 2020, down 50% from pre-Covid-19 levels as per the 2021 Preqin Global Real Estate Report.

While family offices and informal investment groups invest in development projects in GCC markets, formally structured PE funds are still uncommon as compared to international markets. Given the recent rise of real estate investment trusts (REITs) in GCC markets, the logical next step in the GCC's market maturation process would seemingly be the introduction of large-scale, formally regulated PE funds as a funding source for development projects.

THE IMPACT OF ALTERNATIVE FINANCE MECHANISMS ON DEVELOPERS AND END-USERS

Assuming these alternative finance mechanisms become available in GCC markets at levels close to those seen in international mature markets, the effects for GCC real estate developers will be significant. Access to these alternative finance mechanisms comes with a price – a portion of the development profits – in return for significant risk reduction and less financial exposure. GCC developers will thus need to increasingly assess their projects on a risk scale, rather than simply a profit scale. The key question for GCC developers will be, how much is risk reduction and reduced financial exposure worth? The answer to this question will drive the deal terms offered by both mezzanine and PE funds.

- **Developers**
  If GCC developers begin to utilize these alternative finance mechanisms, the market's development dynamics will also shift accordingly. SME developers, with access to alternative finance mechanisms, will be empowered to compete with larger developers – as they will no longer be limited in their ability to deliver large projects due to a lack of developer equity. However, this situation will also increase market risk as SME developers will need to professionalize and modernize their operations to successfully deliver larger-scale projects. For larger developers, access to alternative finance mechanisms will allow them to limit their equity exposure on projects, freeing-up developer equity for investment into innovation (e.g. alternative construction technologies) or for expansion into new markets and new project types.

- **End-users**
  However, the introduction of alternative finance mechanisms comes with increased risk for the end-user / unit buyer. By essentially allowing developers to leverage a smaller equity investment and still complete projects, developer accountability becomes a serious issue, as is the case with international mature markets. Government regulation of the mezzanine and PE sector would need to be carefully crafted to ensure that the individual unit buyer / investor remains protected.

  In addition, it is likely that in the initial stages, foreign funds with significant experience in mezzanine and private equity real estate (PERE) will be the first to enter the market, leaving local GCC-based funds at a disadvantage to grab market share. The risk of local-based funds being ''pushed out of the market'' with the introduction of alternative finance mechanisms, is a key risk factor.

- **Outlook**
  In summary, alternative finance mechanisms for real estate development finance represent both an opportunity and a risk for GCC real estate markets. Considering the increasing market maturity and evolutionary ''growth curve'' in GCC markets, it is likely that alternative finance mechanisms will enter the market during this decade, and both local funds as well as government regulators will need to move quickly to stay ''ahead of the curve'' and ensure that the introduction of these finance mechanisms is executed in a manner that benefits the entire market.

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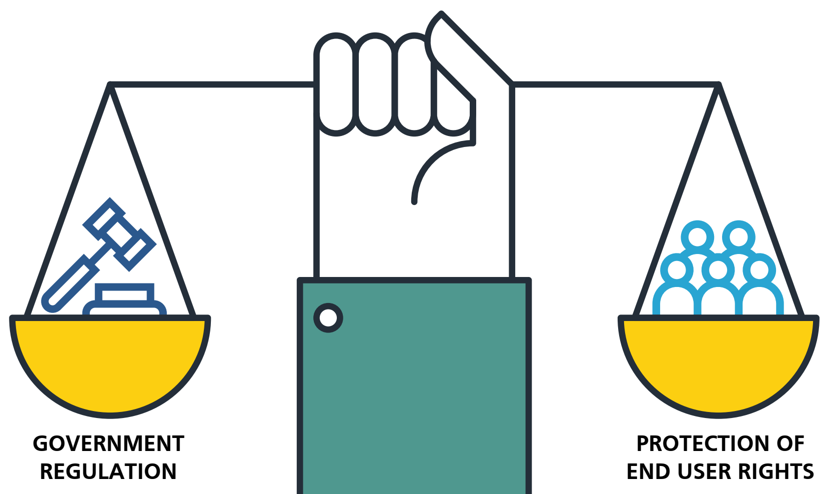
EXHIBIT 4
Balancing act between government regulation and protection of end user rights



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