Emergence of Real Estate Investment Trust (REIT) in the Middle East

5th December 2018

REITs Modelled after Mutual Funds

Real Estate Investment Trust allow investors to participate in a capital intensive sector such as real estate with limited liquidity and a clear exit path

REITs are currently underpenetrated in the Middle East, however we expect them to grow gradually as the real estate market in the region matures in terms of quality of assets, financing, governance and regulations.

We anticipate that there will be shift in business model with REITs in the region shifting from being 'generalist' aggregators of real estate assets to becoming a 'specialist' within a particular real estate asset class. The focus should be on becoming specialists with growth being driven by geographic expansion organically or inorganically.

There will be a flight to quality whereby capital transitions to REITs with strong management teams and a good track record. Key factors that will determine the performance of a REIT are:

Acquisition price of assets

Strength of the underlying lease

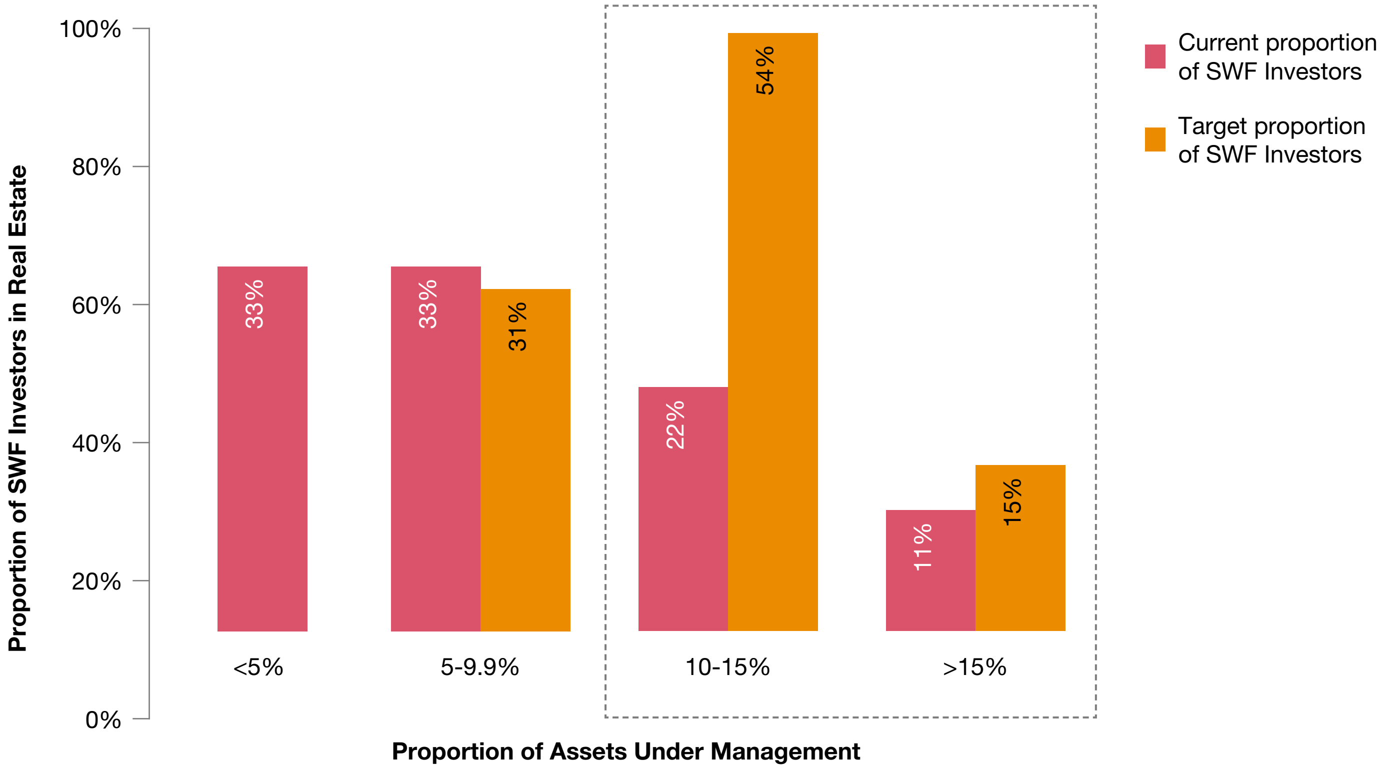
Focus on reinvestment / maintenance

Quality of assets

REITs will benefit the region in terms of the transparency that they will bring to the real estate sector. However this will be a gradual process and will require a significant investment from the REITs to incorporate best practices as they relate to their underwriting/ deal diligence, policies/ procedures, systems as well as governance structures.

A majority of large institutional investors are planning to increase their allocations to real estate

Sovereign Wealth Funds' (SWF) Current and Target Allocations to Real Estate by Proportion of Total Assets Under Management



Attractiveness of real estate to institutional investors

- Ability to achieve **steady cash flows** through rental income
- **Hedge against inflation** (due to contractual escalations in long term contracts)
- Healthy **yields** and prospect of capital **appreciation**

Increasing allocations to real estate

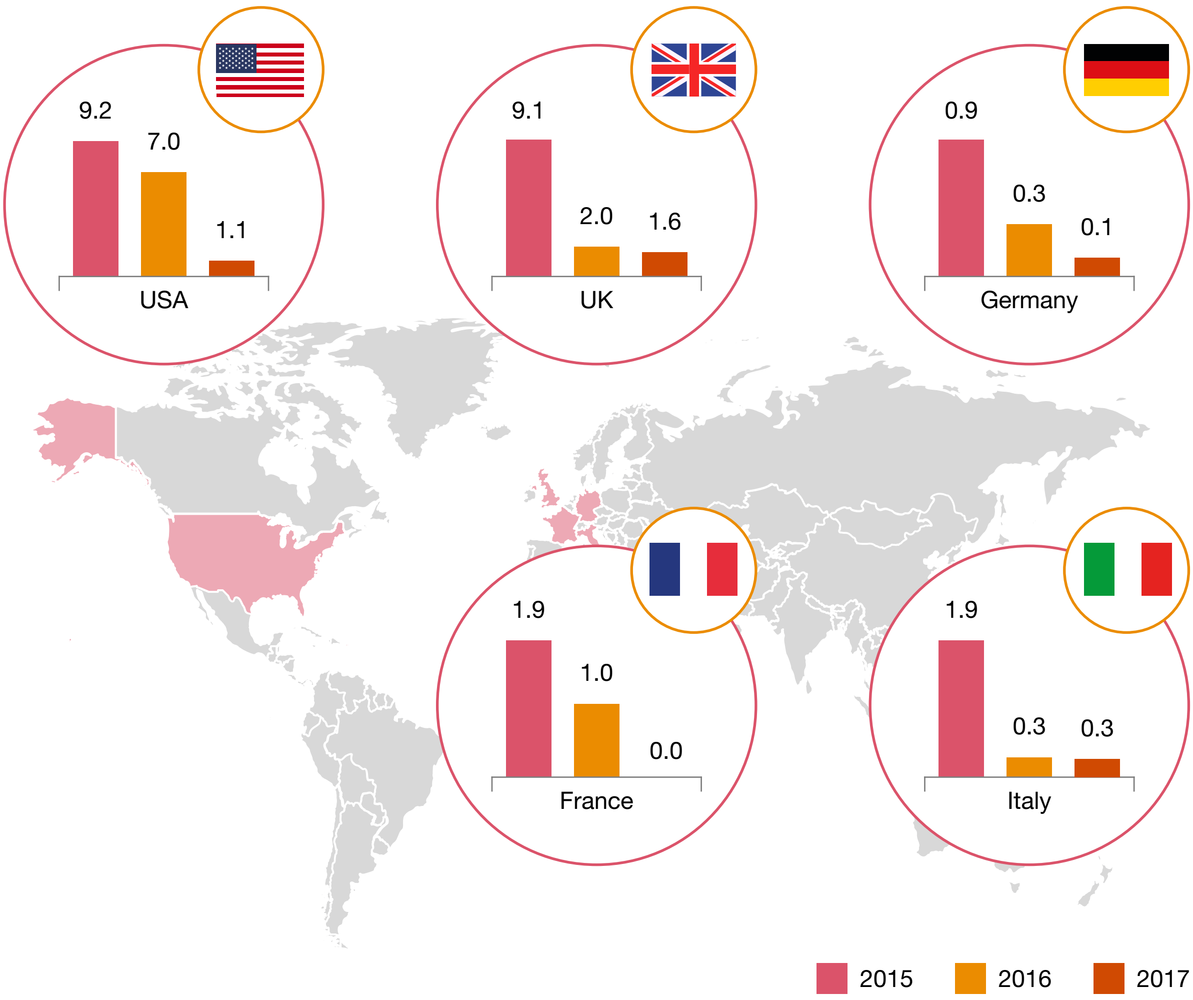
- SWF's have approximately $6.6 trillion in assets under management as of 2017. Historically only 33% of the SWF's had an allocation of 10% or more towards real estate, however that is expected to change with **~70% of the SWF's targeting a 10% or more allocation towards real estate**

Source: Preqin, PwC analysis

Note: Current proportion of allocations are as of 2017

Historically investors from the Middle East have been actively investing in real estate in the western markets. However, there has been a slowdown in outbound capital in the last couple of years.

Outbound capital by Middle East investors in real estate ($bn)



Potential reasons for reduced outbound capital:

- Low oil prices leading to lower budget surplus and therefore potentially impacting allocations to SWF's
- Potential uncertainty due to Brexit as well as timing and quantum of interest rate movement in the US

Source: RCA

Note: Data is as of Q3 2017; Above chart includes outbound capital from UAE, Qatar, Kuwait, KSA, Oman, Lebanon & Bahrain. Outbound capital comprises of properties/portfolios with transaction value of $2.5 Mn or greater

As the real estate market in the Middle East evolves we might see more capital being deployed locally.

There are various trends that are beginning to emerge in the real estate investment landscape regionally:

Real Estate Investor Trust (REITs)	**REITs** are currently underpenetrated in the Middle East and we anticipate that number of REITs in the region will grow
Sale/Leasebacks	Alternate funding strategies such as **"Sale & Leasebacks"** are expected to rise due to limited liquidity and financing options currently in the market
Build to Suit Products	Developers are increasingly **building assets according to needs of tenants** who then rent or purchase the entire building post completion
Co-working	Concept that is witnessing phenomenal growth internationally with members growing at **~2.8x Y-O-Y;** UAE is currently underpenetrated but there is growth in this segment

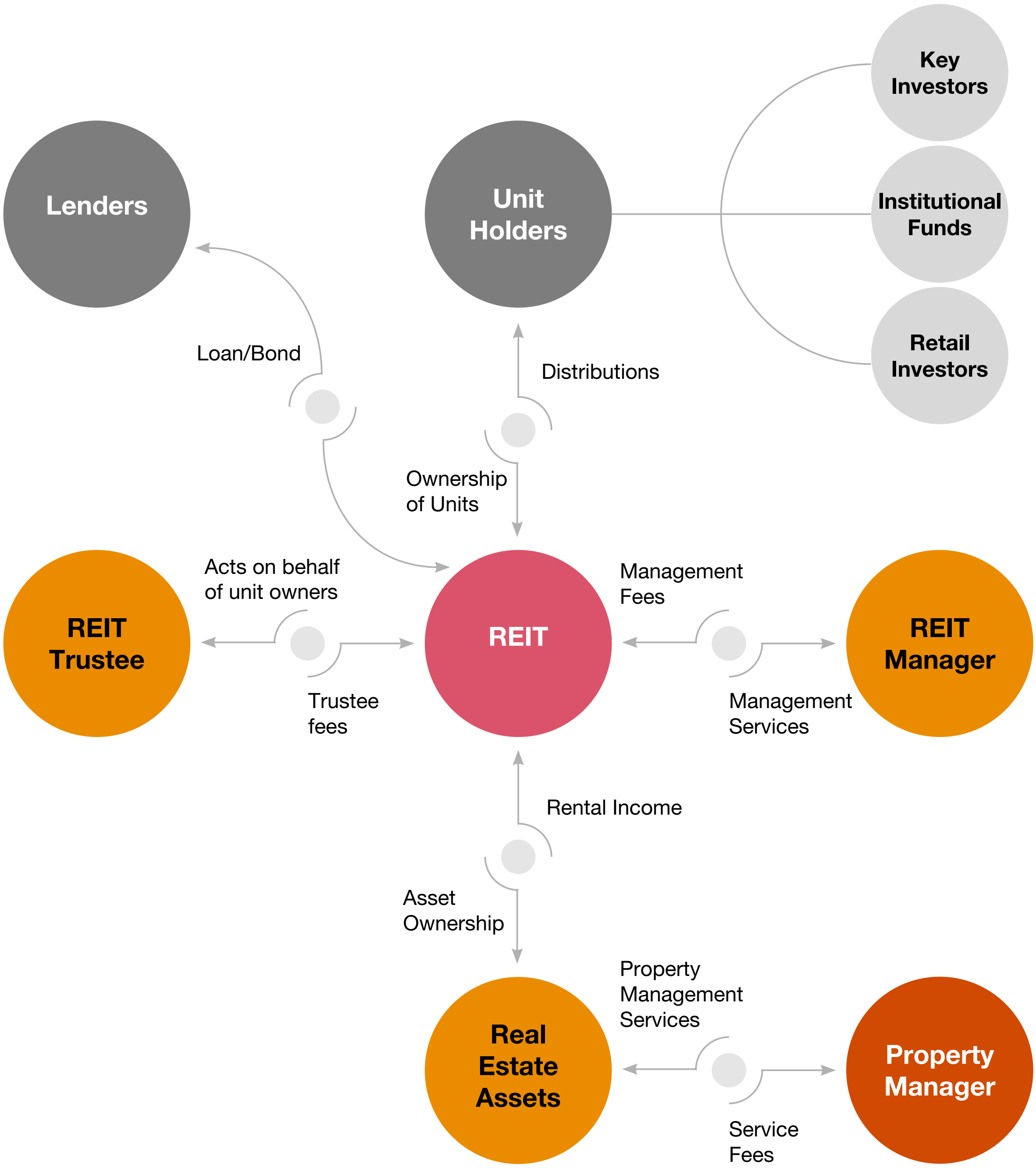
Real Estate Investment Trusts

REITs allow anyone to invest in a portfolio of real estate assets through the purchase of company stock

So, what is a REIT?

- REIT is a company that owns, operates or finances income-producing real estate
- Modeled after mutual funds, REITs historically have provided investors of all types regular income streams, diversification and long term capital appreciation

What is a REIT?



Source: NAREIT

From an investor’s perspective

Clear Exit Path

One of the risks with real estate is that it can at times be illiquid or hard to transact. A REIT allows investors to exit and get their capital out of real estate almost instantly by selling their shares in the secondary market.

Profit Distribution

REITs are mandated to **distribute a minimum of 80% of Net Income to investors** thereby assuring a constant dividend stream.

Security of Cash Flows

Property under **development has to be < 30% of NAV.** therefore returns cannot be significantly skewed by project development or by off- plan sales that are used by private & public real estate companies in the region.

Leverage Protection

REITs are **limited to a gearing of 50% of Gross Asset Value** thereby preventing excess leverage and forcing REIT managers to focus on the property fundamentals in order to deliver returns to investors.

Note: Above regulations are based on NASDAQ Dubai

In general REITs tend to be a safer avenue for investment as opposed to public real estate securities in the Middle East. Although some real estate developers in the region are currently providing stable dividends, a large portion of these dividends are actually being paid through off-plan sales as well as sale of their land bank. Off-plan sales can be quite volatile and selling the strategic land bank can create challenges for the long-term sustainability for some of these developers. REITs on the other hand are restricted in terms of the amount of risk they can take regarding opportunistic development and as a result tend to have a larger focus on operating cash flows making their business model more sustainable.

Developer Perspective

There are strong reasons for developers to potentially consider a REIT structure as well:

1. To **raise money** for expansion of operations
2. To **deleverage financing** on existing property portfolio
3. To **increase market value**
4. To **acquire other companies or property portfolios**
5. To **attract and retain high performing employees** (stock options)
6. To **provide liquidity** for existing owners/ shareholders/ investors
7. To **enhance the company's reputation and business profile** in the market (which could, for example, assist in completing transactions with tenants)

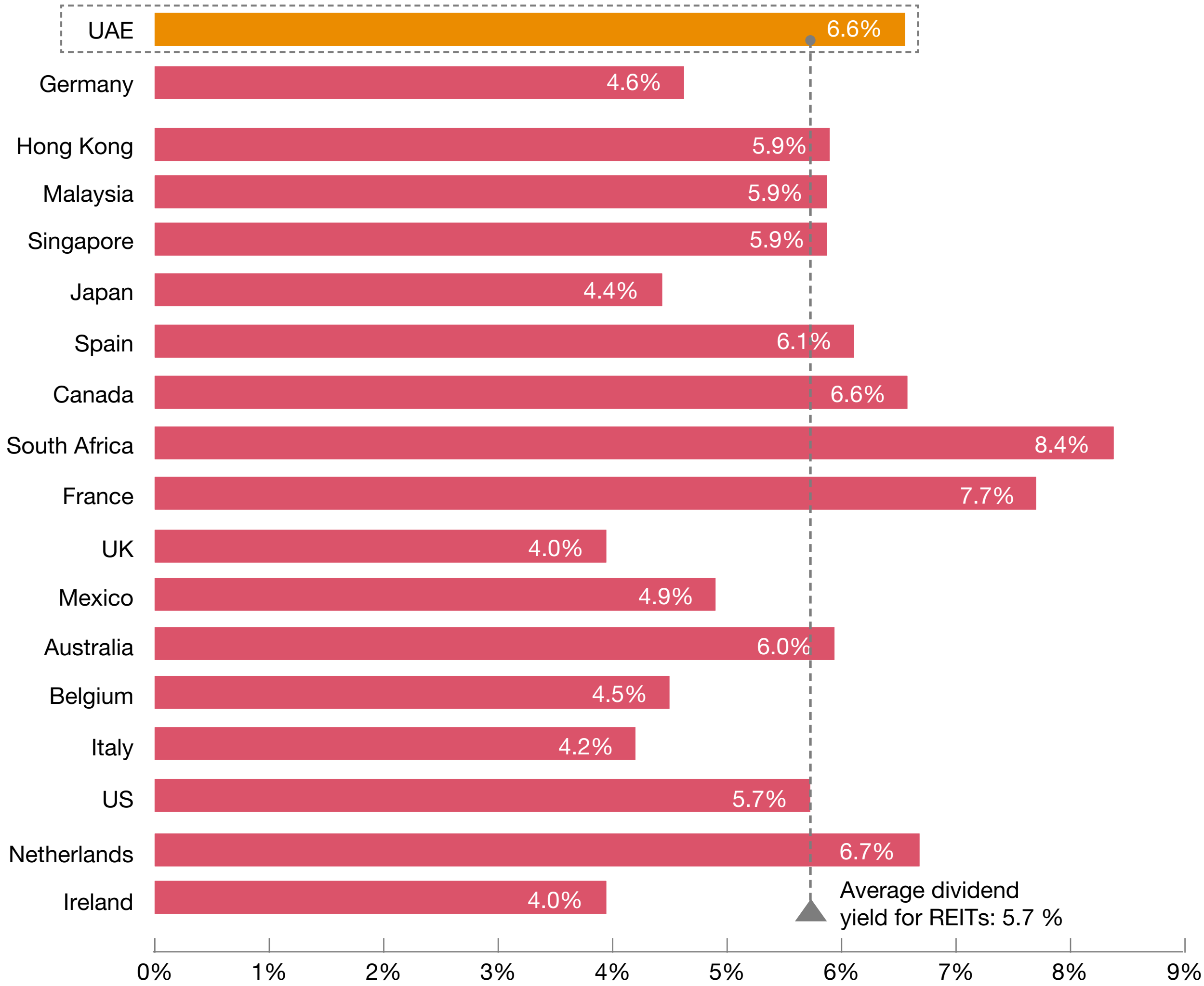
Source: PwC Analysis

Converting from a developer to a REIT is a common approach in the more established real estate markets. Although REIT legislation has been around in the US since the 1960's the real impetus for REIT conversion started in the 1990's in the US when banks were hesitant to lend for ground up development that was not already pre-leased for the most part. Developers realized that they needed better access to capital and that along with tax structuring advantages was one of the primary drivers for developers to convert to REITs. Most of the large REITs currently were private or public real estate developers in the past and over a period of time have converted to a REIT structure.

In the Middle East the trend is almost reversed wherein financial institutions and private equity groups have launched REITs but they have limited development or real estate asset management experience. Considering that banks in the Middle East are becoming cautious lending to the real estate sector, more so in relation to off-plan sales, the need for alternate funding mechanisms might convince some high quality developers, with a focus on sustainable cash flows (build to lease model), to consider a REIT structure. It should be noted though that once a developer converts to a REIT then the amount it can develop at a given point in time will get restricted. The focus would have to shift towards acquisitions or in case there is a strong pool of cash flow generating assets within the REIT then development can be done in a more gradual way.

For most markets, REITs tend to provide a healthy dividend yield

REITs Global Average 1-Year Dividend Yield (%)[1]



In early 2018, REITs in the UAE were offering healthy dividend yields (~ 6.5%) compared to the global average of 5.7%. However, the story emerging in KSA was a little different with REITs offering an average dividend yield of 2.7%. Part of the issue in KSA was that there was a sudden rush in listings with insufficient diligence done on the quality of assets. Early entrants to the market were able to obtain an initial premium on listing, however, the long term performance of a REIT is determined by the underlying quality of the real estate. Although there have been some challenges with REITs in KSA we do believe that there is a market opportunity for REITs across the Middle East. In our opinion, there will be a flight to quality wherein REITs with a good asset base, strong management teams and robust governance structures will continue to grow and attract capital whereas the non-performers will eventually be weeded out. As the REIT sector in the Middle East matures we anticipate there will be an emphasis on sector specialisation - with REITs focusing on a specific asset class within the real estate spectrum such as residential, retail, hospitality or office. Sector specialization allows the REITs to really understand their customers, form lasting relationships and work with third party developers to create properties that are in line with market demand and therefore, yield the right returns for investors.

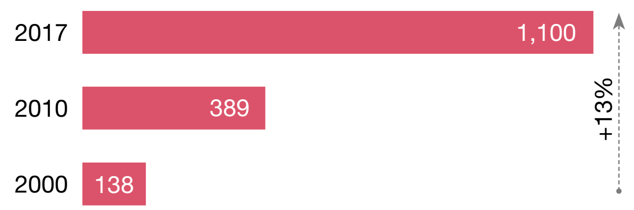
[1] Based on data extracted on 26th February 2018; Yield figures represent the annualized dividend yield based on the market closing price as of the day.

Source: Bloomberg Finance L.P, PwC Analysis

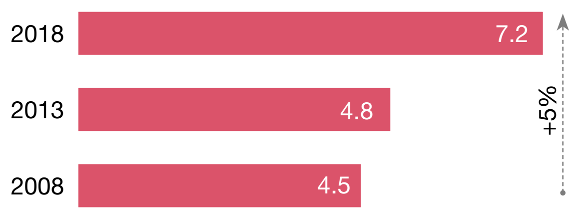
REITs are increasingly growing in prominence globally

Today more than 30 countries have listed REIT securities and several others are considering REIT legislation. REITs have seen a tremendous growth over the past few years with market capitalization of REITs increasing from $389 billion in 2000 to over $1.1 trillion in 2017 in the US alone. Emirates REIT was the first to be established in the region in 2010, however the real push for REITs in the region has only happened over the last couple of years with their being headroom for growth.

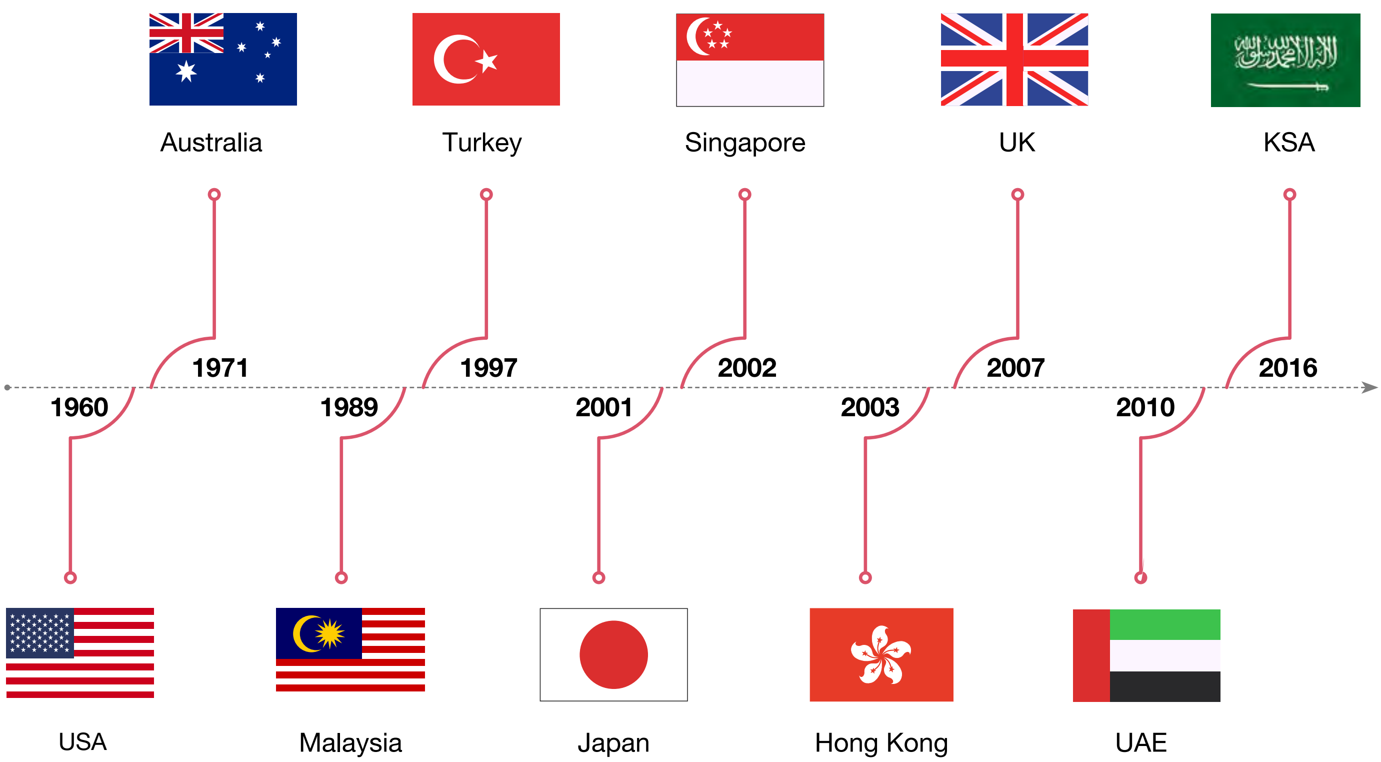
Strong growth in market capitalization (US $bn)



Increasing daily trading volumes (US $bn)



Gaining credence globally



Note: Data is for US REITs as of March 2018

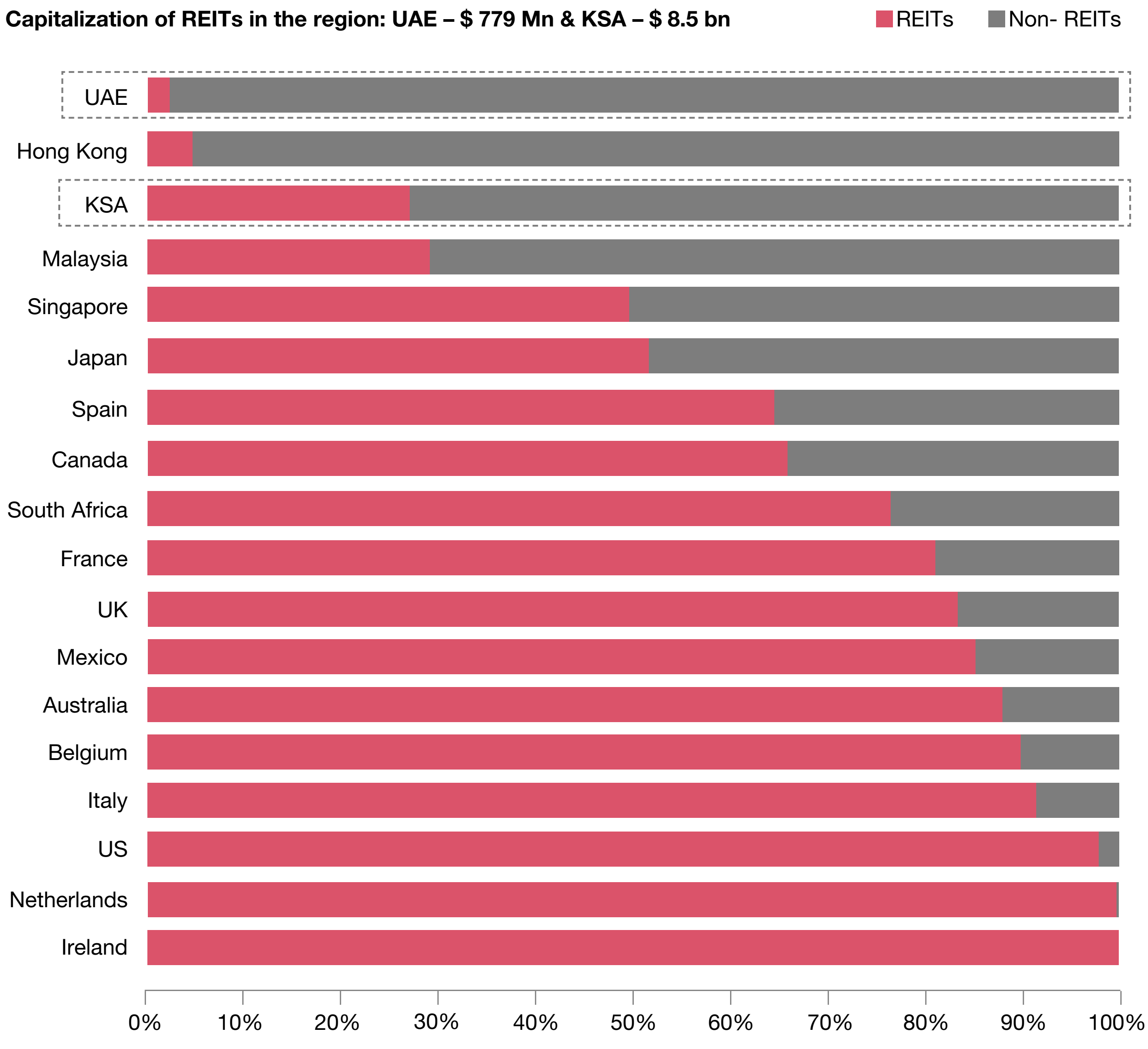
Source: NAREIT, PwC Analysis

Currently underpenetrated, but growth anticipated for REITs in the Middle East

Currently REITs are underpenetrated in the Middle East with only a handful of REITs across the UAE and KSA. The market capitalization of REITs compared to listed real estate is less than 3% in the UAE whereas in more mature markets such as the UK, France and the US at least 80% of the listed market capitalization in real estate is attributable to REITs. The REIT structure is a relatively new concept in emerging economies and therefore they have not necessarily had the time to adopt best practices as compared to more mature markets such as the US where REITs have existed since the 1960s. There might be lessons for REITs in the Middle East from the Singapore model wherein the tiny island of Singapore has approximately 40 listed REITs at the beginning of 2018 compared with only 2 in the UAE. Although REITs have been around for longer in Singapore they have tended to specialize in an asset class and then eventually expanded abroad so as to increase their base of high quality assets and offer healthy returns to their investors.

REIT market capitalisation as a % age of listed real estate market cap[1]

Market Capitalization of REITs in the region: UAE – $ 779 Mn & KSA – $ 8.5 bn



[1] Based on data extracted on 26th February 2018.

Source: Bloomberg, PwC Analysis

What are the requirements to qualify a REIT in the UAE?

REIT Requirements	Description
1 Registration Requirements	A REIT must be constituted either as an Investment Company or as an Investment Trust
2 Leverage Test	Borrowing must not exceed 70% of the net asset value of the fund
3 Distribution Test	Minimum of 80% of REITs audited annual net income must be distributed to shareholders
4 Development Test	Invest no more than 30% of total assets in property under development
5 Asset Test	60% or more of the REIT's assets comprise Real Property

Note: The following information is valid for REITs listed on Nasdaq Dubai

Tax overview of Middle East REITS

1

Globally REITs provide a tax efficient way to invest in property, as REITs are generally exempt from tax or subject to tax at a reduced rate on rental income and capital gains. Subsequent distributions by a REIT to its investors usually follows domestic tax law as to whether tax (e.g. withholding tax) is payable. These tax outcomes are generally codified within the domestic tax law of the jurisdiction where the REIT is domiciled.

2

Although the Middle East has had “REITs” since 2006, the legal framework for REITs is uncertain in some jurisdictions and to date none of the jurisdictions have specifically codified the tax treatment of REITs in their domestic tax law. This makes it difficult to confirm the tax treatment of Middle East REITs with certainty, as the taxation of REITs will depend on the application of general tax principles and practice (and how this can evolve over time) in each territory.

3

Whilst Middle East REITs have far been used to invest within the region, there may be scope for these vehicles to be used as a means of investing further afield. For example, we’re aware of the UK tax authority allowing a UK REIT, wholly owned by a non-UK REIT, to still receive normal UK REIT tax exemptions.

The treatment of REITs from a legal perspective

Legal perspective will vary in each territory dependant on the assets held

Country	KSA	UAE	Bahrain	Oman	Qatar
Regime under which REITS are established	Capital Markets Authority (CMA) in November 2016	Dubai International Financial Centre (DIFC) in 2006 Abu Dhabi Global Market (ADGM) in June 2015	Central Bank of Bahrain (CBB) in November 2016	Capital Markets Authority (CMA) in January 2018	Qatar Financial Centre Regulatory Authority in 2016
Legal form of the REIT	Closed-ended investment fund	Closed-ended investment company or investment trust	Investment trust	Investment fund	Collective investment trust or collective investment company
Distribution Requirements	Minimum distribution of 90% annual net profits	Minimum distribution of 80% annual net income	Minimum distribution of 90% of net profits	Minimum distribution of 90% annual net profits	Minimum distribution of 80% annual net income
Foreign ownership restrictions (investors into the REIT)	Foreign ownership restricted to 49% when listed on the Tadawul	No foreign ownership restrictions	No foreign ownership restrictions	No foreign ownership restrictions	Foreign ownership is restricted to 49% when listed on the Qatar Stock Exchange
Foreign ownership restrictions (REIT investing into assets)	REITs with foreign owners cannot hold assets in Medina or Makkah	No restrictions, unless the assets are located within the area(s) designated to UAE/GCC nationals	Not permitted to invest in undeveloped land and mortgages	No restriction on assets	Untested

The treatment of REITs from a tax perspective

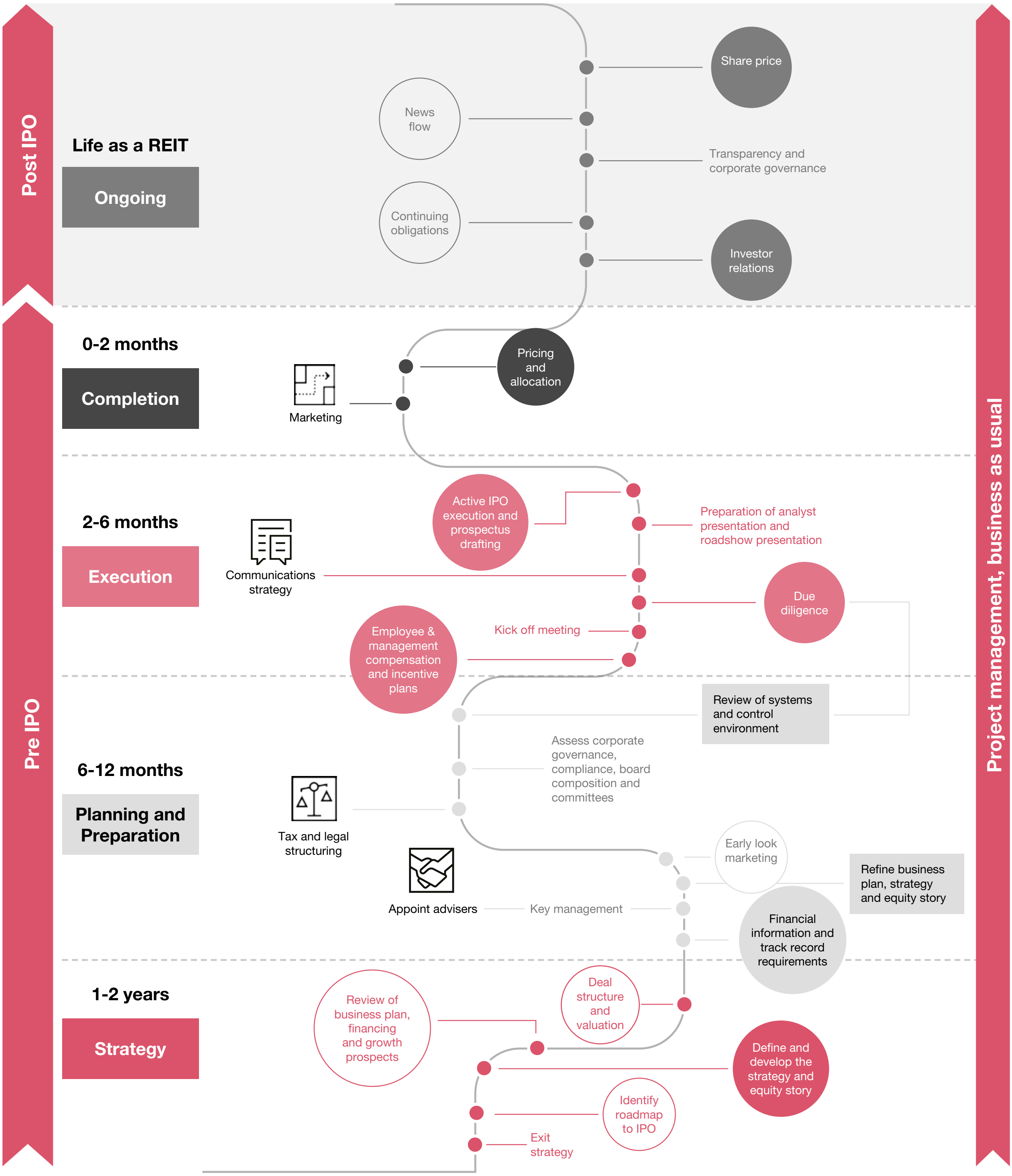
The tax profile of the REIT would depend on the domestic tax law and current practice

Country	KSA	UAE	Bahrain	Oman	Qatar
Targeted REIT legal form from a tax perspective	A KSA fund regulated by the CMA. Currently as CMA regulated funds cannot be registered for tax, in practice they are not taxed	N/A as there is currently no applicable CIT regime	N/A as there is currently no applicable CIT regime	An Omani investment fund incorporated and separately licensed and registered with CMA, which can benefit from tax exemptions for regulated investment funds	A Qatar Financial Center ("QFC") REIT that qualifies as a special investment fund. It is currently untested how Qatari property held by a QFC REIT would be taxed in Qatar
Tax for transferor on seeding of assets into the REIT	Gains subject to 2.5% Zakat or CIT at 20% No property / transfer taxes	No CIT No exemption from UAE property transfer fees	No CIT No exemption from Bahrain stamp duty	Gains subject to CIT at 15% if seeded by a corporate. No tax if seeded by an individual No exemption from transfer taxes	Gains subject to CIT at 10% No property / transfer taxes
Tax on rental income and capital gains received by the REIT	In practice, no Zakat or CIT	No CIT	No CIT	No CIT	Untested
Tax on disposals of REIT interests	No Zakat or CIT for foreign unitholders, as no practical basis to currently register the fund in order to tax the disposal by the foreign unitholders	No tax	No tax	No tax if the REIT is registered with the Muscat Securities Market	Untested
Withholding tax ("WHT") on distributions from the REIT to: 1 – GCC residents 2 – Non-GCC residents	No WHT to KSA residents 5% WHT to other GCC and foreign resident unit holders	No WHT	No WHT	No WHT	No WHT

Note: Based on data extracted on 26th February 2018

Conversion to a public REIT is complex

We are well positioned to advise you through the key steps of the process

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