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Strategy Consultants

Tobias Plate, Fabian Engels, Harald Schmid

GCC REAL ESTATE DEVELOPMENT
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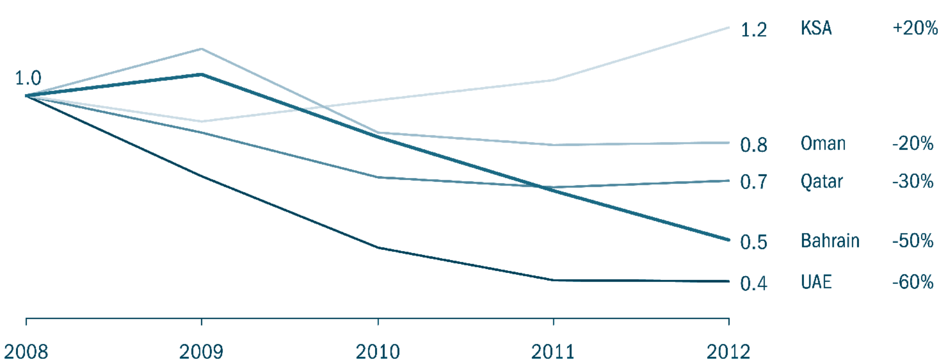
GCC Real Estate market – Hard hit, but clear signs of recovery

Many of the difficulties faced today by real estate developers in the Gulf Cooperation Council (GCC) can be traced back to the early 2000s. A construction euphoria, fuelled largely by government-backed petrodollars and the deregulation of regional property markets, had created very attractive real estate markets. In some GCC countries the freehold system, allowing the complete ownership of land and buildings on such land, strongly raised attention of foreigners to invest in real estate. As a consequence, Foreign Direct Investments (FDIs) increased ten-fold between 2003 and 2008. Developers, however, exhilarated by the revenues and profits generated, failed to realize it was mainly speculation and not underlying demand driving these respective markets.

The era of unparalleled growth came to an abrupt halt towards the end of 2008, when worldwide financial markets collapsed. With tightening liquidity, low real estate demand, oversupply of properties and a lack of investor confidence, real estate financing became increasingly difficult. As a consequence, actual projects faced delays and planned projects were cancelled. At the same time, investors could not sell completed developments as property values plummeted and a potential exit would have yielded losses.

The real estate sectors across the GCC have nevertheless been impacted heterogeneously by the crisis.

FIGURE 1: RESIDENTIAL PROPERTY VALUES PER COUNTRY [INDEXED 2008=1.0]



Source: Asteco, CBRE, Cluttons, Rasmala, Global Research[1)]

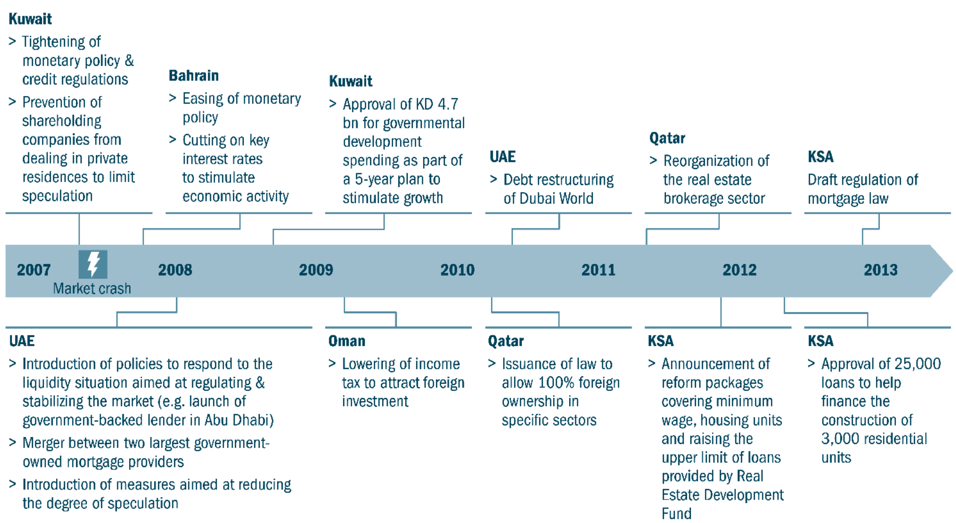
Prices in countries such as the UAE and Qatar had been strongly driven by real estate speculation and have only recently, after years of downward movement, shown signs of stabilization. Bahrain, however, is still impacted by the long-lasting effects of both the global crisis and political unrest. Notably, Saudi Arabia and Oman have experienced a less severe impact from the financial crisis due to genuine demand, swift countermeasures and government support. As such, their residential sectors were only slightly affected before stabilizing and surpassing the pre-crisis levels. Kuwait was very late to enter the real estate game resulting from a standstill of investment due to internal political disputes. By missing most of the boom years it was affected only marginally by the crisis as supply had not expanded to the same extent as in neighboring countries. Nevertheless, most GCC real estate markets should still

1) Based on available apartment rental (UAE, Qatar, Oman, Bahrain) and residential price (KSA) indexes. No reliable data available for Kuwait

be regarded as being in their formative stages, that is far from maturity. For example, price differentiation resulting from the quality of the real estate development has only started recently, while initially the purchase price per sqm for developments was dependent solely on the location. Notably, the UAE has initiated this movement with the completion of many high-quality developments.

Going forward, the GCC real estate market is expected to benefit from favorable economic prospects, which are substantiated by socio-demographic and economic indicators. GCC states are amongst the richest countries in the world, which are reflected in strong trade surpluses and GDP growth outperforming the forecasted global growth rate.

FIGURE 2: MAJOR PRE- AND POST-CRISIS MEASURES TAKEN BY GCC GOVERNMENTS TO STABILIZE AND FOSTER REAL ESTATE MARKETS



Source: Government reports

The GCC region also ranks high in terms of ease of doing business and its investment conditions are considered relatively safe, attracting investors from non-GCC countries in particular, who have been affected by the euro crisis and the Arab Spring. Additionally, the recovery of the real estate markets is supported by various regulatory improvements and mortgage law regulation implemented by GCC governments. Thus, a strong basis exists for the continued recovery of the GCC real estate market.

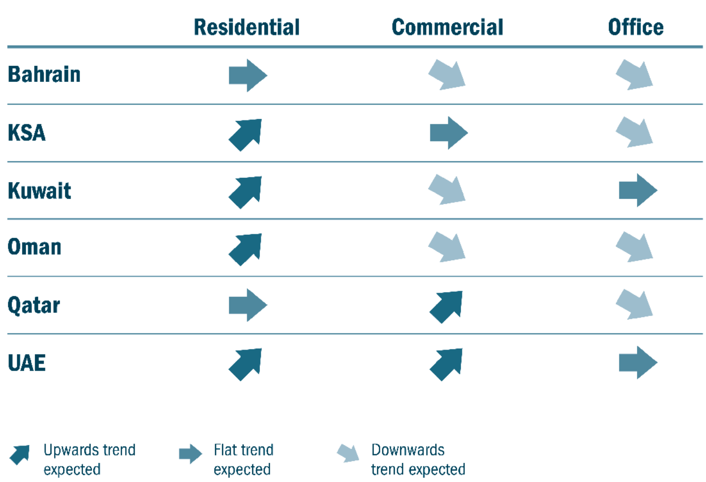
Good opportunities, but making money gets tougher

While macro-economic conditions are improving in GCC countries, investors still remain cautious when regarding new real estate projects. Opportunities have to be carefully selected, taking into account a developer's experience and capabilities. Successfully dealing with increasingly demanding clients, reacting to stronger competitive pressure from skilled international players and getting access to land banks will determine the winners and losers.

Diverse outlook for real estate across the GCC

Real estate markets and segments are diverse and difficult to compare. Identifying opportunities requires developers to scrutinize each market and segment thoroughly – on a country, regional and local level as well as with regard to the sub-segment and in relation to the intended project. Further, supra-regional events such as the Arab spring might also have potential long-term effects, diminishing the attractiveness of developments across all markets and segments.

FIGURE 3: GCC REAL ESTATE MARKET OUTLOOK HEAT MAP



Many projects are expected to be small to mid-sized developments, with few large-scale or show-case projects. In light of the underlying demographics and planned government spending, the creation of affordable housing is expected to provide opportunities for developers across most GCC countries. Also, with the increased influx of expatriates, a shift towards middle income compounds and villas and away from the luxury projects that have flooded the market during pre-crisis times is anticipated in many countries. Oversupply remains a major concern for the retail segments but attractive opportunities prevail, especially in Qatar and Dubai due to high average retail spending and growth in tourism. Nevertheless, more than 1 million sqm of available retail space in Qatar will cause stronger competition among lessors and should counter an upward trend in the rental market. In the office segment, existing oversupply gives tenants the upper hand, which should extract more value for their money. State-of-the-art property management will be the differentiating factor.

Due to the existing uncertainty about the future of the GCC real estate sector, a selective development approach based on thorough assessments of potential opportunities will be crucial for developers to avoid a repetition of the negative experiences of the past.

Increasingly demanding and sophisticated clients

The surge of new developments in city centers, constant renovation and refurbishment of surrounding areas and new developments in the urban sprawl raise expectations towards developers with regard to total completion time, cost and especially quality. Clients, both investors as well as tenants, are increasingly demanding that development and construction standards are on par with international standards. Matching today's local property standards is no longer sufficient in order to attract tenants and ensure high price levels. In response, some regional developers have started to embrace improved skills or partner with specialized international companies to meet required project standards. However others, often smaller investors, might not be able to take these steps, which will likely endanger their business model.

Intensifying competition from leading international companies
Facing saturated home markets in the US or Europe and striving for further growth, international companies have been active in the GCC for a long time and now play a significant role, frequently serving as knowledge providers. This is particularly the case for larger developments or high-end residential or commercial properties, where local players often lack the necessary skills, experience and reference projects. Services provided include feasibility studies, master planning expertise or architectural services, without taking over complete development responsibility. At the same time, in order to extract larger shares of a project's value, integrated services along the value chain are offered by international companies, such as development management during the planning and construction phases or asset/property management during the operations phase. The lower level of skills generally inherent in local service providers has historic reasons. Formerly, companies focused on construction, often underestimated the importance of non-construction related activities such as feasibility studies, cost estimation and project planning for the value creation of developments. Overall, the competitive pressure will lead to the need of raising professionalism and sophistication levels among local developers.

Land banks access is controlled by few and prices are high
One of the biggest challenges that developers are facing in the GCC is related to land access and prices. Despite the abundance of land, supply is usually controlled by the government and a few other stakeholders. As a result GCC land prices are very high compared to international benchmarks with land costs accounting for up to 60% of total development costs. Internationally, land prices usually represent 20% to not more than 40% of total development costs. Only a few countries with very limited land supply such as Singapore or Hong Kong constitute other exceptions. Engaging in joint ventures, cooperations with land banks and "Build-Operate-Transfer" (BOT) or "Public-Private-Partnership" (PPP) schemes are mitigation measures considered by developers.

Opportunistic development approaches will no longer work – How to leverage the status quo and ensure long-term success?

Development decisions have to be taken with due care. The years in which every investment turned into a success are clearly over and are not expected to return. The increasing pressure from international real estate developers and clients subsequently demanding state-of-the-art properties is further stimulated by the opening of markets and the easing of business facilitation for foreign investors and service providers. Therefore, in order to be equipped for the future, local real estate developers have to find answers to several crucial questions:

> How should developers position themselves? Which real estate segments should be targeted, which geographies covered and which clients served? What are realistic growth targets?
> What is the desired business model and the matching asset intensiveness (specialized vs. broad offering)? Based on the intended equity involvement and desired growth objectives, what should the target capital structure be?
> How should project and property portfolios be structured and at what income balance (i.e. recurring income vs. income from asset sales)? Which part of the development value chain provides the required risk-return ratio and how can the exposure to single assets and de-risking of investments be achieved at an early stage (pre-leasing, expanding investor base, etc.)?
> What is the best approach to develop country and segment-specific know-how locally (e.g. joint ventures, partnerships or stand-alone)? How could the acquired know-how and skills be preserved even in times of market downturns and/or high employee fluctuation?
> Which services along the value chain are strategically important for respective developers and should be performed in-house (e.g. feasibility studies, project management tasks, etc.)? Which activities can be outsourced without losing core competencies, while also potentially lifting competitiveness on par with international players?
> How should developers organize themselves to best support the strategic and operational goals? How should they adapt to changing environments? How can qualified human capital be attracted?
> How can developers get access to reasonably priced land (e.g. joint developments with land owners, master developing, parceling)?
> How can developers best get access to financing (e.g. cooperation with funds, land owners or own fund raising team)?

A holistic corporate and portfolio strategy has to be developed and should be reflected in the company set-up

Long-term success in the GCC real estate markets must be based on a set of interlinked success factors. The overall strategic target setting for the company must be subsequently broken down to actionable objectives on project portfolio and individual project levels. The organizational setup needs to mirror the targeted value chain coverage and thereby facilitate achievement of objectives. As such, each success factor should be tackled with equal importance.

An integrated corporate strategy and a clearly defined operating model are absolute conditions for success
Strategic positioning is one of the most crucial aspects of managing a real estate development firm, but it is unfortunately often neglected. Defining a clear strategic position includes not only the definition of future goals but also the derivation of strategic objectives that must be communicated to all senior management and staff. Devising a strategic position therefore ensures that the targeted future position is clearly defined and that a roadmap for how to get

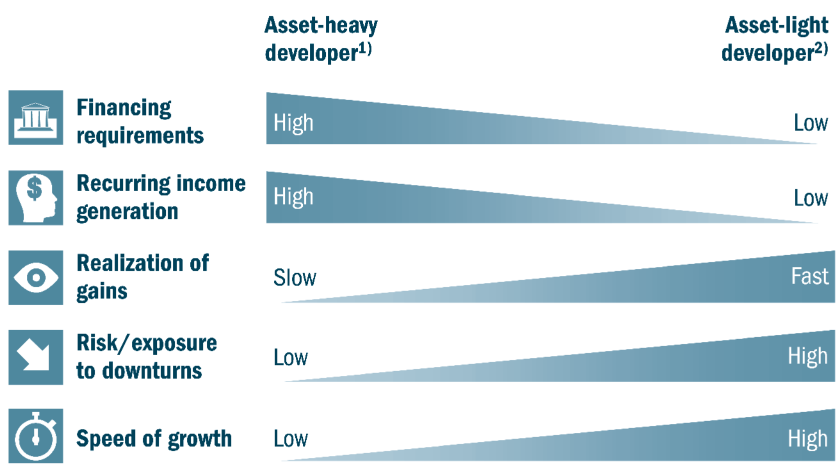
there is in place that takes into account present and forecasted developments.

Target markets – both geographically and by segment (residential, commercial, etc.) must be clearly defined – as well as key clients to address in the future. This serves the purpose of diversifying market exposure, but should always be considered in relation to the available company skill set and the experience required to serve a certain client, region or segment. Since every segment and country requires specific knowledge, partnerships allowing access to required skills have to be considered both on corporate and individual project levels.

The intended strategic positioning as well as the targeted growth and profitability levels have to be matched to a suitable and acceptable risk level. The risk-return ratio is mostly defined by the asset type and asset intensiveness of the strategy and thereby also by the capital structure, both on corporate and project levels.

The spectrum of operating models covers the range from 'asset-light' to 'asset-heavy' developers. The former refers to pure service provision with no own investments into projects, whereas the latter describes larger shares or full ownership of own developments, potentially coupled with a holding period into the operations phase. The longer capital is tied up in a project, the less growth should be assumed over time (reduction of return on capital employed). However, following an 'asset-heavy' approach – including operations of real estate – would yield recurring income and thereby be imperative to mitigate liquidity risks of potential future economic and real estate industry downturns.

FIGURE 4: ASSET HEAVY VERSUS ASSET LIGHT DEVELOPER



Similarly, the corporate level as well as individual project level can be leveraged to facilitate growth. Using debt to fund projects has always been widely beneficial and an integral part of the industry. However, the adverse effects of excessive leverage have been experienced during the financial crisis. To what extent growth should be fueled by debt financing, has to be answered individually.

1) Complete sale after project completion assumed, immediately freeing up cash for investment in new projects
2) No sale after completion, instead income is generated from asset operations (e.g. rent, asset management)

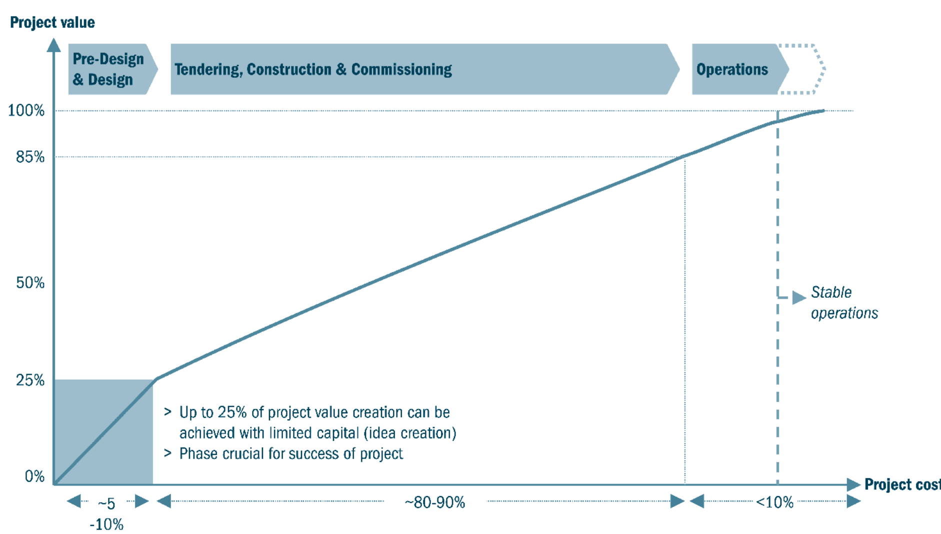
Aligned portfolio and project strategies must translate the strategy to the development level

Corporate strategic positioning and financial targeting has to be translated into portfolio and project strategies. Expected investment returns (i.e. ROCE, ROI and IRR metrics) should match the intended growth and risk profile. The targeted number of ongoing and new projects per year, as well as the level of properties under management has to be planned several years in advance. Target project returns have to be derived accordingly, depending on a number of factors such as property type, location, exit strategy and financing/leverage levels. Besides the full ownership model (e.g. build-own-operate), different business models should be considered to manage the risk exposure of real estate developers. Thus, purpose-built projects (e.g. build-to-suit) or even models in cooperation with the government or public authorities (e.g. build-operate-transfer) can significantly reduce a developer's uncertainty and allow for more reliable cash-flow planning during the investment/holding period.

However, a portfolio strategy does not only consist of overall asset allocation, risk management and potential property transactions. It requires the close management of the selected asset class strategy down to the level of individual projects. Defining and executing project opportunities over the full property lifecycle, from initiation and creation of new developments to the optimization of existing properties, is a key success factor.

The project value curve allows inference on where most money can be made or lost in the development cycle and as such also relates directly to the risks involved in certain stages. Crucially, the first stages (pre-design, design and tendering) will already allow for substantial value creation based purely on stringent highest/best use and feasibility studies and a subsequent business/realization plan without major capital needs. Also, the first stages influence the overall success of the project and hence determine overall project profit or loss, indicating that due care is required from developers.

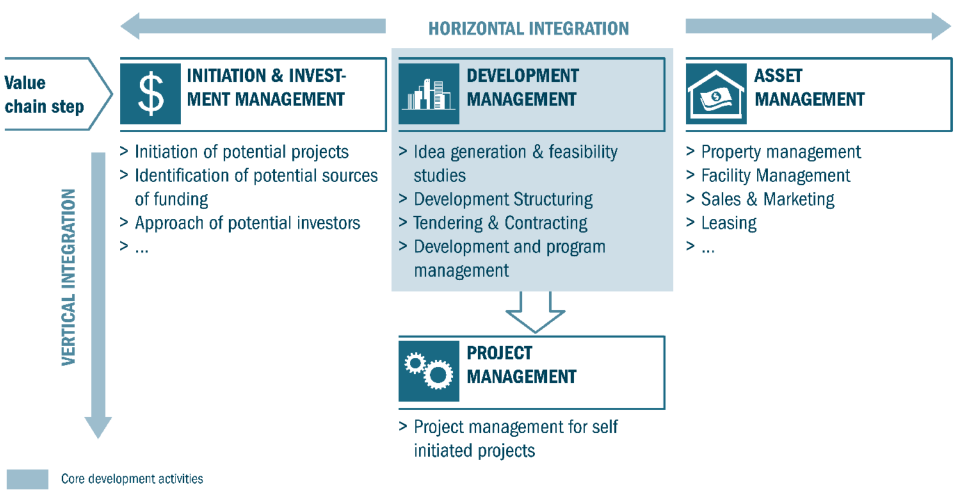
FIGURE 5: INDICATIVE REAL ESTATE PROJECT VALUE DISTRIBUTION ACCORDING TO PROJECT STAGES



Defining the right depth and breadth of the value chain coverage will be key to successful project delivery

The development value chain categorizes generic and specific value-adding activities across the real estate life-cycle in a chronological order from financing to operations. The leanest model covers only activities during the pre-design and tendering & contracting phases. Models with a stronger horizontal and/or a deeper coverage, i.e. a more comprehensive offering in the different value chain segments, include the provision of PMC services for a project or facility management in the operations phase. The focus of provided activities should result from the intended core service offering of a developer to its customers, enabling the strategic positioning and portfolio strategy at the operational level.

FIGURE 6: REAL ESTATE DEVELOPMENT VALUE CHAIN COVERAGE

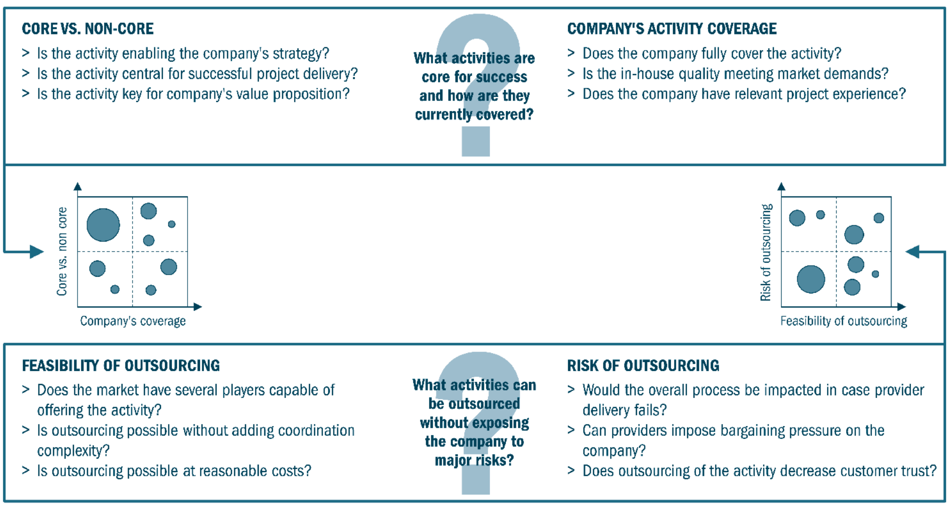


Real estate developers aiming to achieve long-term success in the GCC must provide tailored services to their clients as well as deliver above and beyond their expectations. An integrated offering along the value chain is essential for a successful development organization. Thus, underestimating the consequences of shortfalls along the value chain can severely impact not only the project performance, but also the future of the company. Feasibility studies and business plans that have not been thoroughly prepared can of course lead to wrong investment decisions. Being unable to reach target occupancy rates of developments due to deficiencies of the internal marketing and leasing departments or inadequate price estimation in the feasibility study phase, might also harm the entire business case.

As a consequence, the scope and scale of services, involving the relevance of specific activities for the business and operating model, have to be defined. Real estate developers should address two main questions:

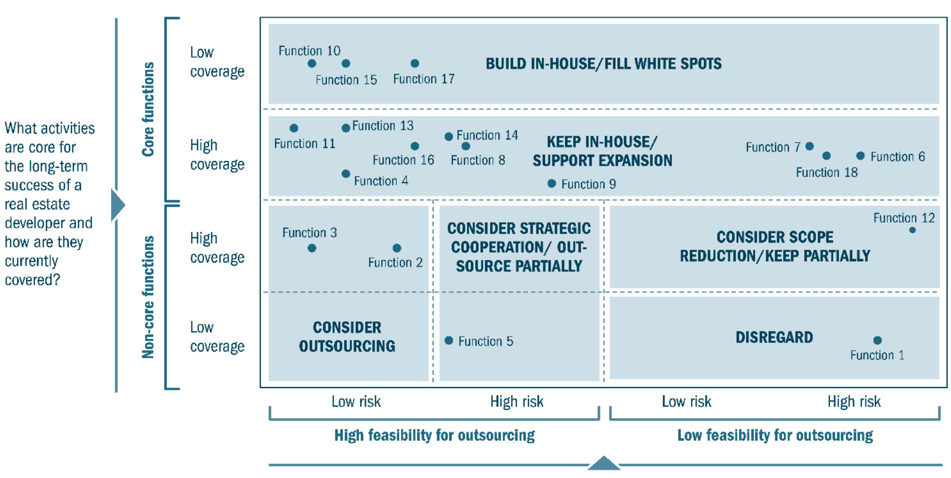
> What activities are core for success and how are they currently covered?
> What activities can be outsourced without exposing the company to major risks?

FIGURE 7: ACTIVITY ASSESSMENT FRAMEWORK



The answers to these questions depend on the individual business model and hence must be decided on a case-by-case basis. The option of outsourcing is viable and should be duly considered. In fact, outsourcing can be the means to achieve state-of-the-art services if they are difficult to establish within the organization. Activities which are not in the core focus of developers, such as project management or operations related services (e.g. property and facility management), are classic examples of areas where outsourcing can provide, not only excellent external knowledge but also the flexibility to adjust to different market conditions and customer requirements. Based on a thorough assessment of activity level, developers can gain transparency and derive required actions such as strengthening, outsourcing or disregarding of single activities.

FIGURE 8: ACTIVITY ASSESSMENT OUTCOME AND REQUIRED ACTIONS (ILLUSTRATIVE)

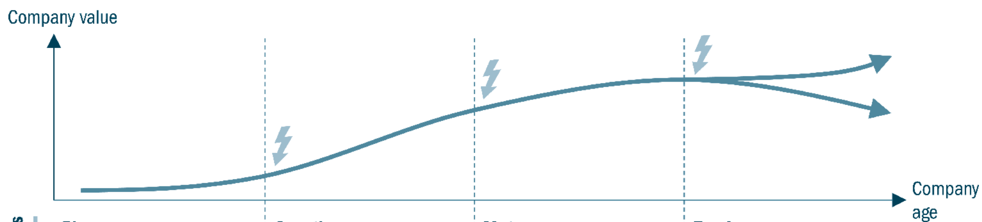


Only a clearly defined, transparent and lived organization staffed with superior talent will yield long-term success

The organizational structure of GCC developers has to reflect and support the envisaged strategy. Only companies with clearly defined, transparent structures and low complexity (i.e. layers and hierarchies) as well as clear roles and responsibilities will be successful in the long-run.

In reality, organizational structures are often historically grown and designed for firms at a former stage of the lifecycle of the company.

FIGURE 9: OVERVIEW OF STAGES OF ORGANIZATION LIFECYCLE



Characteristics

Pioneer company	Growth company	Mature company	Turning company
> Small, young company > Dominating role of founder > Basic formal structures and processes > High market and technology potential	> Growing revenues > First proof of professional leadership system and organization structures > Initiatives for growth with new services and new markets, internationali-zation efforts	> Stagnating profits > High degree of standardization and formalization of structures and systems > Stronger decentralization > Tendency to backward orientation and inflexibility	> Potentially acquisitions and cooperation > Development of conglomerate structures/ financial holding > At the peak of own product life cycle – Execution of down-turn/divestment or – Restructuring/refocus ing on new opportunities

Critical steps in a company's development

An organization, perfectly suited in the past (e.g. with operations in only one country or segment) with only a few smaller developments, might today have substantial issues and risks in light of the current scope of the company's business. It is especially important that the transition from one stage to another in the organizational life-cycle will be managed actively. Continuously reviewing and adjusting the organization will enable developers to better deal with quickly changing environments. A constant adaption to prevailing circumstances is even more important in view of the maturing real estate markets in the GCC.

Having aligned the organization, attracting, developing and retaining 'the best man for the job' constitutes the next management challenge. Decisions on recruiting the right people should be based on a thorough assessment of the required competencies and not only on the attached price tag. A performance-oriented company culture should provide transparency on the performance of employees, set clear incentives and reward employees accordingly. In addition, training and development programs must be set up to further develop and retain talent. Considering the numerous development companies in the GCC, positioning as an employer of choice will be a valuable asset.

The organizational structure and the available human capital have to be supported by systems to continually assess performance. Management systems are of increasing importance in the later stages of a development when tracking of execution versus a defined development plan is critical. As such, state-of-the-art in-house software-based solutions and management reports are important to identify and tackle operational deficiencies at an early stage. Even the best organization, staffed with the most talented personnel, still needs appropriate support through management systems.

Conclusion

Real estate markets have widely stabilized and partially recovered, and show a promising growth outlook with country and segment-specific opportunities across the GCC. Along with market growth, the competition between developers is rising and client-developer relationships are professionalizing while land supply remains limited.

GCC real estate developers therefore have to carefully assess their current strategic position and define their future strategy taking geographies, market segments, clients and operating models into account. Companies have to take a clear view on their risk-return profile, influencing the asset-intensiveness and debt leverage of their developments. Only when these aspects are reflected adequately on portfolio and development levels, strategy will be successful. Finally, defining the right depth and breadth of the value chain and establishing an effective and transparent organization staffed with high caliber personnel will yield long-term success. Investment decisions have to be taken with due care considering the potential impact on the stability of corporations. Due to the long-term nature of the real estate business, every major decision is a strategic one.

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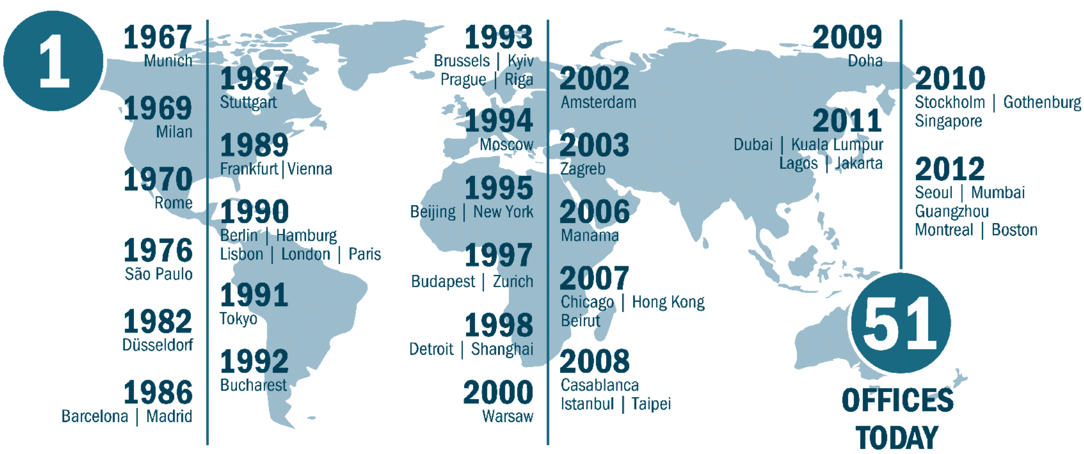
Roland Berger's business is organized into global functional and industry competence centres. Its practice areas include corporate development, marketing and sales, operations strategy, restructuring and corporate finance, and information management. Industry specialties include automotive, consumer goods and retail, energy and chemicals, engineered products and high-tech, financial services, information communications, pharmaceuticals and health care, public services and transportation.



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CONTACTS AND AUTHORS

Dr. Tobias Plate
Senior Partner, Head of Real Estate
Almoayyed Tower, 22nd Floor
Manama, Bahrain

Phone: +973 17 5679 50
E-mail: tobias.plate@rolandberger.com

Dr. Fabian Engels
Principal
Al Thuraya Tower No. 01/1204
Dubai, U.A.E.

Phone: +971 4 44 64 080
E-mail: fabian.engels@rolandberger.com

Harald Schmid
Project Manager
Al Thuraya Tower No. 01/1204
Dubai, U.A.E.

Phone: +971 4 44 64 080
E-mail: harald.schmid@rolandberger.com

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