

Dubai Real Estate Meltdown

Will the contagion spread to rest of GCC?

February 2009

Research Highlights:

Evaluating whether other GCC countries experience a Dubai like situation

"Here we have to admit – we got it wrong. Last year we put out an advisory on this site saying that 'apartment prices have peaked in Dubai.' We were wrong. Dead wrong" – Global Property Guide, June-2008.

The phenomenal growth in the Real Estate activity in Dubai often proved those who claimed they have seen the peak wrong until the last two quarters of 2008. Till then, the market kept extending the forecast year when the supply will exceed demand in almost all of its sub-segments.

Rise in asset prices due to healthy demand prospects and appropriate funding facilitated by adequate liquidity transforms into a bubble due to excesses in demand expectations, leverage and speculation. We intend to look for evidences on the presence of these excesses behind the fall out of Dubai's Real Estate market and to investigate whether a similar scenario exists in other GCC countries.

This paper attempts to measure these excesses from economic, demographic, lending, price and transaction activity related indicators for Dubai and compare their behavior with other GCC countries.

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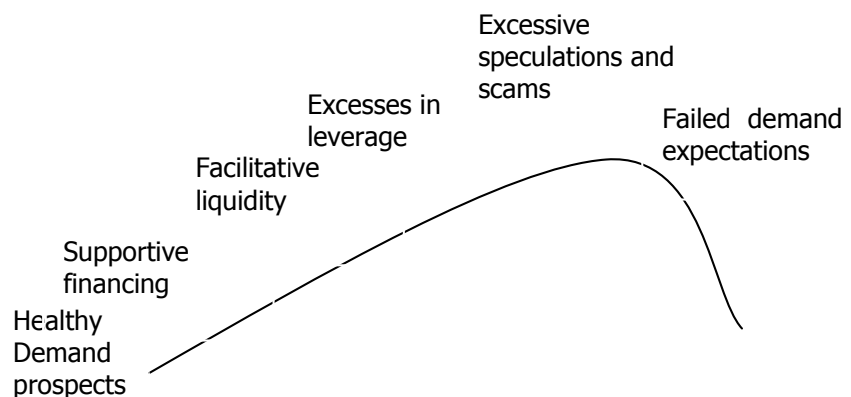
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Our study finds evidence of a bubble in Bahrain although it had less significant impact to the overall economy unlike Dubai while Kuwait avoided it with a less painful correction. We also suggest that the growth in Qatar's property market needs to be closely monitored to avoid a Dubai like situation in the future. Oman and the Kingdom of Saudi Arabia (KSA) never enjoyed any significant growth to enable a bubble creation and an analysis of Abu Dhabi and Sharjah was not possible due to lack of data.



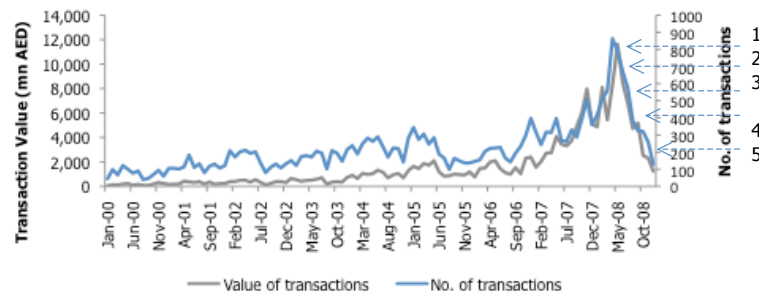
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1. What has happened in Dubai?

The history of the phenomenal rise of Dubai's property market is known to all and it is not too far back from today that one needs to be reminded of. All indicators of the market like rentals, prices, transaction activity, new projects and developments displayed meteoric rise. Average office rentals grew by 86% Y-o-Y in 2006 and by 55% in 2007 and average residential rentals grew by 25% and 18% during the same period (Source: Asteco). New projects started growing at c. 85%, prices grew at c. 25% p.a on an average during this period and Figure-1 shows the rise in transaction activity.

Figure 1: Dubai Value of Transaction



Source: Dubai Land Department

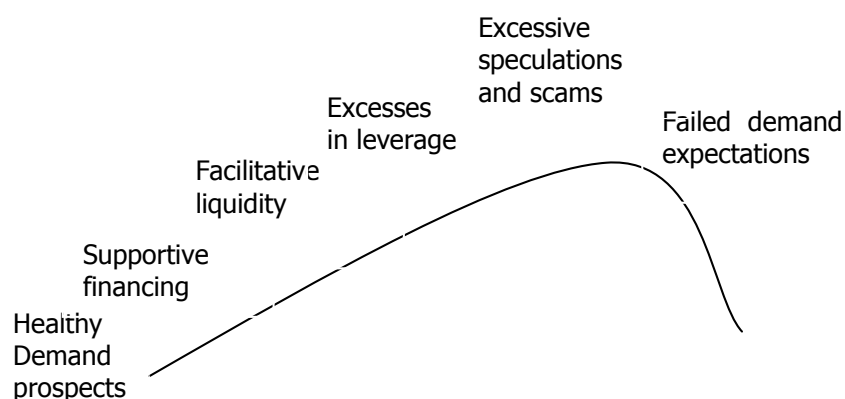
The consistent fall in both the number and value of transactions after the peak in Apr-May-08 (Figure 1) can be explained from the following set of events.

1. Speculators finding a halt in property price rise and starting to walk out unable to service their mortgage obligations and news about perpetrations of scams getting unearthed
2. Wealthy expats diverting from investments in Dubai Real Estate hit by the need for financing back home
3. Mortgagers (banks), fearing possible delinquencies and taking possession/lien of the properties against the loan and being left with possession of properties worth less than the original loan amount, results in reduced willingness to lend fresh RE borrowers thereby draining liquidity
4. Developers with off-plan business model end up having projects with less than optimal takers and heavily leveraged due to the inherent pre-selling nature of the business model
5. Developers face increasing cost of capital (both debt and equity) due to increased risk aversion and negative market sentiment and also face dwindling demand for properties thereby delaying/cancelling existing/new projects

Asset price bubble path – a theoretical perspective

Events that happened in Dubai's in the context of the theoretical path put forth

2. The Dubai asset price “bubble” path



Stage	Description	In Dubai's context
Healthy Demand prospects	Healthy underlying demand for the utility offered by the asset and the resultant growth in the income generating capacity of the asset gets factored in the price of the asset to the extent of the informational efficiency of markets.	The Emirate's objective to become a trading, tourism and financing hub coupled with conducive atmosphere in the region and worldwide triggers growth in the construction and real estate sector
Supportive financing	Growth in real activity in the sector leads to increase in demand for funding and causes expansion in the funds extended to the sector by banks & other providers of capital.	Growth in the sector leads to growth in credit demand supported by extension of credits by healthy banks and increased investment flows from local, regional and international investors
Facilitative liquidity	Active arbitrage possibilities attracting short-term/speculative players thereby providing liquidity in the market	Growth in prices and transaction activity in property market and conducive regulatory structure providing speculators with arbitrage opportunities
Excesses in leverage	The players in the market for the asset is provided with more than proportionate financing backed by perceived strength of the market value measured from the spurt in financing extended to the asset market players compared to the long term trend of both lending and the sector growth.	Credit extension to the sector outgrowing sector growth and/or growth in overall lending and the growth of the economy (2005-2007)
Excessive speculations and scams	Overly enthusiastic speculators flushing the market for the asset with liquidity resulting in a spurt in the transaction turn over the given set of asset.	Sudden spurt in transaction activity (Jul-07 to Apr-08) and unearthing of scams (After May-08)
Failed demand expectations	Valuations getting exorbitant as expectations on the income generation capacity of the asset is perceived to be unrealistic due to unexpected behaviors of drivers of demand for the utility offered by the asset or due to a slowdown in the overall economic activity.	Recessionary trends in the Europe and the US, fall in oil price and reduced growth prospects of the region resulting in reduced demand expectations (4Q-08)

3. Evaluating the presence of a Dubai like situation in other GCC countries

When could there be a contagion??

Contagion could happen only in countries/regions where there are excesses in financing, speculation and demand expectations in the sector similar to the extent in Dubai. The perception of a speculation driven rise in prices in a country/city keeps investors at bay as they wait for clarity to separate speculative markets from a real demand driven market. The uncertainty would be short lived if the fundamentals are strong and appropriate financial conditions exists to adequately lubricate. However, the task to alienate a speculative market from a vibrant demand based market is no easy a task and hence concluding a market to be speculative can at best be an informed opinion.

Contagion possibility can be measured from the presence of factors contributing to bubble creation

Speculative activity is also hard to measure as there is no way to identify and separate speculative transactions from investing transactions. It can at best be inferred from the volume of the transaction activity from the records of the land and building registration departments of countries. That inference is also distorted by the fact that the real speculative spectrum, the flipping of real estate, is not included in these numbers and, in Dubai, the regulation which necessitated the registration of flipping type of transactions came into effect only by October-2008.

While the presence of all factors mentioned in the asset price bubble path section is necessary for a creation of a bubble, a burst can be caused due to factors external to the sector like a fall in the overall economic activity, negative capital flows etc. The correction in prices would be organized and less painful if any of these excesses are controlled by the authorities or the market forces.

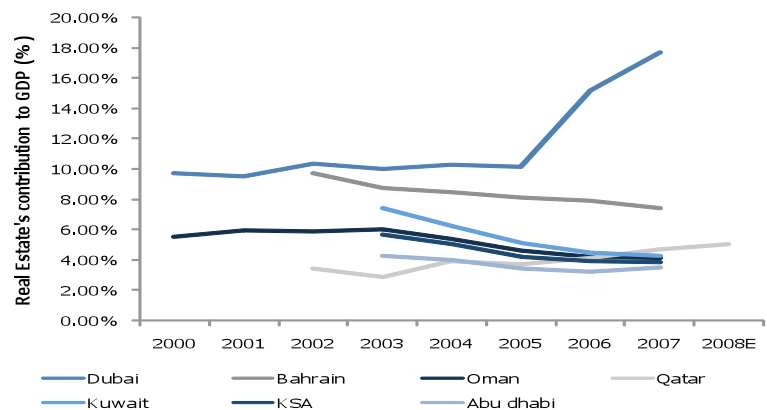
Excessive economic activity

With the luxury of hindsight, we can study the price levels and its collapse and can comment on the rise to be unrealistic but a better approach would be to look at metrics which could suggest that the activity in the sector was getting stretched beyond sustainability. The real estate sector's contribution to Dubai's GDP experienced a steep surge from its six year average of c.10% to 15% in 2006 (Figure-2). We expect that the sector's share in the total GDP would have gone up further to c.18% in 2007. This is in divergence to the rest of the region where the share of real estate to total GDP either stayed flat or even declined.

Spurt in Real Estate sector's contribution to GDP in Dubai from 2006.

Dubai's extensive reliance on the sector made the growth self driven, unsustainable and vulnerable to exogenous impacts of even a minor scale. The pertinent question to ask is what drove up the activity in the sector to these levels. Dubai's attempt to establish itself as a trading, finance and tourism hub for the region, like Singapore for Asia, lead to heavy dependence on continuation of demand for its services from outside the emirate and hence got vulnerable to variances in the player's estimates of demand and at the end to the slump in demand caused by the global economic situation.

Figure 2: Real Estate Sector's share in nominal GDP



Source: Statistics authorities and ministries of relevant countries

Real Estate sector's share in the GDP of peer GCC countries show a falling trend in general except for Qatar

Excessive reliance on employment

Another measure which could throw light on the extensive reliance on the sector is the percentage of the population working in the real estate and construction sector. As per the latest census data available for the year 2005 in Dubai, c.48% of the total workforce of c. 1 million were working in the construction and real estate sector compared to c.12% in Saudi Arabia and we expect it to be at c.50% in 2007. This measure does not include the c. 300,000 workforce who stay in Sharjah and commute to Dubai daily for work. Although a portion of the workforce would have been working for infrastructure development projects, the share of real estate construction is considerable and thus signifies the extent of activity that happens in the sector.

Huge percentage of population working in real estate and construction sector provides with evidence on the extent of the economies' reliance on the sector's fortunes

The table in exhibit-3 shows the percentage of population in construction and real estate sector in other countries in the region. While the average for the region is much higher compared to developed countries (7.85% of total workforce in the US for example), Oman and Qatar shows a possibility for over dependence in the sector compared to KSA but the data for other countries are not available and hence regional comparison was not possible. While this alone wouldn't indicate the presence of a bubble, as there are genuine needs for real estate construction in these countries, we should look for additional symptoms in the other factors which together could indicate the presence of a bubble keeping this factor in mind.

Table 3: Workforce in Construction & RE sector (2007)

	Dubai	Oman	Qatar	KSA	UAE
Construction	43.52%	37.31%	35.15%	8.48%	13.91%
Real Estate services	6.74%	2.50%	2.54%	3.57%	2.03%
	50.26%	39.80%	37.70%	12.05%	15.94%

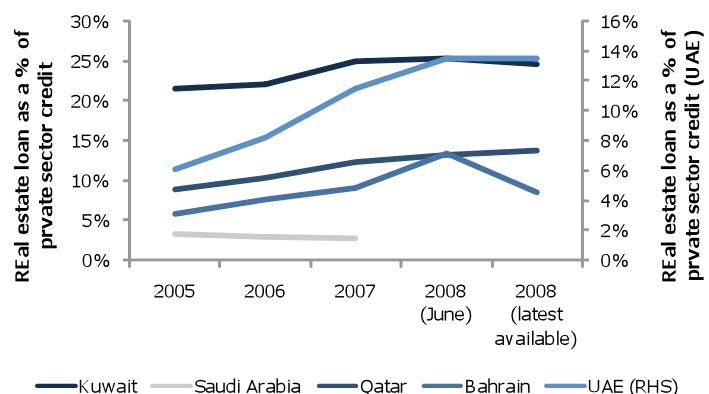
Source: Statistics authorities and ministries of relevant countries

Excesses in Lending

Credit extended by banks for RE Mortgages in UAE grew at a CAGR of a staggering c.85% from c.6% of the total credits extended to the private sector in 2005 to c13.5% in 2007 while the credit provided to the private sector grew only by less than half that rate at c.35% (Figure 4) Here we assume that the majority of the credits extended to the sector got granted to Dubai, given the growth numbers. It is hard to comment on whether the lending has grown in proportion to the sector's growth in Dubai, but as the growth by itself got stretched beyond sustainability, the lending became a contributory to bubble creation. The table in exhibit-5 shows that Bahrain, Qatar and Kuwait had extended credits at a higher proportion to credits extended to the private sector in general. The fact that the RE sector's contribution to GDP has shrunk in Kuwait and Bahrain leaves the sector overprovided with credit and that naturally got corrected to a considerable extent in Bahrain and to a lesser extent in Kuwait during 2008. Though Qatar still shows a moderate rise in the share of RE lending, the sector's share as a % of GDP is also rising, thus justifying the growth in the share of bank's claims on private sector credit. However, we need to watchfully monitor the developments.

Surge in credit extended to real estate compared to the overall private sector credit Dubai

Figure 4: RE loans as a % of private sector credit



Similar albeit a smaller surge can be observed in Bahrain, Qatar and Kuwait as like Dubai

Source: Monetary authorities of relevant countries

Table 5: Growth in lending to RE mortgages

Country	Growth in lending to private sector (2005-2007)	Growth in lending for RE mortgages (2005-2007)	Multiple
UAE	34.52%	84.86%	2.5
Bahrain	26.28%	57.54%	2.2
Qatar	51.83%	79.00%	1.5
Kuwait	31.39%	40.37%	1.3
KSA	15.09%	6.98%	0.5
Oman *	28.19%	21.22%	0.8

* construction

Source: Monetary authorities of relevant countries

Dubai's banks exuberant in extending loans evidenced by the high loan to value ratios

Another measure from which we can judge the excesses in extension of credit in case of residential real estate is the ratio of loan to appraised value of assets. During the peaks of activity, as per press reports, banks in Dubai were lending anywhere from 80% to even 95% of the asset's market value (Table 6). The lower end of the ratio is for the expatriates while the upper end is generally for the nationals. The higher equity demanded by Qatar leaves the banks with adequate cushion should there be a big drop in the prices. Kuwait government restricted the amount of RE mortgage loans to KD 70,000 per person and thus has to an extent placed a cap on the extent of over lending by banks.

Table 6: Loan to value ratio at the time of peak activity (2007 to mid-2008)

Country	Loan to value
Dubai	80%-95%
Qatar	65%-70%
Oman	60%-90%
Bahrain	70%-90%
Kuwait	KD 70000

Source: Monetary authorities of relevant countries and various press publications

Other modes of financing the demand side were also available but were hard to quantify

Apart from bank lending, developers in Dubai were also financed by cheaper equity capital and external fund inflows. The demand side financing is more relevant and hence the supply side financing is not considered for analysis. The external funds which came in from the western and European investors went to finance the demand side but that portion couldn't be analyzed due to lack of data. Some flippers could have availed loans for other business and personal purposes in Dubai and would have channeled the funds to real estate speculation. The data on this too is impossible to get for an analysis and comparison.

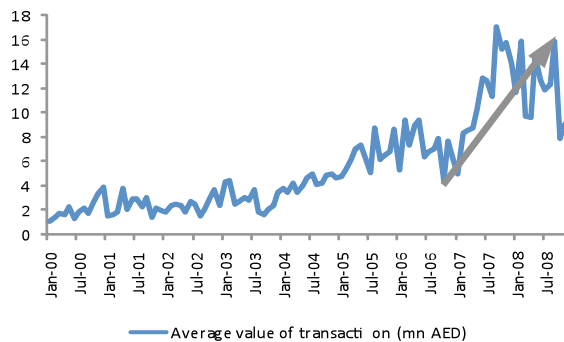
Excesses in speculation

Speculative transactions intertwined with investing transactions and are hard to be identified and separated

The speed with which the price moves will also indicate the extent of speculative activity although a rise in the prices alone need not necessarily imply speculation. Rather than doing a post facto inquiry into the price levels which can be biased, we can consider the average value of land transactions (value per land transaction) as a proxy for prices. Apart from Dubai, only Kuwait and Bahrain provides with official data on the number and value of transactions and hence a full analysis of the region was not possible. Figure-7 depicts the extra-ordinary momentum in price rise in Dubai from Jan-07 to Jun-08 and the average value doubled in this period. It also compares the annual average with Kuwait and Bahrain. In Bahrain, the value of real estate transactions in the first half of 2008 itself was at c.80% of 2007 on the whole, however, it dropped by c.33% in Q3-08 Q-o-Q which can also be inferred from the fall in financing (Figure-4). Average transaction value too got corrected by 30% during this period. This behavior of the market is similar to Dubai and hence is indicative of the presence of a bubble. In Kuwait, the law passed by the Parliament to prohibit banks and investment companies from investing in residential real estate and the limits on lending, which were aimed at controlling inflation, triggered a downfall in the real estate transactions in 2008 (Figure-8) and we can observe a freeze in the speed of rise in prices indicating a halt in excessive speculative activity.

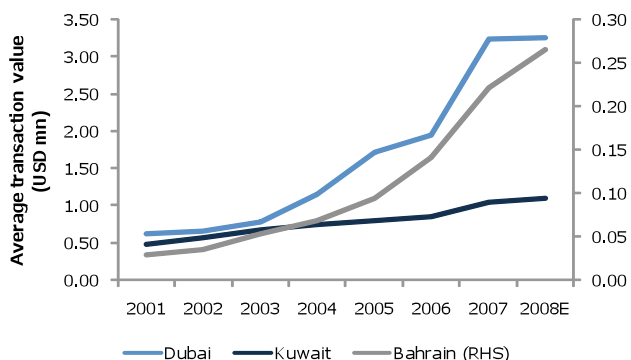
Presence of speculation evident from the surge in average transaction values in Dubai

Figure-7 – Monthly average transaction value (Dubai) and comparison of annual average with peers



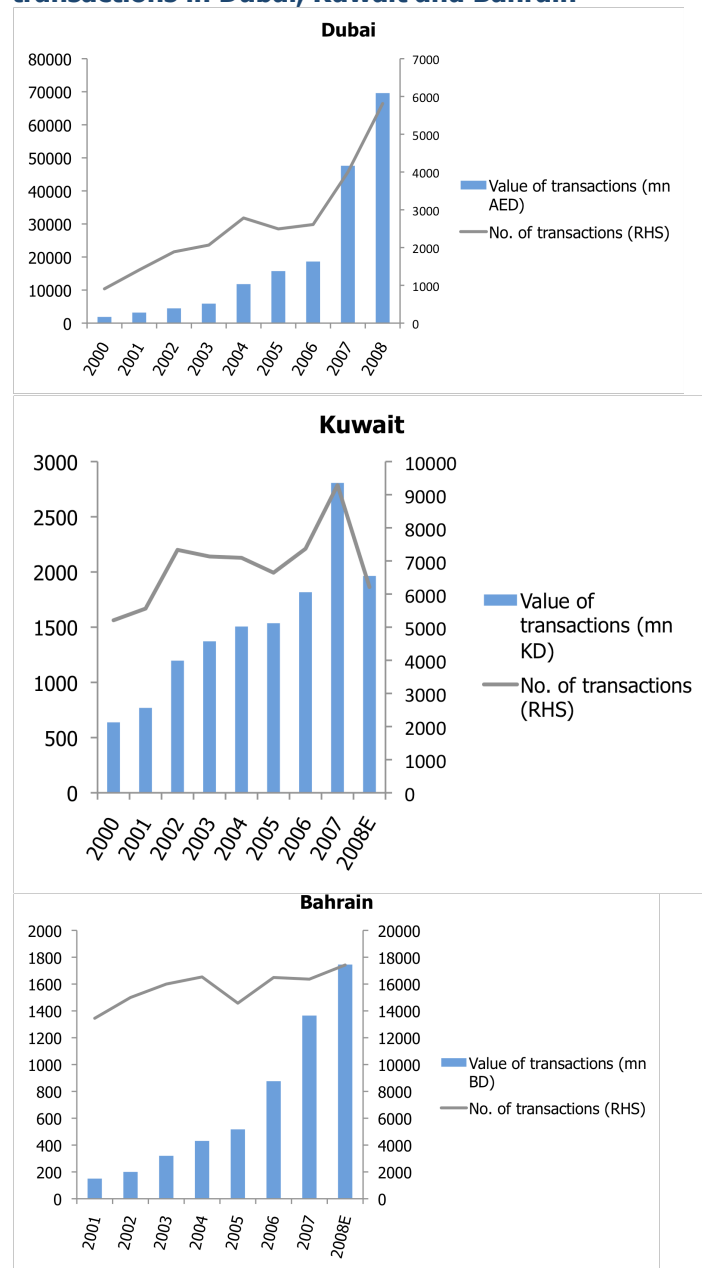
Source: Land transaction registration authorities of relevant countries

Incomparable surge in the average transaction value in Dubai evident when dollarized



Source: Land transaction registration authorities of relevant countries

Figure-8 – Annual total number and value of transactions in Dubai, Kuwait and Bahrain



Source: Land transaction registration authorities of relevant countries

Presence of scams in Dubai and their conspicuous absence in other countries

Extensive speculation can also lead perpetrators of scams and frauds to use the opportunity created by the frenzy. The frauds which came under bright media light like Deyaar Development, Dynasty Zarooni etc in Dubai during May & June and the size of money lost by investors were in essence the trigger for the downfall. The effect of the financial crisis and lack of liquidity has affected the property market in other countries as like Dubai. These conditions will in general put the scamsters in deadlock as a result of which their scams will be brought to light. Despite this fact, no scams of such size and significance has been unearthed in other GCC countries so far.

4. Can other GCC countries/regions do a Dubai?

Measures	Qatar	Oman	Bahrain	Kuwait	KSA	Abu Dhabi
Extensive reliance on the sector	Mixed signs	No	No	No	Data not available	No
Extensive Lending to the sector	Rising with equity cushion	Falling	Rose till mid-08 and got corrected	Rising but the impact controlled with a cap on lending	Stable	Data not available
Speculation	Data not available	Data not available	Spiked up in H1-08 and huge fall from Q3-08	Controlled	Data not available, but not expected to be excessive	Data not available
Scams	None so far	None so far	None so far	None so far	None so far	None so far
Overall Assessment	Need to be watchful	Not a bubble	Bubble not significant to the economy as like Dubai	Bubble avoided with a less painful correction	No bubble in question	Could not be concluded

Qatar

Cannot be concluded that a bubble is present in Qatar but one needs to be watchful on the developments

- The contribution of real estate and construction sector to Qatar's GDP is still rising driven by the past and expected economic growth prospects coupled with huge gap between the demand and supply due to heavy growth in expats population.
- High percentage of population working in the sector provides with a need for a close watch.
- Loans extended to the sector is growing in line with the growth in the sector activity.
- Higher equity demanded by banks for loans makes the financing for speculation dear and also acts as a cushion against the impact banks could face given a fall in prices.
- Transaction data is not available and hence no visibility on the level of activity from which we can infer speculation.
- **Conclusion: Need to be Watchful**

Oman

Cannot be concluded that a bubble got formed in Oman

- Contribution to GDP by the construction and real estate sector has fallen.
- High percentage of population working in the sector is a concern. However, extensive analysis of the real estate cycle needs to be done to ascertain the sustainability of the extent of employability by the sector.
- Loans extended to the sector has fallen in line with the fall in sector activity.
- Real estate transaction data is not available and hence no analysis can be done on the speculation front.
- **Conclusion: No evidence of Bubble**

Presence of a bubble evident in Bahrain although the impact on the economy will not be as significant as Dubai

Bahrain

- Contribution to GDP by the construction and real estate sector has fallen.
- Loans extended to the sector rose till mid-08 and has fallen considerably in 2008 in line with the fall in activity in the sector vis-à-vis the overall economy.
- High loan to value ratio indicates high spirits in bank lending
- Transactions experienced a spike in the first half of 2008 and the picture evidences the presence of a bubble.
- **Conclusion: Bubble but not significant**

Kuwait had all the factors that can feed a bubble but got corrected in an orderly manner

Kuwait

- Contribution to GDP by the construction and real estate sector has fallen.
- Loans extended to the sector outgrew other sectors.
- Transaction activity rampant in 2007
- Legislative interventions controlled lending and reduced transaction activity in 2008
- Real estate market corrected less painfully
- **Conclusion : Full-fledged bubble avoided**

No evidence in Saudi Arabia and lack of information blocks judgment in Abu Dhabi and Sharjah

Kingdom of Saudi Arabia

- Contribution to GDP by the construction and real estate sector has fallen.
- Loans extended to the sector remain stable as a % of private sector credit
- Transaction data not available, however a bubble cannot be expected to have grown without growth in activity and lending
- **Conclusion : No growth no bubble**

Abu Dhabi

No other data apart from the sector's contribution to Abu Dhabi's GDP till 2007 was available and hence no meaningful analysis could be done.

Conclusion : Couldn't be judged for want of data

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