



## **RISKS IN FINANCING REAL ESTATE PROJECTS – RATING AGENCY PERSPECTIVES**

### **Importance of Real Estate Industry**

The real estate sector plays a key role in the development and progress of any economy and is often considered as the leading indicator of the economic health of any country. In USA for example, new housing start-ups are tracked on a monthly basis to gauge public sentiment regarding the economy.

Some of the characteristics of real estate / construction sector are;

- It generally represents a significant commitment by the investor to the economy where he is investing. Since the construction involves creation of immovable assets it represents a far more permanent creation of wealth compared to portfolio investment, which can flow out very quickly in case of downturn.
- Construction industry is an end user for several capital intensive industries like steel, cement and some of the relatively smaller industries like paints, wires, electrical equipment etc. Therefore a robust construction industry generates activity in these industries.
- Construction industry is generally labor intensive and therefore is a vehicle for job creation, which is one the important challenges for a developing economy.

### **Industry Dynamics**

More than most industries, real estate is cyclical .

Population growth and economic growth are perceived to create demand for real estate product in all categories. As a result, developers build to meet demand and attract the cash flows from lease rentals and investment. The result is oversupply leading to declining income, cash flows and values. Consequently there is a reduction in supply over a time period, thereby creating equilibrium between demand and supply. However, due to the inherent sluggish response, the industry players are slow to respond to the new demand, which results in demand exceeding supply and hence again the pent-up demand is created and industry enters into a new cycle.

There are several factors that affect the growth of the industry

- The level of pent-up demand in the real estate sector
- GDP growth of the country
- Capital formation
- Population, per capita income and disposable income together with growth trends
- Inflow of expatriates and nature of expatriates in the economy (i.e. blue / white collar workers)
- Number of industry players, and competition status (i.e. few players dominating / fragmented)
- Regulatory environment
- Supply of raw material (i.e. production or imports)
- New projects expected to be completed within next 2-3 years
- Historical and projected absorption rate of new projects



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### **GCC Real Estate – Some background**

The real estate boom in GCC, which started in the early 2000's with Dubai announcing free hold property rights for expatriates has seen a major change in the structure of almost all the GCC economies. The rising prices of hydro carbon products has only helped to sustain this momentum and has allowed the respective governments to create suitable infrastructure, something which is utmost necessary for the development of a real estate market.

A rough estimate is that the GCC real estate sector is collectively valued at USD 1 trillion and is inclusive of residential, retail, leisure and commercial sectors. (Source : Menaport.com)

The contribution of the construction sector (excluding any real estate services) towards the GDP of GCC economies averages around 4.7% with Kuwait being the lowest at around 1.7% to UAE being highest at around 8%.

We have picked up Kingdom of Saudi Arabia and will explore certain facets which we believe will influence the future potential of the industry (Source : Menareport.com, Global Investment House research reports) .

- The contribution of the construction sector is around 4.5% of GDP.
- The support of the Government to the sector is evident as large number of infrastructure projects are in the pipeline. These include schools, hospitals, roads, railways, power and water plants, oilfield and industrial facilities, the expansion of the industrial cities of Jubail and Yanbu, the creation of a new financial district in Jeddah and the start of work on the four ambitious new “economic cities” which have been announced for Rabigh, Medine, Hail and Jizan.
- The factors which have attributed to surge in real estate market includes increasing young population (thus increasing demand), increase in disposable income, low cost government financing and low interest rates.
- Saudi population has grown at a CAGR of around 2.5% over the last 5 years to reach around 24M. This is considered as among the highest growth rates in the world. An estimated more than 50% of the population is less than 25 years old, signifying higher demand for new housing in the coming years.
- In its strategic 20 year plan (2005-2025) the government envisages doubling of GDP per capita from around SR 43K (in 2005) to around SR 99K (in 2025). This will lead to an increase in disposable income.
- Credit facilities to building and construction sectors have increased substantially from around SR 15 billion in 2001 to over SR 50 billion in 2007 at a CAGR of more than 20%.
- The real estate market is expected to get a further boost by the implementation of the mortgage financing law.
- Makkah and Madinah are prime religious tourism destinations for more than 1bn Muslims worldwide. Nearly 4mn pilgrims (Saudis and foreigners) travel to Saudi Arabia every year to perform the Umrah and Hajj, with estimated spending of US\$1000 per head. Projections by the



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Ministry of Hajj reported total pilgrims will reach 5.62mn by the end of 2009. This translates into a CAGR of 7.4% over the period 2004-09

- Another new trend in the real estate industry is the announcement by government of construction of new economic cities in 2005 and 2006 which will feature major residential and commercial real estate developments. Around 1.5mn people are expected to be accommodated in the medium term and three times as many by 2020. These cities (King Abdullah Economic City, Knowledge Economic City, Prince Abdulaziz Bin Mousaed Economic City and Jazan Economic City) will drive investment, which will increasingly be a driver of economic growth going forward. The estimated cost of these four economic cities is more than SR250bn. A study is underway to establish two more economic cities, one in Tabuk and one in the Kingdom's Eastern Region.
- It is estimated that during the seventh development plan (2000-2004) new housing units constructed were 300K bringing cumulative housing units to around 4M, out of which 92% were in private sector.
- For the 8<sup>th</sup> development plan (2005-2009) it is expected that the demand for new housing would be around 1M units. This would be met through both government and private sector construction, with latter absorbing 80% of the demand.
- All of the above mentioned indicators point to an increased activity in the real estate sector, led by the private sector but supported by the Government initiatives.

## **RISK PRESENT IN REAL ESTATE INDUSTRY**

While the real estate sector looks forward to exciting times in the future, caution needs to be exercised to avoid overheating the sector. Regulations by the Government and initiatives by the private sector are required to ensure smooth and healthy progress of the industry.

As a rating agency we want to present our perspective on the different kind of risks present in the real estate industry.

The risks inherent in the real industry can be broadly classified into industry risks, developer specific risks and project specific risks. The industry risk i.e. cyclicity has been discussed under the industry dynamics. We will now describe the latter two risks.

### **Developer Specific Risks**

A developer's ability to deliver has certain risks such as;

#### **A) Capacity Risk**

Capacity risk in itself can be broadly classified as legal risk, history risk, and reputational risk

##### **A.1) Legal Risk**

This pertains to developer's ability to comply with legal requirements. This among others includes compliance to building bye-laws of local authority, receipt of completion and occupancy certificates from the competent authority and transfer of clean titles to investors / customers.



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### **A.2) Past Construction History**

The risk pertains to whether the developer has the capacity to undertake such kind of project. This risk is examined by reviewing the scale and size of past projects that have been completed by the developer and the total area developed under different categories. The developer's commitment to safety as demonstrated by the quality of past projects is also considered. Other factors include the quality of on-site and off-site infrastructure provided to customers, compliance with agreed specifications as detailed in the agreement and the level of after-sales services.

### **A.3) Reputational Risk**

The market perception, reputation of the developer and the brand value attached to its properties are considered under the reputation risk. The sales record of past projects is a healthy indicator in this regard. Any complaints outstanding in the courts and other disputes need to be evaluated

### **B) Operational Risk**

#### **B.1) Organizational Risk**

This risk pertains to whether the organizational structure is suitable enough to undertake the projects. This includes examining the staffing, management style and availability of a qualified talent pool within the organization. A professional approach on these parameters indicates the developer's vision and ability to do a long term business.

#### **B.2) System Risk**

This pertains to whether the developer's organization has suitable systems in place to execute the projects. This includes understanding the extent to which a developer adopts a structured approach to business management and controls. This management and control processes include standardization of workflow processes, adherence of time schedules and cost estimates, material and labor specifications, project monitoring and transparency in flow of information to investors / customers.

#### **B.3 ) Strategy Risk**

The developer's strategy is crucially important as incorrect strategy would lead to non-execution / delay in project. A developer's strategy is examined in view of the number of projects that are undertaken at one time, the kind of projects where the developer wants to concentrate, the vision for backward integration etc.

#### **B.4) Diversification Risk**

Geographical diversifications or diversifications into related or other businesses provide strategic comfort as they reduce the concentration risk, help moderate adverse business cycles and provide an alternative source of funds, when required.

### **C) Financial Risk**



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A developer's financial risk is evaluated to ascertain its ability to complete projects on time with adequate cash flows. This requires an understanding of the company's past financial performance and financial flexibility. The following are analyzed

### **C.1. Existing Financial Profile**

Real estate projects are capital intensive. A large quantum of funds is required upfront and during the course of construction. Therefore the developer should have sound cash flows or assured funding as otherwise the developer will find it difficult to complete the projects on time. The existing financial profile i.e. the funding lines that are available and the utilization of those funding lines are examined. The funding patterns for the past and on-going projects are also analyzed.

### **C.2. Lack of financial flexibility:**

A developer's financial capacity is viewed in relation to the number of projects under development and the funding tie ups for the same. The ability to generate funds whenever needed, either through equity or debt, is an important factor in financial flexibility, as inability to generate funds at the right time may cause delay in the project and harm the developer's reputation

### **Project Specific Risks**

Now let's look at specific project risks.

#### **i) Demand and Supply Risk**

The demand risk is evaluated in terms of the overall economic situation of the country, the existing supply and lease rentals for the different type of properties, the vacancies in the existing properties and disposable income of the consumers. It also assesses the demand specific factors of the kind of project (like residential, office or retail) and target market (upper, medium or lower end of the market). Additional supply being created and its relationship to documented demand is crucial in the evaluation.

The number of projects similar to the one under review is evaluated and the advantages / disadvantages of each of them are compared. An undersupply or oversupply of similar projects will be a crucial factor in determining the success of the project.

#### **ii) Legal Risk**

A good legal title for the land is necessary for the project. Under legal risk, it is examined whether the title is clear and marketable and whether the property is free from encumbrances. The origins of all title documents are examined and legal opinion is sought if deemed necessary.

The development agreement between the land vendor and the developer needs to be carefully reviewed to understand what kind of development can be made on the particular land and what are the terms and conditions for the development.

Another document that is closely examined is the sale agreement between the developer and the buyer to understand the rights and duties of each of the parties. Particular importance should be given whether the contract is of fixed price or whether the developer is allowed to increase the price due to abnormal increase in material, labor or other related costs.



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The availability and practice of escrow laws needs to be examined as these provide significant comfort that the inflows for the project would be used for the project itself and will not be diverted for other projects / investments.

### **iii) Participant Risk**

Normally in a project, a developer engages a number of other parties to complete the project. These include but are not limited to consultants, architects, main contractors, sub-contractors, equipment suppliers. A study is undertaken about the capability of each of them as failure of one of them to complete its part may lead to an overall delay / non-completion of the project. Particular emphasis should be given to understand the requirement of specific machines, man-power and ascertain the probability that these would be available on time for the completion of the project. The sources and supply of raw material need to be studied carefully as well.

### **iv) Completion Risk**

Completion risk in itself is a combination of several factors and is directly linked to the complexity of the project itself. These factors include structural quality which is the ability to translate the plan into a sound civil structure; Infrastructure around the project like parks, roads, sewerage, water and electricity; and Finishes both external and internal. All of these need to be understood in order to arrive at the overall completion risk of the project.

### **v) Weather Conditions and other natural factors**

A review needs to be done whether there are specific natural factors which may be a hindrance to the completion of the project i.e. in some countries rain is a factor and it may not allow the project to be completed on time. Therefore the timings of the construction become a significant factor to consider.

### **vi) After –Sales Services / Maintenance Risk**

The extent and type of after-sales / maintenance planned by the developer for the project needs to be evaluated. This is generally stipulated in the sale agreement and therefore a careful study of the sale agreement with regards to these aspects must be undertaken.

### **vii) Financial Risk**

Crucially important is the financial risk of the project. How much equity has been invested, what is the cash inflow expected from investors and at which stage, what percentage of sales is forecasted before the construction , during the construction and after the construction and are these realistic in terms of past and future market projections. Also the contingency plans need to be examined to see what plans the developer has in case the forecasted sales do not happen. Does the developer have deep pockets to inject cash or have significant borrowing lines available.

### **viii) Likelihood of Time and Cost Overruns**



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The ability of the developer to complete and deliver the project on time is one of the key factors. Whether the developer has the capacity to complete the project on time and are there any external factors which may hinder this ability like development of the infrastructure by the competent authority.

Apart from external sources, the key factors affecting the timely completion of the project are adequate cash flows and monitoring systems to ensure adherence to schedules. Delayed inflows from institutions and investors, low project sales and limited financial flexibility adversely impact the timely completion of project.

The existences of punitive clauses in favor of the buyer are also studied to understand their impact on the developer and the project.

Another important area to consider is the likelihood of any cost overruns. For this a careful evaluation has been done for the various supply contracts, timing of procurement, and nature of contract with the main contractor and other sub contractors. Also it needs to be checked whether there are stipulations in the sale agreement allowing any cost overrun to be passed to the buyer.

### **IIRA'S GOAL : A HEALTHY DEVELOPMENT OF REAL ESTATE INDUSTRY**

Islamic International Rating Agency (IIRA) has designed a real estate developer rating methodology which is basically to provide the stakeholders with a balanced view about the strengths and weaknesses of the developer and to create a healthy environment in the industry. The rating provides an independent and objective opinion on the relative financial capability of the developer in line with the commitments made to the stakeholders. Since it would be very difficult to legally fence simultaneously ongoing projects of a real estate developer from one another, we would analyze all the ongoing projects of the developer and arrive at an overall rating of the developer.

IIRA also provides ratings of individual real estate projects if they are ring fenced and developed as a legal entity, using the same analytical approach as described above.

### **Who are the beneficiaries of IIRA's Real Estate Ratings**

IIRA's Real estate rating offers a useful comparative tool to the industry. The specific benefits to each of the constituents are outlined below:

#### **Real Estate Developers**

A developer rating gives real estate developers a tool to highlight their strengths in project execution and marketing. It can thus be used to command a better price. The rating increases credibility and substantiates the informal word-of-mouth mode of appraising developers.

The rating also acts as a benchmark for developers and helps them to identify their shortfalls vis-à-vis the best practices in the industry. This will lead to continuous improvements in quality and services levels.

The rating will help develop a healthy competition between the real estate developers

Further, a good rating can also help developers to mobilize institutional funds and other financial services for their projects and enhance their ability to market the project.



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### **Banking, Financial and Lending Institutions and Investors**

Real Estate Developer Rating would provide the lenders' with an independent third-party opinion on the ability of the developer to meet its financial obligations, thereby enhancing the lender's confidence in the project(s) and the developer.

### **Government and Regulators**

The rating service gives an incentive to developers to maintain standards. This is expected to facilitate the orderly growth of the sector, leading to a self-regulated industry framework. It may also help the regulators to regulate licences in line with the rating.

We sincerely hope that our rating methodology would help in the development of the real estate industry and would also help to avoid the mistakes that may lead to financially bad assets.

THANKYOU.