We won't go back to a situation where you have 190 percent financing. I think that the loan-to-value ratio will probably average somewhere between 60 and 80 percent

FINANCIAL LANDSCAPING: BACK TO BASICS?

With financing a major challenge and reliance on government reserves to prop up a stagnant economy an expectation, **Claire Malcolm** looks at the future financial landscape and learns that the way forward could mean going retro

Much has been made of the visionary nature of the real estate sector in the UAE over the past few years as investment and development opportunities fuelled a boom-time tsunami that blithely swept everyone along, leaving just a few detractors in its wake. The financial fallout has been brutal, with a virtual embargo on lending to both individual investors and major developers effectively bringing the market to an abrupt halt.

The cyclical nature of this economic downturn may be small comfort, but the global magnitude of the problem has governments strategising the world over. While the UAE government's deep pockets have been put to good use in recent months, the uncertainty of funding at every level – from individual investor to major developer – is an ongoing concern as the region pulls together to get the real estate sector back on track.

FEDERAL POCKET

The mid-February announcement of a US$20 billion long-term bond programme by the Dubai government, with US$10 billion subscribed by the UAE Central Bank, has been a major boost for across-the-board market sentiment. Charles Neil, CFO of Dubai-based Landmark Advisory, and a 25-year Gulf banking veteran, says: "The fact that it is a bond subscribed by the Federal Government has led to a perception that this is now no longer a Dubai problem, but a federal issue."

He believes that Q2 will see a clearer picture emerge as to the future health of the UAE economy, but the need for further fiscal stimulus remains an active subject, as he explains: "I think there's going to be a need for more. The credit crunch hit Dubai later because it was more cushioned and had more momentum behind it, but we are still behind what's happening in the rest of the world.

"House prices have come down, but the question is whether this bond will help in any way. You saw how it affected the DFM and when you see volatility like that it means that you are probably getting nearer the floor. As the economy improves less people will leave and hopefully more will continue to come in, so you're going to get a levelling out of prices; but we will probably reach that floor now a bit more quickly."

Neil also considers the knock-on effect onto the industry. "In physical terms, a lot of that US$20 billion can be used by the Dubai Government to complete projects, pay the contractors on time who can then pay their subcontractors and suppliers, who can then pay their bank loans – and then the banks will have the liquidity to make new loans and that's how you start to move the money."

Barmak Besharaty, managing director of Almas Capital, has a different take on the bond issue. "It's helping to keep financial institutions stabilised but it potentially just propagates the situation with bigger consequences down the road. The best thing to do is to just let deflation occur; it will be painful but asset prices will come down and then we will have a reasonable market with reasonable growth potential.

"With all these stimulus measures you are trying to keep the old system going. Tamweel, Amlak, ADCB etc, are being encouraged to lend but it doesn't make sense when the prices are up here and the incomes are over there."

Besharaty is firm in his belief that adjusted asset prices are key to kick-starting recovery, as he explains: "When lending becomes less stringent it will ameliorate the situation, but asset prices have to come down. I think it will fall to a rational level whereby a family can afford to buy a regular house that will match their generated income and be able to make a decent down-payment, get a loan and be able to provide for that property up to 30 percent of their income. This will potentially mean affordable housing for middle class families."

PERVERSE REPLACING AVERSE?

The confidence level of lenders and investors may have been shot to pieces in recent months, and mitigation is the current watchword, but the US$20 billion will at least allow overseas banks to heave a small sigh of relief and file away default concerns. Neil says: "There are a few steps to go before the lenders get to a comfortable level again. The banks here relied a lot on foreign lending and so did a lot of the Dubai government or quasi-governmental entities. The US$20 billion probably won't be used to repay loans, but the mere fact that it's there means that lenders know that there is money available and are not going to demand it back."

Besharaty says that there are "pockets" of lenders who are starting to cautiously unlock funds, "If you're a lender, the main concern right now is not the return on your money, it's the return of your money. Are you going to get it back?"

Landmark Advisory's recent discussions with the banking community are also starting to yield some "green shoots" according to Neil. "The Islamic banks in particular are a little bit more liquid than the commercial banks, as are the Abu Dhabi banks." He also says that this could be an opportunity for Shariah-compliant financing to move forward. "We won't go back to a situation where you have 190 percent financing. I think that the loan-to-value ratio will probably average somewhere between 60 and 80 percent. And we are starting to see more willingness by the banks since the tail end of last year, when they stopped completely. It is slightly more optimistic in that respect than in other markets."

This doesn't mean that the financing floodgates are open for business and Neil believes that it will take time, particularly as some sectors are currently complete no-go areas. But lending is starting to yield approvals, albeit not without other issues. "One big problem is that we are seeing buyers with pre-approvals who are sitting and waiting, but that means that they have been approving loans more recently which is a positive sign," he adds.

LENDING ETHICS

While for lenders, due diligence is now more important than ever, the investor is also looking more intently at who they are dealing with. Neil says: "There is now a history to see how different lenders behaved and a lot more transparency in terms of fees. I think that the lenders who are greedy will have a problem, as people have long memories. The responsible lenders will come through it and those who try to make a quick profit will suffer.'

The potential of consolidation within the financial sector is also a hot topic and Neil thinks this is inevitable. "A lot is going to depend on what happens over the next six months as the real figures start to come out. If they see capital ratios weakened, then the Central Bank will certainly encourage banks to merge. They've never pushed the issue before because they've never had any leverage, but if they're asked to bail out a bank now, then they can insist."

Besharaty adds: "I don't think that we will see the big finance names potentially go under, as you have a finite number of institutions and a large number of reserves, particularly in Abu Dhabi, and so this would see a massive loss of confidence in this region."

FINANCING TO COMPLETION

It isn't just the individual investor who is strapped for cash, with some of the non-government backed developers, who were traditionally self-financing through their investors, also looking for assistance.

"There are a lot of negotiations ongoing. When you're a bigger borrower the bank has more of an incentive to work with you, if you're in the AED100-200 million bracket it's more a case of restructuring rather than refinancing," says Besharaty.

According to Neil there is light ahead for some developers. "Those who are able to get financed one way or another, i.e. through an arrangement with Tamweel to finance the buyers, don't have to worry because it is the mortgage provider or the bank who will pay them through to completion. What I can say is if you have mortgaged finance in place, the project will be completed because they will find a way to finish it.

"For those developers without finance in place, although it's still too early, I think you will start to see private equity funds come in and then get involved in a profit share at the end. But we are probably another year away from that happening."

With prices in freefall recently, the possibility of projects moving from stalled to cancelled status is a lesser threat, as Neil explains: "What I think is going to happen is that there will be a floor reached this year. If things start to pick up there is still what you call an 'overhang' of properties coming up in the future, which will need to be absorbed. Interestingly, with the developers, the ones who are probably 60 to 70 percent complete on a building will definitely finish, they're not going to stop nor are the investors." →

What is most important is to pass laws that offer bankruptcy protection, this is nothing new, it has always been an issue in the UAE

According to Besharaty even the government and quasi-governmental companies are being affected on the finance front, as he explains: "They will continue to operate but in terms of viability of their projects I think that will reduce as asset prices have to come down, so there will be a lot of projects put on hold because of the supply/demand equation and also from the sales angle."

RETURN TO LENDER

One issue that the UAE hasn't had to face, until now, has been the prospect of a massive number of home buyers defaulting on their loans and surrendering the keys. If a glut of 'jingle mail' properties come flooding back onto the market, banks could find themselves saddled with a hard-to-shift real estate portfolio and not enough eager investors waiting in the wings.

Besharaty agrees. "This is something that was totally unexpected. Unlike the UK or US there hasn't been massive lending here, a lot of it has been developer end-user finance and now people are saying 'I can't make the next payment, you can take it back'. If people continue to lose their jobs, and aren't living in completed properties you will get the jingle mail scenario."

Neil doesn't believe it will come to that, as he explains: "I think that when the mortgage companies start to see defaults they are going to realise that they will have to make some adjustments. Currently they charge around a four percent margin, which is unsustainable. In the UK, banks make a tiny margin on the lending and make up for it on insurance products and add-ons that they sell. This market will mature and go that way."

Similarly, the topic of purchaser recourse, should projects be cancelled altogether, is currently a grey area. Neil says: "I think it will be handled on a case-by-case basis to see if they can pay the money back or if they can do a deal with the investors and it take a bit longer with the end result that a building may complete.

"If the developer gets into litigation with the buyers, then ultimately these units won't come onto the market and there'll be a stalemate. So if the developer is clever he's going to try and reach an accommodation."

Besharaty doesn't see a clear resolution argument either. "If you don't have the money to reimburse people what are you going to do? It will definitely be a very interesting phenomenon to read about in the months to come and it's very messy. RERA has said 30 percent capped but what if someone has laid out 60 percent, what is going to be the expectation?"

LEGISLATING FOR STABILITY

The injection of capital into the market is one way to promote recovery, but legislative moves are also something that both Neil and Besharaty believe are vital to guarantee the long-term economic prospects of the country, across all seven emirates. Asset guarantee initiatives, for example, have been mooted in the media, but Neil identifies bankruptcy legislation as a key need.

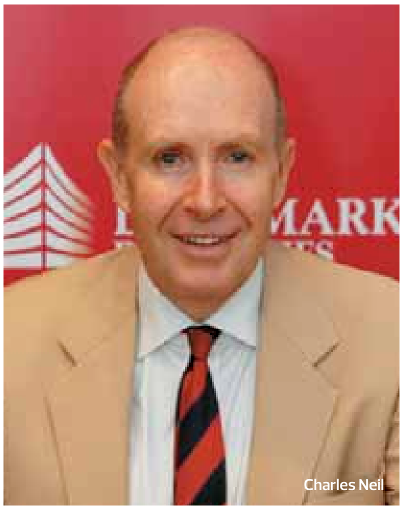
"What is most important is to pass laws that offer bankruptcy protection, this is nothing new, it has always been an issue in the UAE. There are no bankruptcy laws here, so in many ways if you want to come through a recession quickly then your legal infrastructure has to support that.

"The big problem is that people end up in jail if they can't pay their debts and it's not a way to resolve the problem. People will now skip the country once they start defaulting on mortgage and car loans, not just through business failure.

"If you have bankruptcy laws you actually consolidate the problem, so a company can go into Chapter 11, or administration, whereby it is protected and can't be harassed by its creditors while it works out a rescue plan. It does mean though that creditors may take a 'haircut' on it, but may only lose 20 or 30 percent rather than 100 percent, and the companies can emerge again," he adds.

Neil also says that the decriminalisation of bounced cheques would promote the potential for a much quicker recovery and change the financial landscape for the better. ➔


Barmak Besharaty



Charles Neil

A tightening of controls on local developers gets Besharaty's vote, as he explains: "RERA has such a huge mandate that they are trying to regulate everything and you need a Pentagon-sized department to handle that. The government really has to crack down on developers and call them to task. They need to have much higher regulation in terms of off-plan sales and the proposed registry of developers is a very positive move, but the quality of the final product also needs further controls and all this is feasible only in the long-term."

The 50s model whereby a classic family unit with one income could afford to buy a home is where we need to be. Up until now it hasn't been feasible

BACK TO BASICS

The net result of economic recovery for the region will, according to Neil, be a paradigm shift among the banking fraternity in terms of how it operates. Neil says: "Banks are going to be a lot more cautious going forward and a lot of the greed will be removed because people will not be able to secure the bonuses they were used to and we will see a return to basics – the old style of banking that I'm used to.

"The whole regulatory thing will get shaken up because the regulators were asleep at the switch and we will see the implementation of some very hard and fast rules such as not being able to lend more than 70 percent of a property, credit cards issued with a mandatory 10 percent pay back etc."

He continues: "What will happen is that a quasi-financial sector will emerge where you'll get private equity houses who aren't borrowing from the public, because the regulators are there to protect the public, so if you want to get a higher return you put your money in with a private equity house who will then lend to a developer or another borrower for a mortgage or whatever. I foresee a lot of those institutions coming up."

For Besharaty, the short-term will see a different investor enter the local market. "Vulture funds will come in and scoop up assets at dirt cheap prices. I don't see a lot of innovative financial vehicles right now because of securitisation issues. Who's going to buy right now when they've already had their hands burned? People who are savvy investors with a lot of cash are floating funds to buy distressed assets at rock bottom prices."

Securitisation will also reappear once the banks and mortgage companies start to build up their portfolios, as Neil explains: "But they won't be allowed to repackage and sell them on as they did before. There will be a lot more purely primary transactions in the market. Definitely for the next five to 10 years."

And this pared-down approach to financing casts obvious comparisons with the 1950s model of home ownership. Neil agrees. "The 50s/60s model is very healthy and reduces the risk of repossession. Lenders will do a lot more of what we call 'stress testing' to see what the consequences would be if a client loses their job, if interest rates go up etc.

"I think there will be more products to help buyers through that, but the downside is that first-time buyers will have to save to get their 30 percent deposit and the days of easy money will be over."

Besharaty agrees: "The 50s model whereby a classic family unit with one income could afford to buy a home is where we need to be. Up until now it hasn't been feasible."

If taking a leaf out of the financial history books is the way forward for long-term stability in the real estate sector, then heralding a back-to-basics mandate for recovery could be the cure-all shot in the arm for market confidence.