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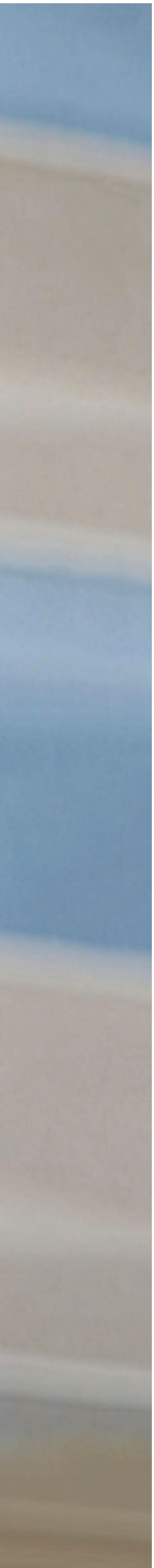


"Proceed with Caution"

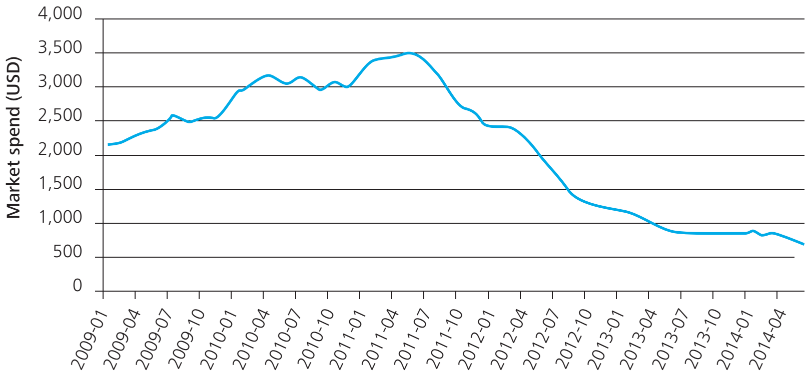
Better controls for a burgeoning development market

During the previous Middle Eastern development boom, consumer confidence was high, investment was of a staggering scale and all aspects of economic life appeared to be on an upward trajectory. Reports of tickets, used simply to gain access to the offices of some of the major developers to purchase units, were exchanging hands for hard currency, and lavish launch events were held for virtually all new development projects.

Forward to 2009/2010 and the picture is markedly different. The world economy is in crisis, the debt market is in turmoil and real estate development is on life support. The days of profligate spending, extravagant lifestyles and speculative development were ended virtually overnight. The causes of such failures are well documented, but ill-considered, highly leveraged and over-engineered developments were always likely to fail in a market as dynamic as this.

The graph on the following page says it all. Between 2009 and 2014, the number of cancelled developments in U.S. Dollar value alone is truly staggering, peaking at US$3.5 billion in the summer of 2011. This statistic applies only to the UAE but it could be extrapolated across the entire region and produce similarly startling results.

Figure 1: Project Values (US$ million) cancelled in the UAE from 2009 to present day



Source: *MEED Projects*

When a market that has become artificially inflated, as the development market in this region was back in 2008, there really is only one inevitable direction, and that is down. But the speed and depth of the decline here in the Middle East was probably the most surprising thing.

Fast forward to 2013

If we now look over the past 12-18 months, we can already see that the development market is slowly returning to pre-2008/2009 levels. Press reports abound relating to unsustainable rental increases, stampedes at developers' offices when new schemes are launched and the questionable levels of cash purchases that are inflating the market. According to *MEED Projects*, there are US$2.5 trillion-worth of projects either planned or underway as at April 2014.

Figure 2: Development activity across the GCC, February 2013

Source: *MEED Projects*

The International Monetary Fund (IMF) has been active in expressing caution over the GCC's latest development cycle, urging restraint and calling for greater control at policy level to curb debt to equity ratios, increased due diligence in respect to cash purchases and much greater powers for government to even out the peaks and troughs of such a cycle. Moreover, the IMF has been actively promoting the introduction of mechanisms to prevent "flipping" properties in the region and it is certainly something that governments across the GCC are considering.

While this is commendable at a policy level, what is needed is constraint at a systemic level by ensuring there is sustainable growth across real estate and construction industries by implementing better controls and mechanisms across all sectors, through changing behavioral patterns.

Consider, implement, monitor

So what are the appropriate control mechanisms that need to be put in place to avoid a system-wide crash as experienced in 2008? Due diligence, cautious planning and careful monitoring are some of the controls that spring to mind.

Historically, key lending and credit decisions have been made with misleading and/or incomplete information, typically prepared by construction specialists who lack the financial and commercial expertise to translate project specific information into a format suitable for use at credit committees. Often, a detailed business case that considers fully all of the risks and opportunities for that particular investment would not be made, nor would it consider in finite detail the wider financial contemplations outside of the raw construction costs.

When projects run into difficulties and lenders are asked to provide additional financial support, they often request both legal advice and an independent review of the financial position and forecast performance in order to understand the severity of the situation. This involves an independent third party review of construction progress and remaining costs to complete, in addition to a review of prevailing market conditions in order to understand income projections, which are then translated into revised financial forecasts. After this, much stricter financial controls are often put in place through to ultimate completion.

This could potentially be avoided by implementing tighter, integrated controls at the outset of projects. In order to reduce the risks attached to real estate project financing, an integrated approach to monitoring should be taken from initial feasibility assessment through to ultimate completion, handover and operation. This would typically include the full range of construction and financial technical skills and commercial expertise required to understand and continuously monitor the financial performance of projects overall.

This typified "Integrated Project Monitoring" would incorporate an initial feasibility study to give an indicative, high-level assessment of project viability prior to any facilities being extended. This would be followed by a detailed construction program and risk review, and preparation of the financial business model against which ongoing performance will be monitored, and would then be followed by detailed periodic monitoring of performance and analysis of variances against the original business plan.

So while the real estate and construction markets may well be returning to levels akin to those in 2007/2008, certainly in terms of releases of new developments, there does appear to be acknowledgment at policy level to better control the surge in development that is predicted to 2020 and beyond.

Although there has been alarm at the perceived escalation in rental values in the residential sector, there is some evidence to suggest that unit sales (as opposed to rental prices) are at least cooling. Indeed, there have been numerous articles recently written about the waning of prices in the residential sales market, and this has been supported by the recent announcement from

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Moody's, the ratings agency, to categorize one of the region's largest developers at B1 status (which is one step below investment level.) While this is not viewed as a reflection of that particular developer, it is a reaction to the potential over-supply that may inevitably impact sales prices.

This brings us full circle. By implementing a more considered approach through Integrated Project Monitoring, the initial business plan will be far more robust as there will be a greater level of financial and technical due diligence from the outset. Furthermore, by initiating a regime of detailed and independent checking, it will ultimately safeguard the investment by tracking progress against pre-determined metrics (financial, technical and time-related) using appropriate advisors to provide this level of assurance.

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