CUSHMAN & WAKEFIELD | CORE

DUBAI INVESTMENT OUTLOOK

2018

FOREWORD

Analysing real estate investment opportunities and risks in the backdrop of contracting yields and continued market softening.

As 2017 came to a close, a clear trend in residential sales prices remains elusive. A variety of economic parameters in Dubai are beginning to face headwinds; real estate is no exception, and faces its own particular challenges in 2018. Further rental declines, the ongoing strength of the US dollar and the imminent – albeit probably limited – inflationary effects of the introduction of VAT in the emirates are all expected to compress investment yields.

Dubai's real estate market will weather a number of headwinds over 2018 including further rental declines, continuing US dollar strength and the imminent – albeit probably limited – inflationary impact of the VAT.

Nevertheless, strengthening economic growth and comparably low prices and acquisition costs suggest that long term investment opportunities are still available to those discerning investors equipped with perceptive market intelligence.

This report highlights some of these real estate investment opportunities in both the residential and commercial markets, in addition to alternative asset classes such as warehousing, education and real estate investment trusts (REITs) to suit a variety of investor appetites.

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Investment Outlook

This publication

This document was published in January 2018. The data used in the charts and tables is the latest available at the time of going to press. Sources are included for all the charts. We have used a standard set of notes and abbreviations throughout the document.

Economic overview

The UAEs economy has weathered an extended period of low oil prices over the past few years and is expected to see growth pick up over 2018. The Dubai government budget for 2018 is significantly larger than in 2017 – due to infrastructure-related expenditure in the run up to Expo 2020 – and is likely to support recovery, particularly in concert with a number of economic reforms that promise to streamline government spending and increase efficiency. Nevertheless, businesses are still adapting to a more challenging environment created by the economic weakness of previous years; many firms have consolidated their operations and are now working on leaner structures in order to reduce costs.

Currency fluctuations

The Emirati dirham, which is pegged to the US dollar, has strengthened slightly over the past three months relative to Sterling and the Euro, recovering from a marginal decline seen earlier in the year. Given that the AED/ USD has strengthened almost 26% over 2014–2017 against a basket of currencies*, the UAE has become a relatively expensive destination for inward real estate investment from important source markets such as India and the UK.

* Federal Reserve US Dollar Index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners including the euro and the sterling.

Oil price trends

Oil export values decreased almost 50% over 2014–2016, in line with the decline in oil prices.

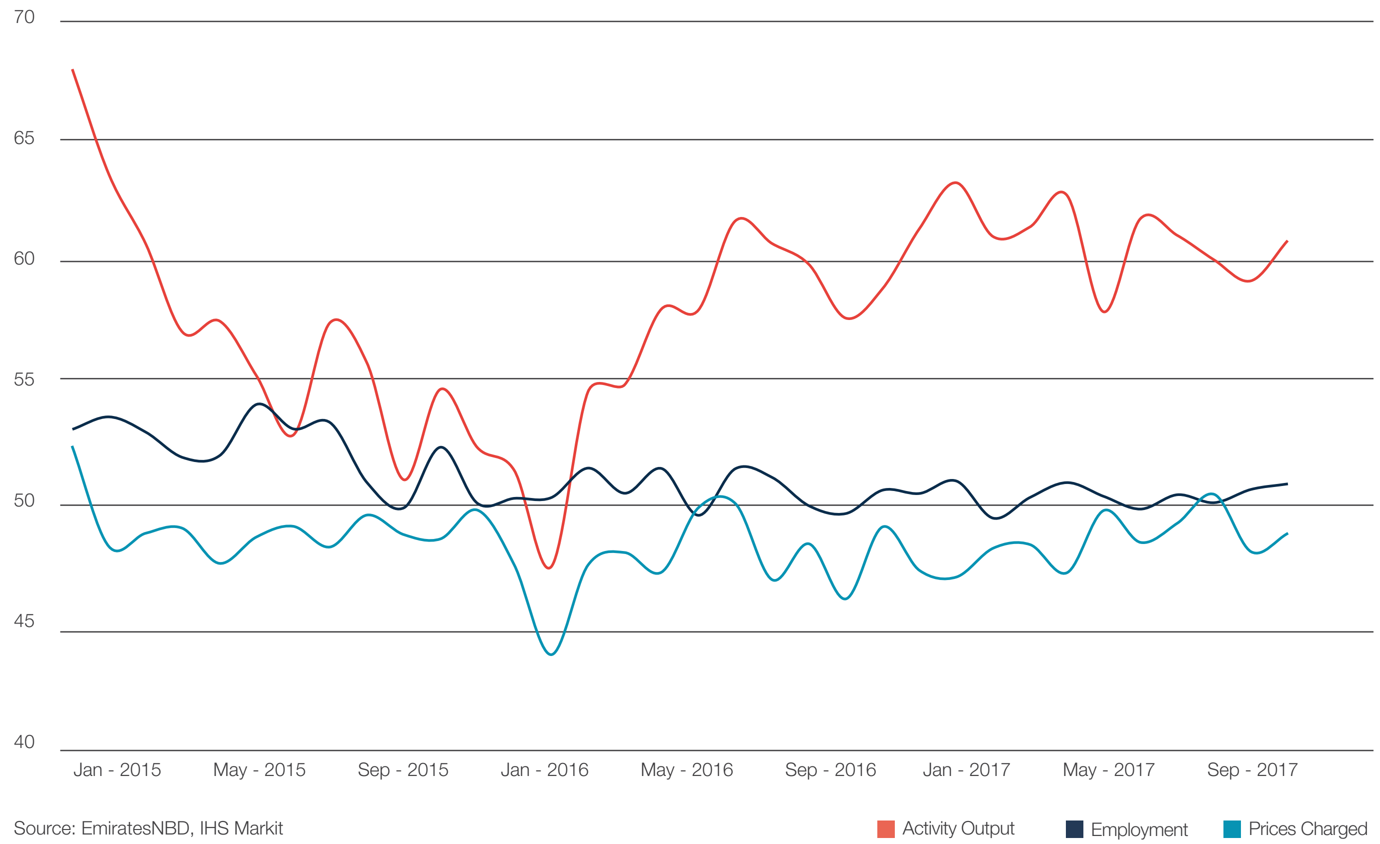
Although exports and prices recovered slightly in 2017, ongoing OPEC discussions to continue curbing production are likely to keep exports from rising significantly in the near term.

Demand indicators

The Emirates NBD Dubai Economy Index, which tracks the city's growth across a range of sectors and indicators, shows a marked improvement due to the steady increase in new orders and output. The tracker, which had dropped below 50 in 2016 Q1, averaged 56.3 over 2017.

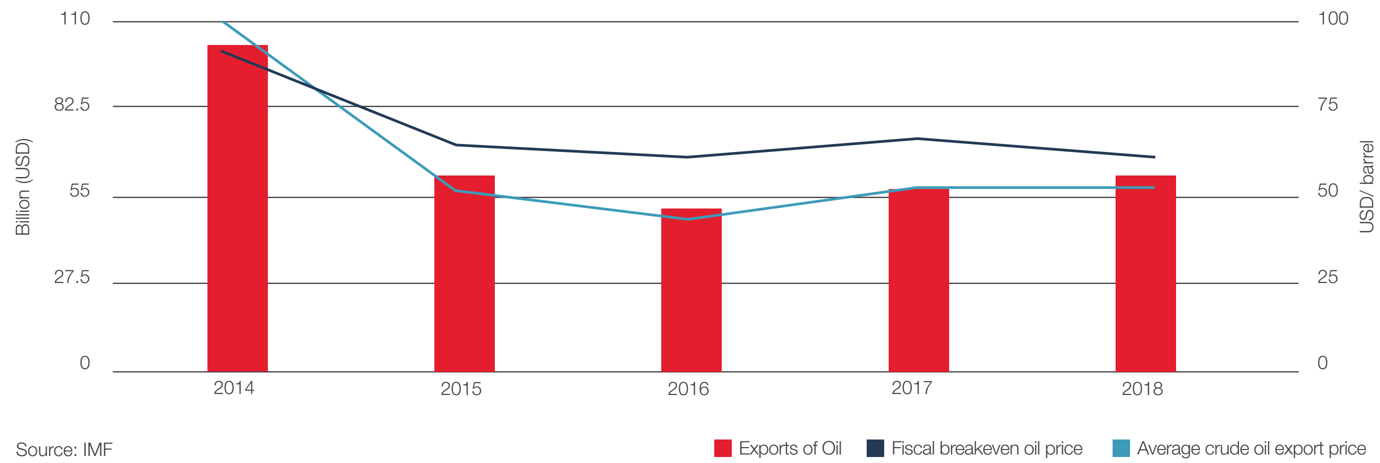
Nevertheless, this has not been reflected in terms of employment; according to the Monster Employment Index, online vacancies in August 2017 were almost half the level seen in the same period in 2016.

Dubai Economy Tracker Components



Source: EmiratesNBD, IHS Markit

Oil Output, Breakeven Oil Prices



Source: IMF

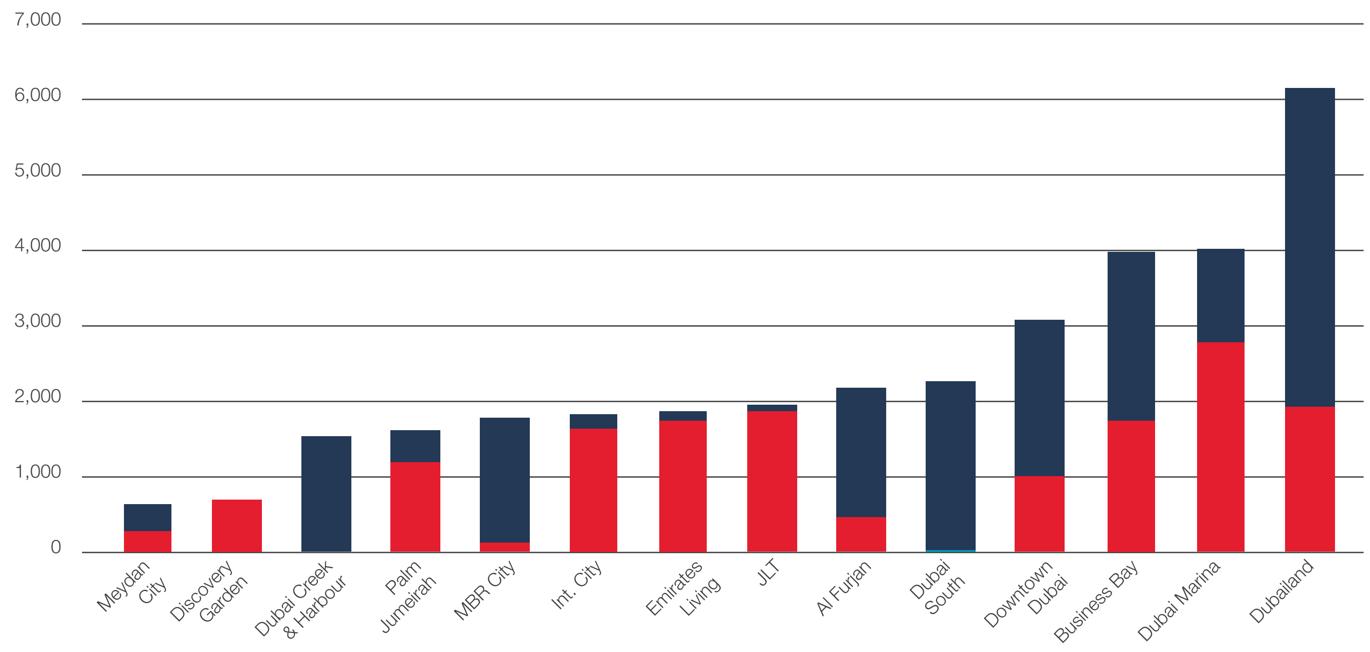
Residential investments

The residential market continues to see further downward adjustment in rental rates, resulting in yield compression in several areas. Although this trend is likely to continue as the next cycles of lease renewals lead to further relocations, the rate of decline is expected to slow in the near term.

The underlying fundamentals for this compression vary by segment and reflect the market's adjustment to the ongoing trends of the previous few years.

> "The residential market continues to see further downward adjustment in rents, resulting in yield compression in several areas, although the underlying fundamentals for this compression vary significantly by segment"

Number of transactions by area - 2017



Source: Cushman & Wakefield Core Research

Dubai residential market dynamics

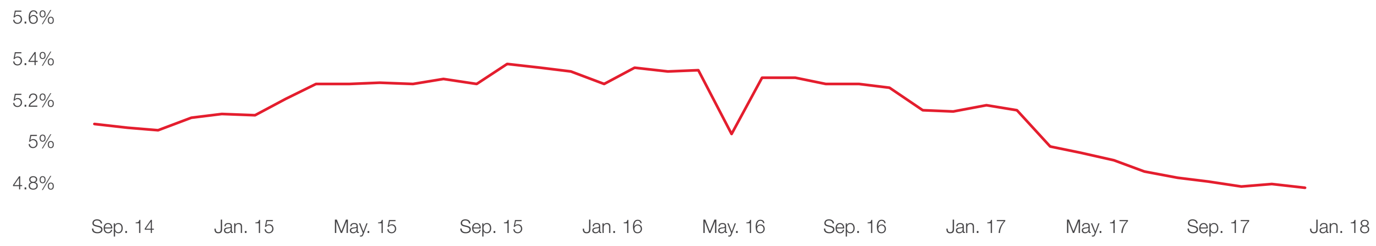
Prime

Over 2014-2016, the significant declines in prices (relative to rents) in the prime and upper mid-market segment caused yields to increase approximately 28 base points representing a relative increase of 5% over this period. This combination of weakening prices but comparatively stable rents expectedly encouraged a share of tenants in this segment to shift towards ownership.

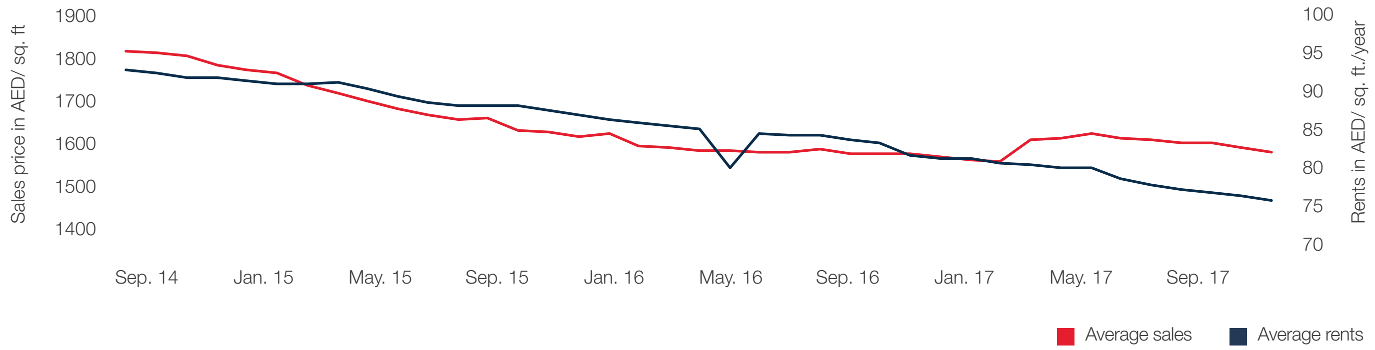
However, this effect – seen across communities as tenants relocated to capitalise on weak prices – eventually drove down rental demand and gradually caused prices to stabilise during 2017. This caused yield compression by an average of 57 base points, representing a relative decline of 11.2% across prime and mid-market communities during 2017.

In the near-term we expect prices to continue stabilising in the prime and mid-market segment but the current decline in rents to decelerate allowing yield compression to slow down.

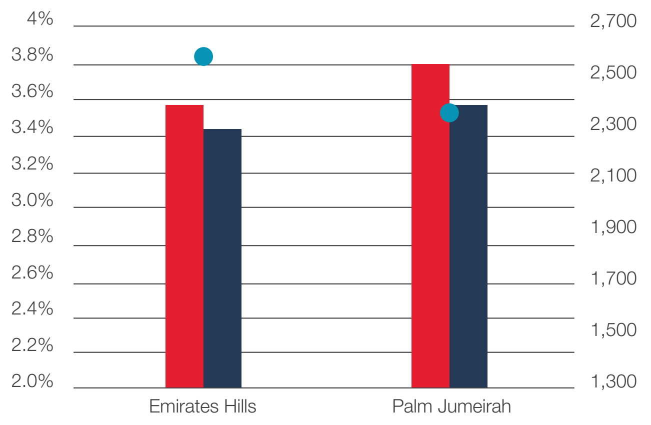
Prime and upper mid-segment yields



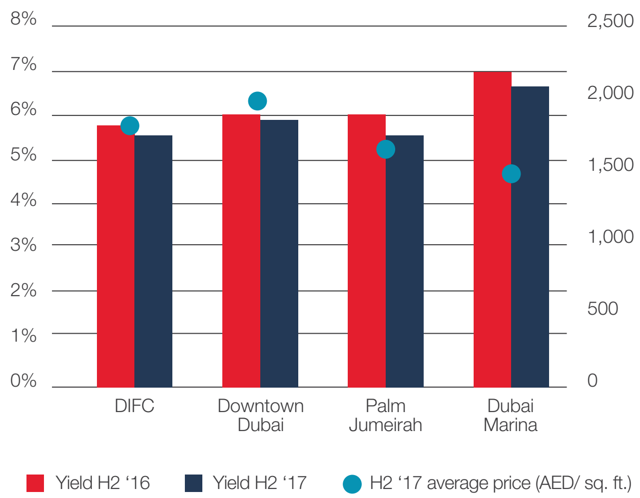
Prime and upper mid-segment sales and rents



Prime villa yields



Prime apartment yields



Source: Cushman & Wakefield Core Research

Affordable and Mid-market

Yields in the affordable and lower mid-market segment have also followed a similar trajectory although for significantly different reasons. Over 2014-2016, the stronger decline in prices and only a slight weakness in rents allowed yields in this segment to rise 68 base points representing a relative 8% increase, which worked towards increasing demand (similar to the prime segment). However, most of this buyer demand was led by investor buyers as opposed to end users; who could not afford to shift to ownership due to continued affordability issues.

This increased investor demand allowed the affordable segment to see prices relatively stabilise over 2017. However, given that lower-income buyers were not shifting to ownership, it was one of the main reasons the tenant pool did not shrink as much; affordable properties, therefore, did not see rents decline as significantly as seen in the prime market. This prevented yields from declining as visibly: from mid-2016 to the end of 2017 yields compressed only 35 base points representing a relative decline of 3.8%, only half of the decline witnessed in the prime segment.

Investor buyers, therefore, continue being drawn to the affordable segment due to the expected high level of yields and easier payment plans while developers see robust off-plan transaction volumes as an encouraging sign of higher absorption activity and continue bringing more stock to the market.

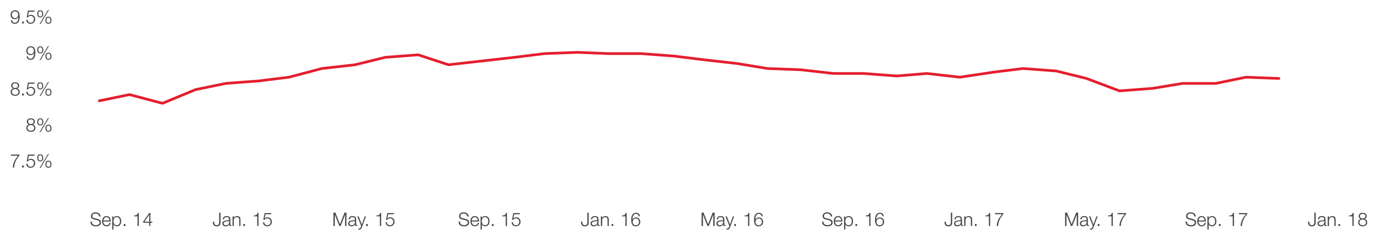
Given that affordable segment's supply pipeline is looming with substantial off-plan deliveries in the run-up to 2020, the high yields expected by many investors post hand-over, are unlikely to be sustained.

If rental demand of these projects is insufficient at handover, this supply surge is expected to exert considerable downward pressure on rents, leading to faster yield compression. Eventually, this contraction in yields will reduce investor demand, in turn pulling sales prices down over the mid-term.

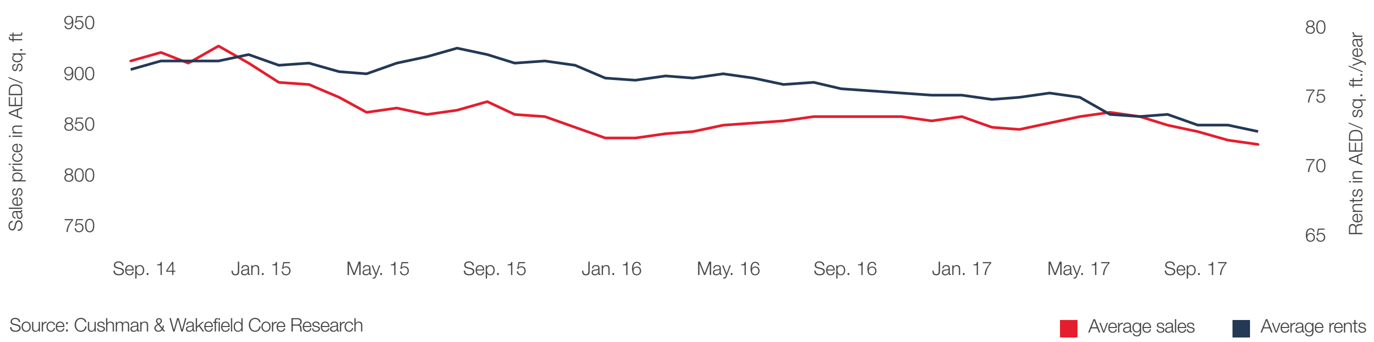
It is important to note therefore that yield trends do not provide a full investment picture, as similar yield trajectories in different segments can hide very different economic realities and divergent risk profiles. Although yield compression is often considered to be indicative of lower risk, in the current market, this may hold true for the prime segment but not the affordable.

Q2 2016 – Q4 2017	Rent decline	Yield decline BPS	Relative yield decline %
Prime	11.2%	57	10.6%
Affordable	5.1%	35	3.8%

Affordable and lower mid market yields

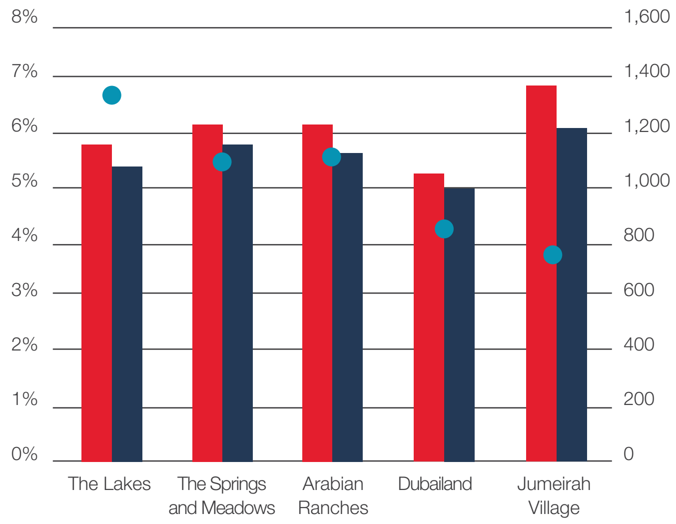


Affordable segment sales and rents



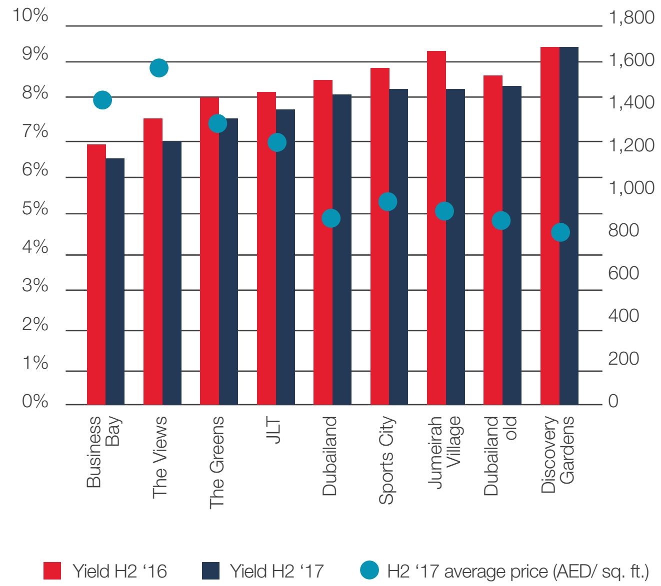
Source: Cushman & Wakefield Core Research

Mainstream Villa Yields



Source: Cushman & Wakefield Core Research

Mainstream Apartment Yields



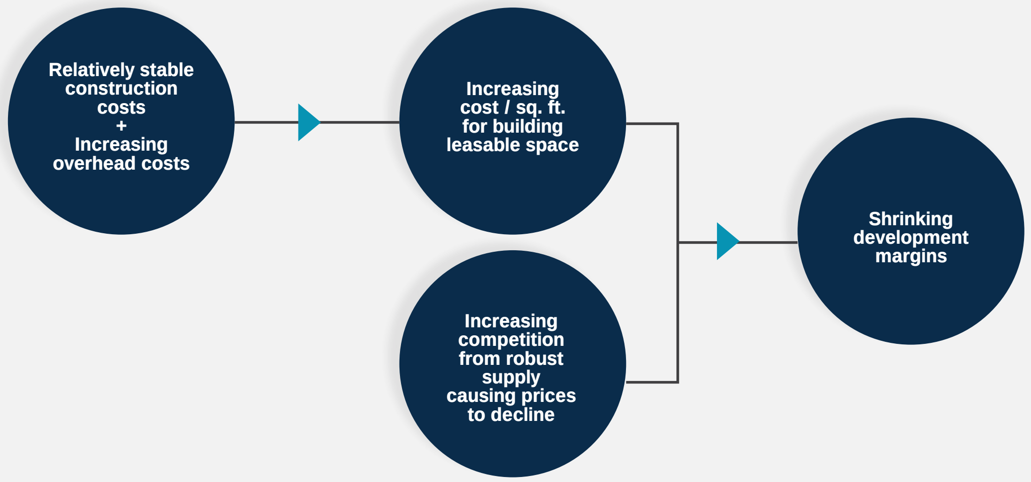
Construction Cost

Despite relatively stable construction costs, developers have seen total expenses rise significantly over the past few years. This is largely due to increasing overhead and compliance costs associated with the introduction of regulations which require developers to raise construction and development standards.

Although the implementation of such regulations will work towards strengthening Dubai's real estate market in the long term, the high charges associated with compliance (often exceeding 10% of the total construction costs) are placing a major burden on budgets. All other factors being equal, developers have seen profit margins decline significantly.

Developers' margins are also being compressed by increasing price competition in the market, and many are reducing their prices per sq. ft., bringing down average prices particularly in the off-plan market. Despite rising costs, their competitors are being forced to do the same, thus further shrinking developer profit margins.

Over the long term, such competition is likely to drive less efficient developers (and those that have not factored in these costs) out of the market. This effect is most likely to impact smaller developers that cannot benefit from significant economies of scale and find it unviable to bring new products to market, even if they are of high quality. Although this may potentially improve market competitiveness, it may also create a scenario where many developers offer lower quality products, resulting in value and quality reductions in the market.



Office Investments

Dubai's office market exhibits the key characteristics of an attractive prospect for global commercial investment. Occupancy levels of Grade A office stock in core locations are notably high due to strong demand from blue-chip occupiers choosing to locate their regional headquarters in the city.

Furthermore, lease acquisition costs remain low alongside high but steady yields. Although investment interest in this segment was previously limited due to the lack of willing sellers and buyers able to enter at high price points, a few recent large acquisitions by institutional investors indicate a potential shift in the market towards increased available supply and buyer interest.

Over the past few years, investment in the office market has been largely led by smaller investors in the strata segment. Developers of Grade B stock were typically hesitant to accept leasing risks, preferring an early exit by selling strata, predominantly due to a lack of understanding of mature development and disposal strategies. In a few cases it was also because selling strata provided monetary injections to strained construction cash flows.

The office market previously saw fewer institutional investors due to the limited of investment-grade stock available for sale. Master developers of Grade A stock have traditionally preferred not to sell due to the high rental demand. Such developers are typically cash-rich and can therefore sustain the leasing cycle, allowing them to hold on to the stock indefinitely. Prime districts, including DIFC, D3, Tecom and One Central for example, all experience high demand, evidenced by steady pre and post-leasing activity.

Institutional investors typically prefer investment grade assets that are tenanted by blue-chip occupiers with long-term leases of 15 years or more, as is common practice across global commercial hubs. The average lease terms for prime occupiers in Dubai, however, are much shorter, ranging from five to nine years, largely due to the 4% transfer fee applicable on the total lease value for a duration above 10 years, which deters occupiers from considering longer term options. Furthermore, many office complexes within freehold areas are developed and controlled by freezone authorities, while land in onshore areas remains leasehold.

Given the city's dominant rise as an economic hub, international funds aiming to geographically diversify across the globe are increasingly pressed to include Dubai in their portfolio. In view of the steady performance of Emirates REIT, which allocates over 47% of its portfolio to commercial assets, along with the Emirates NBD REIT and the announced ADFG Etihad REIT, institutional investment is expected to gain progressively greater exposure in this market.

The close control of the market is gradually changing, with public–private joint ventures materialising recently, such as the partnership between Investment Corporation of Dubai (ICD) and Brookfield Property Partners, the flagship listed real estate company of Brookfield Asset Management. ICD Brookfield's first major project in the UAE will be ICD Brookfield Place, a 1.5 million sq. ft. mixed-use development in Dubai International Financial Centre (DIFC). Other acquisitions include the Standard Chartered office building in Downtown Dubai bought by a Kuwaiti sovereign fund, and two buildings in Emaar Business Park sold to a regional family investment fund, both of which indicate a maturing landscape.

Impact of VAT on Real Estate

VAT in the UAE is expected to have a broad inflationary impact on the real estate market, particularly in view of the following:

- Commercial real estate sales and leases are subject to 5% VAT, thereby proportionally increasing costs for commercial tenants. (Landlords of such properties will be able to claim back VAT expenses.)
- Existing/ready-built residential properties are VAT exempt. (Landlords in this category will not be able to claim back VAT expenses.) Nevertheless, given that landlords will see their operational costs increase due to VAT paid on expenses such as maintenance, the value of their property investments are likely to see marginal declines.
- New residential properties which are currently being handed over are zero-rated, allowing developers the right to claim back VAT expenses. Nevertheless, given that developers are not likely to claim back expenses at the same pace/speed as payments, their cash flows are likely to be weighed down.

VAT is therefore expected to reduce investment return values in some sectors and increase costs in the short term, effects expected to be particularly significant for small businesses. Although this is unlikely to have a visible impact on the wider economy, potential short-term weakness in the SME sector, which has faced the most significant challenges over the past few years, may work towards compounding the decline seen in rentals for Grade B commercial space. Nevertheless, in the medium term these impacts are likely to be absorbed by a broad inflationary effect across the market.

Warehousing and Logistics Investments

Dubai's position as a global logistics and manufacturing hub is aided by its geographical advantages, its aviation and port infrastructure and supporting legislation. Accounting for almost 30% of Dubai's GDP, the manufacturing, transport and logistics sectors combined are the largest contributor to Dubai's economy and function as the backbone for other economic segments.

However, with the ongoing slowdown in trade volumes and continued lull in oil prices, this market segment has seen dampening levels of demand and widespread rental softening. Consolidations amongst logistics operators are also creating an upsurge in supply levels that is expected to further adjust rents downward. Furthermore, the acquisition process and land ownership regulations make this asset class relatively cumbersome and non-liquid.

Potential investment opportunities do exist in certain segments due to the lack of suitable gaps in the market. International grade stock is witnessing relatively steady absorption, higher levels of occupancy and steady yields in the range of 9–12%, reflective of the relatively higher risks compared to other assets classes. Despite more free zone authorities/funds/private entities offering competitive purpose-built facilities for long term tenants, acquisitions of such assets remain limited.

As existing units are increasingly improved and renovated according to occupier requirements, we foresee further segmentation between higher and lower performing assets. Rents and vacancy levels will gradually reflect these preferences, leading to the emergence of a two-tiered market similar to Dubai's office sector. This is expected to eventually push operators/landlords to revamp existing stock, thus elevating the overall quality of supply on offer and making the industrial market relatively liquid to trade as investment grade assets. Nevertheless, thus far investment in this asset class has largely come from specialised funds/institutions due to complex transaction models and the high degree of customisation.

Education

Investment inflows in the UAE's education sector have increased steadily over 2017. This has been demonstrated by the completion of a number of high profile investments including Emirates REIT's sale and lease back agreement with British Colombia Canadian School in DIP, ENBD REITs purchase of South View School in Dubailand and the Dubai Investments acquisition of Kent College in Meydan.

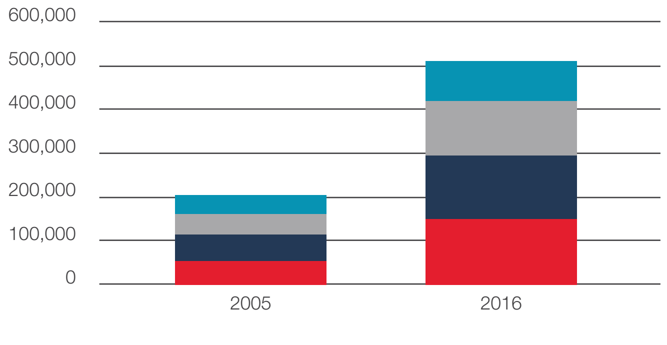
Continued government support for investors in this sector, including the recent announcement by the Abu Dhabi Department of Education and Knowledge to offer investors incentivised land plots, indicates the significance of the education sector to the UAE's development vision.

Investment in the education sector is largely responding to the steadily rising demand for private schools seen in 2006–2016. This demand has been driven by the increasing proportion of school-aged expatriate children in the total population and the growing number of Emirati families seeking private education for their children. Given that the population of children in the 0–4 age group almost tripled between 2006 and 2016, demand is likely to continue increasing rapidly over the near term. The tertiary education sector rate has also seen steady increases as the UAE becomes a popular destination for regional students to come and study. According to the KHDA, Dubai is expected to require an additional 77 private schools by 2020.

Investments in education assets through real estate sale–leaseback agreements are typically considered to be low risk. Investors benefit from the stability of longer term leases and periodic dividends from rental yields in the 8–10% range, in addition to potential capital appreciation in the long term. As larger investors seek to increase their exposure to alternative sectors, investments in education real estate are likely to increase further.

Nonetheless, assets in this sector can carry relatively high levels of risk for investors/institutions that need to prioritise liquidity, as they cannot necessarily be easily sold or used for other purposes.

Population of school-age children



Source: Dubai Statistics Center

REITS

The UAE's REIT sector saw expansion accelerate in the last few quarters, with the launch of Abu Dhabi Global Market's Etihad REIT, scheduled for floatation in 2018, and Equitativa's Residential REIT and 5 holding's Hospitality REIT. Dubai saw the flotation of the ENBD REIT and a number of high profile acquisitions including the purchase of The Edge, Uninest and South View School by ENBD REIT and the European Business Centre by Emirates REIT.

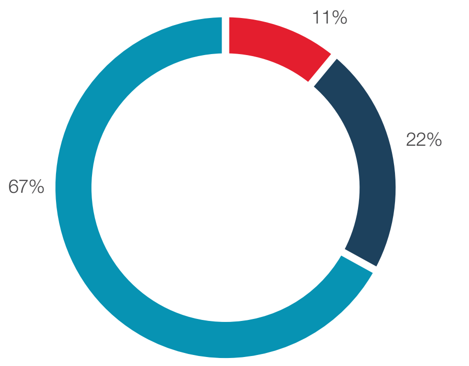
By further integrating the real estate market with capital markets, these REITs will support the expansion of funding channels available to developers, and provide smaller investors access to diversified property investments.

While REITs currently represent a notably small share of the UAE's listed real estate market compared to other countries, they clearly have significant potential to grow. They account for less than 5% of the UAE's listed real estate, compared to other countries such as the UK and Singapore where REITs make up more than 40% of total listed real estate. Nevertheless, given that REIT legislation differs notably between countries, non-REIT structures continue to be the preferred option to invest in listed real estate in various prominent real estate markets such as Germany and Hong Kong.

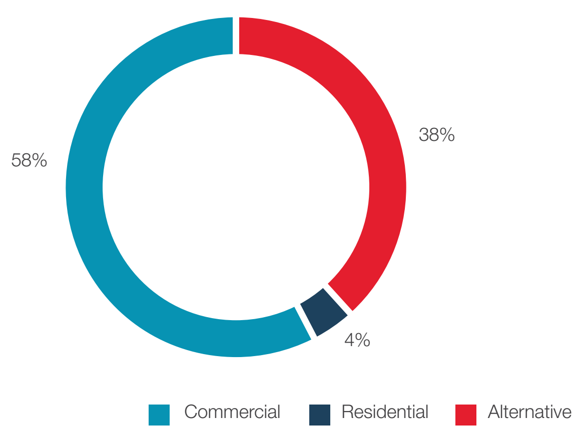
These investment instruments are still relatively new to the region, given that the UAE's first public REIT was launched in 2010, which suggests a lack of public knowledge concerning their structures and specific advantages. The market will most likely benefit from increased education and information regarding the function of REITs, enabling this sector to gain traction amongst retail and institutional investors.

> "REITs account for less than 5% of the UAE's listed real estate, compared to more than 40% in countries such as the UK and Singapore."

ENBD REIT Portfolio



Emirates REIT Portfolio



REIT Case Study

ENBD REIT announced its acquisition of The Edge office building in Dubai Internet City on 8th October from developer SWEID & SWEID, with a transaction value of AED 280 million. This transaction was facilitated by Cushman & Wakefield Core.

Tenants of the Grade A, 92,000 sq. ft. office building include Oracle, Snapchat and McGraw Hill. The building also offers occupiers a central, accessible address, high-end interior design and quality facility management. The entire asset is expected to deliver a gross yield of 7.4% and a net yield of 6.6%.

The Edge office building

Acquired by
ENBD REIT

AED
280 million

Grade A tenants
92,000 sq.ft.

7.4%
expected gross yield

6.6%
expected net yield

Regulatory systems

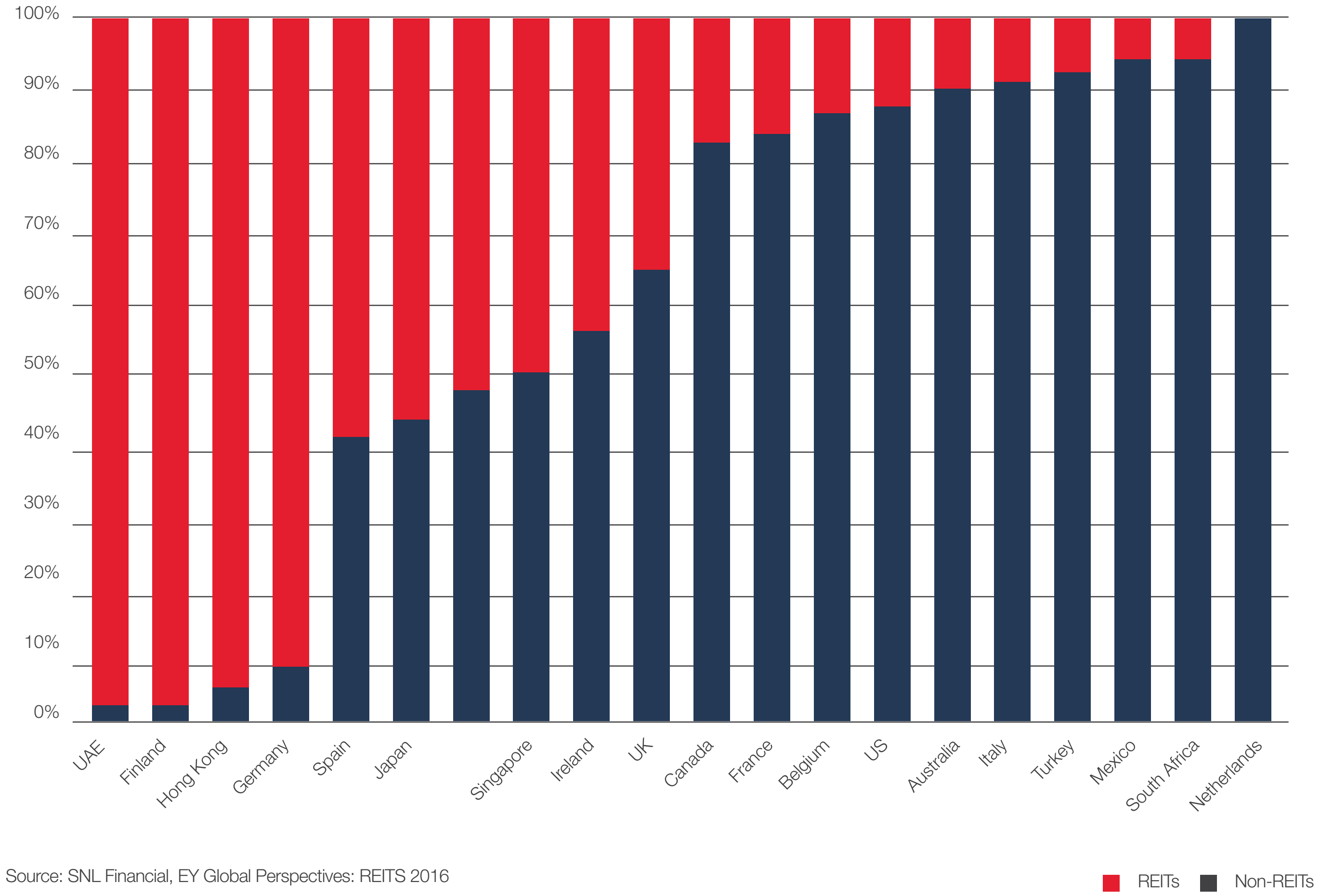
Presently the UAE maintains two regimes for REIT managers to list their property funds, the DIFC (2006) and the ADGM (2015). Although both have the same limitations on the proportion of real estate that may be under development (30% of net asset value) and the distribution of net income (minimum 80% of net asset value) the ADGM is the only regime to offer private REITs.

Aly Kassam, an attorney with the law firm Latham & Watkins LLP, commented that generally, there have been very few REITs used as investment vehicles in the UAE. As a result, onshore in the UAE, the regulations and standard market practices are less developed than in international markets where REITs are much more frequently used and where standard market practices and regulations have developed over time.

To meet these requirements the Dubai Land Department and the Real Estate Registration Authority have announced that they will issue new rules regarding the regulation of REITs.

REIT	Year Launched	IPO	No. of Properties	Portfolio Value (AED)	Occupancy	Loan to value
Emirates REIT	2010	Apr-14	10	3 billion	83%	38%
ENBD REIT	2005	Mar-17	10	1.59 billion	83%	32%

REIT market cap as a percentage of listed real estate market cap



Source: SNL Financial, EY Global Perspectives: REITS 2016

Cushman & Wakefield Core Investment Outlook

	Ticket size*	Stability in prices**	Liquidity***	Overall risk	Total return****	Risk to reward ratio
Off-plan residential (Affordable)	3.5	1.5	1	Cloudy outlook	Cloudy outlook	Cloudy outlook
Off-plan (Mainstream)	3	2.5	2	Neutral Outlook	Mixed outlook	Mixed outlook
Off-plan residential (Prime)	2.5	2.5	2	Neutral Outlook	Mixed outlook	Neutral Outlook
Resale residential (Affordable)	2.5	1.5	2	Mixed outlook	Neutral Outlook	Mixed outlook
Resale residential (Mainstream)	2	3	3	Neutral Outlook	Neutral Outlook	Neutral Outlook
Resale residential (Prime)	1.5	3	2.5	Neutral Outlook	Neutral Outlook	Neutral Outlook
Office – Grade A (Core + locations)	1	3	3	Neutral Outlook	Neutral Outlook	Neutral Outlook
Office- Grade B	2	1.5	2	Mixed outlook	Neutral Outlook	Mixed outlook
Warehousing (Grade A)	1	2	2	Mixed outlook	Mostly bright outlook	Neutral Outlook
Education	0.5	4	1	Neutral Outlook	Mostly bright outlook	Mostly bright outlook
REITs	5	2.5	5	Mostly bright outlook	Mostly bright outlook	Mostly bright outlook

***Ticket size:** 0 -highest entry point I 5- lowest entry point
****Stability in prices:** 0 - highly variant I 5 - most stable
*****Liquidity:** 0- illiquid to trade I 5 – liquid to trade
******Total return:** Factoring yield and capital appreciation

Bright outlook | Mostly bright outlook | Neutral Outlook | Mixed outlook | Cloudy outlook

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