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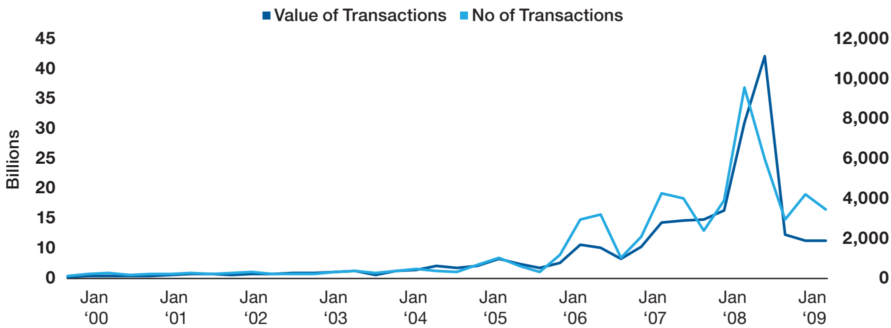
# *Dubai Real Estate Meltdown, 2009*

Dubai, the jewel in the UAE crown, changed with times. In 1966, the discovery of oil changed the landscape of the country. Those were early periods of success, as the UAE slowly came to be known for its wealth and grandeur. It was oil that catalysed the country's economic boom. Of course, the presence of a forward-thinking government helped in channelling the oil revenue into developing non-oil sectors, attracting foreign investment, and financing infrastructure projects, which further contributed to the growth story.

The mid-1990s was the initial phase of the real estate industry. Within a few years, the government realised the potential of real estate and showered the sector with some initiatives. The market prospered, rocketing between 2002 and 2008, and at one point, UAE contributed 60 percent to the property boom in the GCC region.

It was the best of times, as the numbers showed. Average office rentals grew by 86% Y-o-Y in 2006, and by 55% in 2007. Average residential rents increased by 25% and 18% during the same period. Ongoing projects crossed USD 1 trillion by 2008; almost two-thirds of these were in the UAE, and of those, a majority were in Dubai. And then the fall happened.

*Dubai value of land transactions (in AED)*




Source: Dubai Land Department

## A tale of two reasons

The days of success had people questioning the reason behind the growing prosperity.

The first reason was that the Dubai rulers were pragmatic to know that one-day, not very far away, oil would dry up. An economy that depended solely on oil would invite danger. So the government decided to reduce its reliance on oil revenue and diversify the economy to non-hydrocarbon income areas.

This push was spectacular as it resulted in an increase in the non- oil sector from representing 46% of Dubai's GDP in 2000 to 95% of Dubai's GDP by 2008. Simultaneously, the government turned its attention towards areas such as trade, transportation and storage logistics, professional services, tourism, construction and financial services. In what was rightly analysed as 'push for diversification', these efforts had a positive spill over on to UAE's real estate sector.

The second reason was that it opened up the housing market.

Dubai had enticed the wealthy from all over the world to invest in the city. It began the process by issuing the Foreign Property Ownership Law in March 2006 and legalizing foreign ownership of properties in designated areas of Dubai. This legalization resulted in high demand from the resident expatriate population, and foreign investors looking for attractive investment. Additional factors, such as low taxation levels, stable political economy further complemented Dubai as an investment haven in the Middle East. Major Dubai real estate developers had amongst themselves done close to USD 625Bn business in 2008.

The increase in demand led to a big spurt in housing supply, predominantly delivered by the Government-related real estate companies. These entities enjoyed the twin benefits of (i) access to newly serviced land and (ii) easy access to finance from regional and global lenders. Some of the prominent real estate government-related enterprises (GREs) were Nakheel, Dubai Properties, and Emaar Properties. These companies, along with some more large developers, were fiercely competing for landmark projects. Nuaimi Real Estate Global LLC was one of them.

The push towards diversification and the opening up to foreign investment in housing helped the real estate market to grow boundlessly. But things changed.

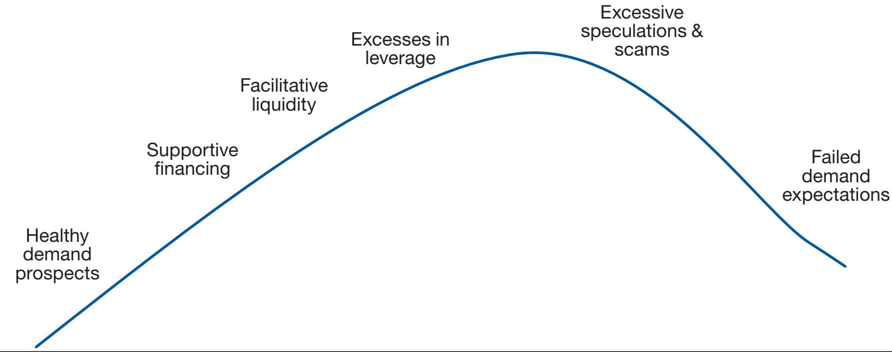
## They ignored the tell-tale signs

Key inputs about the prospective negative state of the economy were not taken into consideration at the time.

In the last quarter of 2008, the economy turned chaotic. Dubai's property values nosedived, and created a property bubble, due to unsustainable price dynamics. The Land Department's statistics showed residential prices drop by over 50 percent between Sep 2008 and Sep 2009. By now, all the critical sectors of Dubai's economy, such as logistics, tourism, retail, finance, real estate and trade bore the brunt of the global financial crisis. It was the worst market tragedy since the Great Depression of 1929.

The world's top monetary body, the International Monetary Fund, named the region as among the significant three economies with the worst decline in property values.

*Asset price bubble path*




### *What lead to Dubai's real estate bust? Price of presales contracts*

In this context, let us evaluate 'Presales' or 'Off-Plan' contracts. Under these contracts, the developer would 'pre-sell' the yet-to-be-built property to a buyer, who will then pay the developer according to a promised construction schedule. The initial payment was 10% of the property value. The smart buyer would resell these contracts, as the property prices would have now started rising.

Let us say, a property is assessed at 2Mn AED. The initial presale payment would be 0.2Mn. AED. As parts of the assets get constructed, the value of the asset rises. In this case, let's say it raises to 2.1Mn. AED. The original buyer will now sell off his presale contract to a new buyer with a premium of 0.1Mn.

AED. (2.1Mn less 2.0Mn.) This premium would mean a profit of 50%, on an initial investment of 0.2Mn.

These contracts were repeatedly traded, as the prices increased during the construction of the property, and there was never any intention of taking delivery. The widespread use of these contracts encouraged both the housing price boom through 'property flipping' and an oversupply of new units, above what long-term market fundamentals would support.

### *Excesses of money supply and inflation*

There were some indications that credit extensions were excessive.

One, the UAE's mortgage market had expanded too rapidly for comfort during the years preceding the crisis. For example, total real estate mortgage loans grew from 4.1% of GDP in 2001 to 15.2% of GDP in 2008. In September 2008, total outstanding mortgage loans rose by nearly 100% from December 2007, to touch AED 115.7 (USD 31.5) billion.

Two, during the peaks of activity, Dubai banks were lending anywhere from 80% to 95% of the asset's market value. The lower end of the ratio was for the expatriates, while the upper end was for the Nationals. A debt-equity ratio of 19:1 predicted a clear failure.

Three, in 2007, the UAE witnessed massive financial inflows in the form of foreign banks deposits. The speculation that the UAE currency would appreciate against the dollar propelled these inflows. The UAE Central Bank reported that the money supply increased by 36.7 percent in 2007. This dramatic increase fuelled the fires of inflation. The IMF estimated Dubai's 2007 inflation rate at 11 percent, compared to the U.S. inflation rate of below 3 percent.

Thanks to the AED-USD peg, domestic inflation rose above 12% for the UAE, and negative real interest rate facilitated the growth of credit and quest for yields in real estate and other investments. There was an extraordinary momentum in price rise in Dubai from Oct-06 to Jul-08, and the average value increased almost three-fold. (Figure-2)

### *Excessive economic activity and employment*

The real estate sector's contribution to Dubai's GDP experienced a steep surge from its six-year average of 10% to 15% in 2006 (Figure-3). The sector's share of the total GDP was 18% in 2007. This proportion was in divergence to the rest of the region, where the percentage of real estate-to-total GDP either stayed flat or even declined.

Another measure that threw light on the extensive reliance on the real estate sector is the proportion of the population working in that industry. As per the census data for the year 2005, in Dubai, 48% of the total workforce was working in the construction and real estate sector. This number excluded the 300,000 strong work-force who stayed in Sharjah and commuted to Dubai daily for work.

*Workforce in construction & real estate sector (2007)*

| Sector | Dubai | UAE |
|---|---|---|
| Construction | 43.52% | 13.91% |
| Real Estate and Services | 6.74% | 2.03% |
| **Total** | **50.26%** | **15.94%** |

Source: Statistics Authorities and Ministries

## Dubai -world's debt standstill announcement

The damaged economy faced a second round of disruption when the government of Dubai announced in late November 2009 that Dubai World would seek a six-month standstill on repayments. The news sent shockwaves across the world. A USD 20bn lifeline from the oil-rich neighbour, Abu Dhabi, was a timely help.

Dubai World is part of Dubai, Inc., which is the informal name used for the complex network of government-related enterprises (GRE) that dominate the Dubai economy.

Dubai Inc. is a web of commercial corporations, financial institutions, and investment arms owned directly by the Government of Dubai under the umbrella of three major holding companies (Dubai Holding, Dubai World and the Investment Corporation of Dubai). Each holding company includes several property developers and is involved in different property ventures in Dubai and around the world.

Amongst the DW subsidiaries, Nakheel (developer of palm-shaped islands and The World islands) and Limitless (planned 75-kilometer Arabian Canal project) were the most leveraged companies. Dubai Inc. entities leveraged themselves extensively during 2004-08, to fund their foothold in the large-scale commercial and residential property development segment.

These entities were always exposed to the maturity mismatch risk, as much of the borrowing had short maturities, and cash flows from property development would be realized over a longer duration. With the collapse of local property markets and the global crisis, the severity of these risks accentuated.

On November 25, 2009, the government-owned conglomerate, Dubai World, announced that it was seeking a 'standstill' on debt repayments while it restructured some of the borrowings. The standstill and restructuring were to affect USD 26 billion worth of bilateral bank loans, syndicated loans, and bonds, including a Nakheel Sukuk, due to mature on December 14 and was guaranteed by Dubai World. Approximately USD 6bn of the USD 26bn in debt of Dubai world was related to Nakheel.

As of January 2010, the debt of the GRE of Dubai Inc. accounted for 78% of the total public debt of Dubai. The Government of Dubai (GD) debt of 22% was significantly lower than the debt of Dubai World. Out of the aggregate USD 26bn outstanding debt of Dubai World, the standstill debt accounted for USD 14.4bn.

*Dubai's publicly held debt (as of January 2010)*

| Debt Holders | | | Total (USD Mn) | Share of "Dubai Inc." |
|---|---|---|---|---|
| Total Dubai World (DW) | | | 26,043 | 24% |
| a. | Dubai World stand stilled debt | Sub-total | 14,350 | 13%% |
| b. | Other Dubai World subsidiaries | Sub-total | 11,693 | 11% |
| Total Dubai Holding (DH) | | Total | 14,794 | 14% |
| Total Inv. Corp. of Dubai (ICD) (including ICD-owned banks) | | Total | 20,404 | 24% |
| **Total Other Dubai Inc.** | | **Total** | **24,352** | **22%** |
| A. | Total for "Dubai Inc." | | 85,593 | 78% |
| B. | Government of Dubai (GD) (Assuming direct and indirect Abu Dhabi support is 100% drawn) | | 23,700 | 22% |
| **C.** | **Total "Dubai Inc." and GD DEBT** | | **109,293** | **100%** |

Source: IMF [2010], 2009 UAE Article IV Review, Annex Table 1, p.49

The global recession coupled with financial market crisis and Dubai's real estate bubble burst raised concerns amongst investors with regards to Dubai's ability to service its debt, particularly in the case of highly levered real estate enterprises. With the 'standstill' announcement, market participants could no longer assume an implicit sovereign guarantee for Dubai GREs, which were downgraded by several notches, most to non-investment grade.

The announcement had a sharply adverse effect on the stock markets of UAE. It also had a contagion effect on other GCC countries, resulting in higher volatility in the equity markets, and marginal widening of CDS spreads, in the week after the announcement.

On 14, December 2009, Sheikh Ahmad Bin Saeed Al Maktoum, Chairman of the Dubai Supreme Fiscal Committee, announced that the Abu Dhabi Government was supporting the Government of Dubai with a USD 10bn facility, to limit the contagion to other parts of the U.A.E.'s economy. USD 5 billion was provided through two Abu Dhabi banks, and the remainder was to be included in Abu Dhabi's 2010 budget.

The Government of Dubai used part of these resources for the timely redemption of the Islamic bond issued by Nakheel, the subsidiary of Dubai World. The remainder was to be used to cover payments to contractors, working capital, and interest expenses through to April 2010, conditional on a standstill agreement being reached between Dubai World and its creditors.

## Aftermath of Dubai real estate bubble burst

UAE was hard hit due to the global recession, a subsequent bursting of the Dubai property bubble, and plummeting oil revenue. This resulted in a halt in property development, and a plunge in property prices. Once the global financial crisis of 2007 spread to Dubai a year later, lending declined; many foreign investors left, and confidence in the Emirate's overinflated real estate market lay shattered.

The overall implications of the housing turmoil remained erratic and were mostly restricted to the financial companies in Dubai and Abu Dhabi that fell victim to the crisis. The magnitude of the impact can be envisaged from the contraction in corporate revenue of the leaders.

Emaar properties lost 35% in revenue from property sales during 2009, compared to 2008. The following year, the Emaar Group had to reduce its USD 480mn investment in WL Homes, the Group's US subsidiary.

The revenue for Aldar Properties declined 60% in 2009. The crisis impacted the developments under construction for Aldar, which dropped from USD 6.2bn at the end of 2008 to USD 4.8bn at the end of 2009. Arabtec Holding, primarily engaged in the construction of high-rise towers, residential villas, and related activities, witnessed a YoY 22% decline in revenue in 2009.

## Could they have done something?

Questions were raised about Government's role in limiting the extent of the crisis. For instance, could the Dubai Land Department not have jacked up the real estate registration fees earlier to curb flipping by speculators? They had now doubled the property registration fees from 2% to 4%.

Could the developer not have been mandated to own the land fully and keep money in an escrow account, which is mandatory now?

For instance, today a developer will have to own the ground fully and hold 20% of the construction cost in a particular escrow account if units are to be sold before completion of 20% of the building of the project. Some developers now went to another extreme, by banning the resale of unfinished properties before 40% of the asset's value is paid!

Could registration of real estate transactions not have been made mandatory before, as the Dubai Land Department has now done?

Why hadn't the Central Bank of the United Arab Emirates (CBU) acted earlier, as they have acted now? Today, the loan-to-value (LTV) ratios for mortgages are limited to between 60% to 80%, depending on the value of the property and nationality; and 50% for off-plan properties.

The borrowers' debt-service-to-income (DTI) ratios are limited to 50 percent. Banks can now lend to Emirate governments and Government-Related Entities (GREs) to a maximum of 100% of their capital, and not more than 25% of their money to a non-commercial GRE.

A few points merit attention.

One that Dubai's real estate meltdown had its roots in critical gaps in the UAE's regulatory infrastructure. It included the lack of prudent regulations to check building of speculative asset bubbles, backed by excessive leverage. He realized that while limitations on leverage set for the GREs is a positive step, this has to be followed up with strengthened corporate governance practices and increased transparency for State Owned and Government-Related Enterprises.

Two, though the mortgage market of the UAE is small and a majority of purchases during the boom were with cash, the UAE banks have attempted to prevent the mistake of poor underwriting of commercial and residential estate loans. The banks target to achieve this through better banking regulation, supervision, and stronger internal risk management. Cash flows, pre-sales, and leverage are the areas of real estate lending under focus for regulation and oversight.