





# A balancing act: a look at the property markets in the GCC

---

A rate of over-supply in the property market can be beneficial. But how much is too much? And what are the effects of too much available property on the market?

---

## Initial real demand and take-up served to mislead many developers into believing there were only sunny days ahead, when in actual fact storm clouds were gathering.

An element of over-supply within most property markets is not undesirable as it enables people and businesses to physically expand and move to larger spaces that can accommodate their growing requirements. It is rather the volume of over-supply that must be carefully balanced as too much vacant new stock can have serious consequences on the immediate market and the economy it forms part of.

Take the office sector for example. Within certain mature markets there is a general consensus that anything between five and seven percent of total stock represents a healthy vacancy rate. In contrast, emerging markets may have significant pent-up demand and are able to accommodate much higher volumes of development. However, each market is different with unique drivers.

Where over supply of new stock exists and accommodation remains vacant or unsold for long periods of time, developers may be unable to generate the rental income or sales revenue they had anticipated. As a consequence some may not be able to meet their loan obligations. In certain markets, if covenants are imposed, liquidation may be the only solution. The ripple effects are that creditors and suppliers alike are caught in the downward spiral and economic fallout.

In parallel, competition between landlords attempting to lease vacant space may induce price wars and consequently, deflation. This is precisely what lenders and developers fear the most as loan to value ratios are challenged, lending covenants are reviewed and the snowball gathers pace!

### Office, anyone?

Without exception, today all Gulf Cooperation Council (GCC) states have an element of over-supply in at least one particular-use class, whether residential or commercial. Whilst this phenomenon is not exclusive to the Middle East, what is concerning is the sheer volume of over-supply in certain countries. Although the markets across the region remain relatively non-transparent and reliable data is difficult to obtain, it is not difficult to ascertain that certain GCC office markets have an over-supply of up to 40 percent of new stock which, given depressed economic times, is very concerning.

Much of this over-supply has been created by a development frenzy that started around the middle of 2003 and was abruptly halted in September 2008 with the collapse of financial markets worldwide. Thereafter there was obviously an overhang of stock under construction that was added to already completed stock over subsequent months.

So what prompted this over-supply across markets that up until then had only experienced minor variations in development activity? A combination of factors, not least of which is access to plentiful debt as well as the ability to make super profits through the off-plan sales route. Particularly in the case of the latter, in certain markets, developers demanded phased payments against calendar dates as opposed to milestones, often enabling them to cash-fund schemes.

Ironically, initial real demand and take-up served to mislead many developers into believing there were only sunny days ahead, when in actual fact storm clouds were gathering. In reality, many developers were reluctant to depart from the super profit curve, ignoring the fact that speculators were now driving demand, but who in reality had little or no intention of occupying the end-product, nor did they have the funds to make all the required payments!

Sadly, in many markets the balloon didn't deflate but rather exploded and the last ones left holding the end-product were the losers. Given their flawed business plans, which relied on being able to flip the end-product to another party, asset rich but cash poor speculators assisted in bringing down developers.

It was just too easy, lenders forgot the basics and the need to secure loans against tangible assets. In parallel, many developers lacked experience and had little appreciation for the need for a demand-led market as opposed to a supply-led one.



### Plugging the holes

So how do you prevent over-supply and ensure that supply matches demand going forward? As the vast majority of property markets are imperfect, there is no simple answer. However, there are a number of safety valves that can be put in place to reduce the risks.

The most obvious is through lending control. Lenders should carefully analyze applicants' business plans and stress test their assumptions. They should insist that borrowers appoint qualified industry specialists to undertake detailed market research which supports their development plans and includes conservative take-up assumptions of the accommodation being developed.

All loans should be asset-backed with phased payments against milestones. Again, this will require third-party professionals to approve and sign off completed works, which will have previously been monitored by another tier of professionals.

From a higher level, government and municipal bodies should impose development control through planning: developers will only be able to develop stock within defined geographic areas against strict guidelines such as developable density and use. Developers will further be obliged to deliver a minimum level of amenity to support the immediate infrastructure. All this is likely to lead to higher development costs and potentially lower returns as developers compete for a much limited land pool. By default this will serve to weed out the cowboys who were profit-driven in the shortest time

---

## Whilst an element of speculation is sometimes a good thing, control is better.

possible. Ultimately this will also lead to a flight to quality and as such the experienced developers will rise to the top.

Hopefully lessons have been learnt from the recent downturn, however as history has shown, mistakes will almost certainly be made again in the future. Developers, lenders and occupiers alike should always remember that markets are driven by real demand and whilst an element of speculation is sometimes a good thing, control is better.

### Where do we go from here?

The recent global economic fallout and its immediate impact on many of the Middle Eastern property markets has been a painful lesson to many. This correction was however, necessary, as it introduced a much-needed dose of reality. In simple terms the supply of any property stock should match real demand and whilst a small amount of excess supply can be healthy, this should only be led by developers who have one eye on economic drivers and the other on the ability to service debt.

by **Robin Williamson**, managing director,  
Real Estate advisory, Deloitte Corporate Finance limited