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As Saudi Arabia Embraces REITs, Investors Need To Do Their Homework

While Real Estate Investment Trusts (REITs) have been operating in Saudi Arabia for only 24 months, already the market has seen significant developments.

In less than 24 months a significant market for Real Estate Investment Trusts (REITs) has sprung up in Saudi Arabia. Regulations were established in 2016 by the Capital Markets Authority (CMA), and the first REIT was launched in November that year. At the time of writing there were 15 of the investment funds listed on Tadawul, with a market cap of around $3 billion according to Knight Frank, with more in the pipeline.

Could anyone have anticipated how quickly the REIT industry would grow? Perhaps. After all, real estate is a traditionally favored asset class in Saudi Arabia, and REITs make it possible for investors to gain exposure to diverse geographies and market segments, with limited capital outlay and an investment that remains highly liquid.

REITs allow investors to purchase stocks in ring-fenced, cash-generative real estate assets, designed to provide strong yields at lower risk than investing in real estate equities, says Steve Drake, head of PwC's Capital Markets. With REITs in Saudi Arabia required to pay out 90% of their earnings as dividends, this gives them a similar profile to a fixed income investment, says Drake. "What REITs provide for an investor is security."

At least in theory. But after a roller coaster price ride for Saudi's REITs, investor security has arguably been in short supply. While globally most REITs trade at a slight discount to their net asset value (NAV)—the global average price to NAV benchmark is a 17% discount according to a report by Knight Frank—in Saudi Arabia, initial offerings were oversubscribed and prices rose steeply in post-launch trading, with some more than doubling in value. By the end of September 2017, the ratio between unit price and net asset value of REITs (P/NAV) stood at 1.49, according to Frank Knight, a nearly 50% premium.

Market watchers blame a misunderstanding on the part of Saudi investors for driving prices so high. "Investors didn't understand how REITs operate, or the fundamental theory behind REITs," says Gaurav Shivpuri, head of Capital Markets MENA at JLL, who describes a "market frenzy" with speculative buying. "People thought REIT is going to be the new equity and they just kept buying and the share price kept going up."

The initial bull run also prompted a rush to bring new REITs to the market, to take advantage of the windfall for asset owners. James Stull and Nabil Issa, partners at legal firm, King & Spalding, working on documentation, saw a spike in activity. "When we were setting them up they were just like hotcakes. We were deluged with clients either selling assets to a REIT being formed, or a party wanting to form a REIT, because they would list and they would have a 30-40% increase on day two, so clients felt like it was printing money," says Stull.

Back To Reality

Saudi Arabian investors have long been accustomed to a company's shares rising post-IPO, so some of their enthusiasm can be understood. The launch of the REITs also came amid a dearth of new equities listings, partly due to "nervousness" about a possible Saudi Aramco listing sucking liquidity out of the market, with REITs "plugging the gap," says Drake. The REITs were also a new form of investing.

But the optimism of investors was ranged against the fundamental economics of the REITs. Whereas equities can reinvest earnings to grow the business, and the stock price, because REITs pay out 90% of their earnings as dividends there's little scope for capital appreciation. "REITs are not for trading, they're more for the purposes of capital preservation and growth with inflation," notes Shivpuri.

With real estate returns in the region roughly capped at around 8-8.5%, that means returns from REITs are capped at around 6-7%. Meanwhile, investors who bought units in REITs at double the list price were halving the effective yield, which at 3% would likely only just cover the cost of funds, says Shivpuri. Once investors realized this, "That's when the selling started," he says.

By March 2018 the P/NAV ratio had fallen to 1.01, and by mid-August the industry average was at 0.87, a 13% discount according to Knight Frank. Investors who bought at the market peak are now likely sitting on significant capital losses.
Shivpuri believes that the market is now trading in the right range, though "obviously there are some REITs that will go down." Indeed, no doubt investors themselves are wiser to the nature of REITs, while the CMA responded to the frenzy with updated regulations, including an increase in the minimum size to SAR500 million, to ensure that standards are kept high.

Price Separation Ahead

With the market now largely bottomed out, the task for investors is to pick REITs that will offer good returns for the long term, says Shivpuri, with prices currently bunched together quite a bit. "What I foresee is a separation of the pricing over the next two years as investors start to realize that certain REITs are better assets and certain REITs are weaker assets," he says.

That means that investors need to do their homework. Making that task more difficult is the newness of the market in Saudi Arabia, with many REITs yet to post full year returns. In more mature markets, investors analyzing REITs can often–look at years of results.

The good news is that compared with most other real estate investments in Saudi Arabia, REITs offer a wealth of transparency and information. David O'Hara, director and head of Cluttons Saudi Arabia, says that REITs are required to have their portfolio valued twice a year by two independent, third-party valuers to establish asset value and the information publicly disclosed, meaning that investors can get a "pretty good level of detail" on the market. Indeed, he believes that the high level of transparency is one of the main reason why REITS are so interesting to investors. "There are not a lot of markets in this part of the world where you can enter that level of transparency."

As for downsides to REITs, "the risks are about the nature of the market," says O'Hara. What are those risks? Headlines include a sluggish economy (the IMF estimates that real

GDP growth will amount to 1.7% in 2018), a building boom triggered by the white land tax putting pressure on lease prices as the market absorbs hundreds of new buildings, as well as an expat tax that has caused hundreds of thousands of foreign workers to leave the kingdom, decreasing footfall at malls and other commercial locations.

Nevertheless, despite market softness, O'Hara believes that talk of rental income contracting is superficial. "The rental income for prime properties is actually increasing and it's the properties from 10-20 years ago, that are not of sufficient quality, that are really suffering," says O'Hara. Less attractive properties not only have falling rates, "but more significantly have an incredible vacancy rate, so I think that's a big risk," he says.

To hedge their bets investors can also look beyond REITs that are diversified across geography and market sectors, to thematic REITs that are concentrated in sectors such as education and healthcare—said to be defensive because they are less affected in the event of an economic downturn. Raya Majdalani, research manager at Knight Frank, says that while the vast majority of existing REITs are non-thematic, the emergence of more thematic REITs is an opportunity for investors. "It is likely that thematic REITs will take the lead over diversified REITs in the longer term," says Majdalani.

JLL's Shivpuri believes that the strength of the leases is a vital factor in determining the long-term performance of individual REITs. "Most of the REITs are still new so the leases are in place now, but when the leases come up [for renewal], if they've not been bought at the right price, and tenants leave or leases fall, then that REIT will suffer," he says.

He believes investors holding substantial stakes in REITs should analyze their funds in detail, looking at the tenancies and if necessary getting third-party help to forecast the strength of the leases. Some investors may need to adjust their portfolios, he suggests, given that REITs with lower returns will fall in value while those that outperform the market will gain. "The question is, are [the returns] sustainable over time?" says Shivpuri.

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