

'IT ALL LOOKS ROSY AND GROWTH IN THE SECTOR IS PREDICTED TO CONTINUE'

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The real estate developments that are taking place in Dubai, Doha, Abu Dhabi and Bahrain are all truly mind boggling. For many readers it might sound all too good to be true and many expect the real estate bubble to burst.

However, for the moment it all looks rosy and growth is predicted to continue, partly because many developers and investors are making incredible returns and want the boom to continue. This article will show through a generic example, just how little equity is being used to finance many of the residential and real estate developments in the region and how high investment returns can be in a booming market.

Most developments of apartments are financed with both debt and equity capital. Debt comes from institutions such as banks and other similar capital sources. Equity is typically raised by the owner and can come from friends, family, investors or equity funds.

The main difference is that debt service has first preference. Because of this, the return requirements are typically lower than those of the equity investors. Financial leverage is a method

of increasing the returns to the equity investors by borrowing debt capital with lower return requirements, and thus reducing the amount of equity needed to finance the residential development.

However, in the Gulf, an additional method is used — pre-sales. The development costs of an apartment consist of the land, the building and pre-sales activities. The latter is a very important aspect, as it can keep the level of equity investment low.

The pre-sales activity allows developers to raise income to fund the financing of the residential complex. Factors such as location, access, visibility, size, shape, frontage, views, mix of apartments, zoning are important and will affect the sales price and pre-sale opportunity. The return on investment includes a cash flow from the sale of the apartments after debt service, with return typically expressed as a percentage of the capital invested.

Let us say you want to develop a 50-storey apartment complex, with a mix of one-, two- and three-bed room apartments, which equates to an average gross size of say 120 square metres.

Based on average market data, the

EQUITY IN FINANCE

PERCENTAGE OF EQUITY

| Construction Cost | 2,500 | 3,000 | 3,500 | 4,000 | 4,500 | 5,000 |
|--------------------|-------|-------|-------|-------|-------|-------|
| Sales Price | | | | | | |
| 5,000 | 20% | 24% | 27% | 30% | 32% | 33% |
| 5,500 | 17% | 21% | 25% | 28% | 30% | 32% |
| 6,000 | 14% | 19% | 23% | 26% | 28% | 30% |
| 6,500 | 11% | 16% | 20% | 24% | 26% | 28% |
| 7,000 | 8% | 14% | 18% | 22% | 25% | 27% |
| 7,500 | 5% | 11% | 16% | 20% | 23% | 25% |
| 8,000 | 2% | 9% | 14% | 18% | 21% | 24% |
| 9,000 | -4% | 3% | 9% | 14% | 17% | 20% |

FINANCE WITHOUT USE OF EQUITY

| Down Payment | 2.5% | 5% | 7.5% | 10.00% | 15% | 20% |
|--------------|-------|-------|-------|--------|-------|------|
| Debt | | | | | | |
| 30% | 62.0% | 54.1% | 46.1% | 38.2% | 22.3% | 6.4% |
| 40% | 52.0% | 44.1% | 36.1% | 28.2% | 12.3% | - |
| 50% | 42.0% | 34.1% | 26.1% | 18.2% | 2.3% | - |
| 60% | 32.0% | 24.1% | 16.1% | 8.2% | - | - |
| 70% | 22.0% | 14.1% | 6.1% | - | - | - |
| 80% | 12.0% | 4.1% | - | - | - | - |

Source: Middle East Strategy Advisors (MESA)

* Equity as part of a total finance required

RETURNS ON EQUITY

| | Yr 1 | Yr 2 | Yr 3 |
|-----------------------------|------------|--------------|--------------|
| Pre Development Cost | 12,853,750 | | |
| Construction Cost | 84,000,000 | 84,000,000 | |
| Cash Outflows | 96,853,750 | 84,000,000 | |
| Down Payments % (by buyer) | 10% | 50% | 40% |
| Debt | 50% | 48,426,875 | (24,213,438) |
| Down Payments | 31.8% | 30,800,000 | 154,000,000 |
| Equity | 18.2% | 17,626,875 | (45,786,563) |
| Cash Inflows | | 96,853,750 | 84,000,000 |
| Equity Cash Flows | | (17,626,875) | 45,786,563 |
| IRR | | 300% | |

Source: Middle East Strategy Advisors (MESA)

construction price for this property could be an estimated Dh3,500 per square metre. However, the selling price of an apartment complex is significant higher with an average of Dh7,000 per square metre. Please note, in the generic model we assume a free hold situation and exclude the calculation of the land cost and interest payments.

Based on this average data, the total construction cost for this 50-storey building is an estimated Dh168 million. The sale of the apartments would have taken place prior or during the first year of construction with potentially total sale price of Dh308 million, based on 100 per cent sale of all apartments within the first year.

Now let us suppose that the pre-development cost equates to 7-8 per cent, with the buyers having to make a 10 per cent down payment for each apartment. This would raise approximately Dh31 million in pre-sales. In other words, Dh31 million is created without constructing any of the apartments.

In this generic example we have assumed that 50 per cent of the building will be financed by debt. The total eq-

uity finance required for this development equates to just under 20 per cent (Dh17.6 million). The resulting returns on equity are truly amazing.

At a debt of 70 per cent and 10 per cent down payment, the development can even be financed without the use of equity, based on the assumed parameters.

Moreover, let us assume that the construction cost and sale price are different, but keeping the down payment at 10 per cent, it becomes clear that the maximum level of equity as part of total finance required is 33 per cent.

In summary, in terms of cash flow, this example indicates that the returns can be phenomenal, assuming that 100 per cent pre sale can be released at the required construction and sales price. However, the risk for the developer or investor is in the area of installment payments and poor pre-sales.

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PRICE CHART

CONSTRUCTION PRICE VS SELLING PRICE

| | Sale | Construction |
|--------------------------|--------|--------------|
| Floors | 50 | 50 |
| Apartments | 8 | 8 |
| Size apartment m2 | 110 | 120 |
| Total m2 | 44,000 | 48,000 |
| Floors/total m2 | 880 | 960 |
| Price per m2 | 7,000 | 3,500 |

Source: Middle East Strategy Advisors (MESA)

US Building industry and FBI target 'ecoterrorists'

The FBI and a building industry group in the US recently said they will begin offering \$100,000 rewards for information leading to the arrest and conviction of ecoterrorists.

The main target is the Earth Liberation Front, a group that has claimed responsibility for setting fires at construction sites in housing developments, calling attention to what it sees as the growing problem of suburban sprawl.

"While ELF used to spike trees and sabotage logging equipment, they're now firebombing neighborhoods and burning down apartment complexes," Lyle Fox, president of the Building Industry Association of Washington, said in a news release. The "increasingly brazen" attacks raise the likelihood that someone will be hurt or killed, he said.

ELF is an underground movement with no public leadership, membership

or spokesperson. E-mails seeking comment were not immediately returned.

The FBI estimates that ecoterrorist groups have committed more than 1,100 crimes in the United States since 1976, causing about \$110 million in property damage.

The builders group claims ecoterrorists have caused nearly \$8 million in property damage since 1996 in Washington state, much of it in housing developments. California has taken a \$53 million hit, and Oregon has had more than \$3 million in damage, according to the group's estimates.

In a statement this month, the Seattle FBI office said it was investigating several arsons and attempted arsons in Washington state over the past year and a half that seem to have ties to ELF.

—ASSOCIATED PRESS



The Osus Stargate project coming up at Zabeel Park will be a hi-tech spaceship concept, and is billed as a family 'edutainment' centre. From left: 1. An aerial view of the Dh200 million project; 2. The Mars Dome, which has a zero gravity kids' play zone with many indoor rides; 3. The Saturn Dome, which houses D3D, a hi-tech edutainment theatre with a seating capacity of 260; 4. The 'lunar snow' area within the Moon Dome.



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