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A REAL ESTATE INDUSTRY ANALYSIS IN A MACROECONOMIC CONTEXT

Alexandra Bratu
The Bucharest University of Economic Studies, Romania
alexandrabratu89@yahoo.com

Abstract

Despite significant declines registered in the real estate performance metrics, the UAE remains amongst the top global countries if we look at the investments on the long term, especially when considering the positive market fundamentals. This article provides an overview of the UAE real estate industry for companies looking to establish their business in this country. The areas covered in this article include macroeconomic aspects and a focus on the real estate market. Based on the analysis performed, the Emirates have attractive real estate markets for investors for several reasons: positive economic growth, good infrastructure, a favourable tax system, safe and secure environment. The article contains further details on key issues that companies should consider when deciding whether to enter the real estate market in the UAE or not.

Keywords: UAE, macroeconomic, productivity, GDP, real estate, market, factors

INTRODUCTION

The real estate sector in the United Arab Emirates (UAE) is facing increasing discussions and concerns amongst local investors that the market might be affected by important price changes. Despite significant declines registered in the real estate performance metrics, the UAE remains amongst the top global countries if we look at the investments on the long term, especially when considering the positive market fundamentals. The purpose of this article on the UAE real estate market is to evaluate the industry, examine the external and internal factors that affect the sector and establish how a company can gain advantage in the real estate industry.

MACROECONOMIC OVERVIEW

Developed economies are characterized by a modest positive growth and if we look at the top macroeconomic indicators that influence the real estate industry, we observe that the United Arab Emirates is not an exception.

Gross Domestic Product Growth

The table below contains the calculated growth rates of the nominal GDP for the period 2010-2015. It shows that the highest growth rate was registered in 2011 so, we can say that from 2010 to 2011 the nominal GDP in the United Arab Emirates has increased by 21.84%. On the other side, the highest decrease of the nominal GDP was registered last year when the GDP decreased by 7.30%.

For example, in 2010 the GDP growth rate is:

$$G_Y = \frac{Y_{2010} - Y_{2009}}{Y_{2009}} = \frac{286049.34 - 253547.36}{253547.36} = 12.82\% \quad (1)$$

Table 1. The growth rate of the nominal GDP in the UAE

Year	GDP (mil. USD)	Growth rate (%)
2009	25347.36	
2010	286049.34	12.82
2011	348526.07	21.84
2012	373429.54	7.15
2013	387192.10	3.69
2014	399451.33	3.17
2015	370292.72	-7.30

Source: Author's calculations using data from the World Bank

Similar formulas have been applied in order to obtain the growth rates of capital and labour. Because labour and capital data is not available in 2015, the period for calculating the productivity is 2010-2014.

$G_K = \frac{\Delta K}{K}$ and $G_L = \frac{\Delta L}{L}$

The results can be found in the table 2, together with the data used for calculation:

Table 2. The growth rates of labour and capital in the UAE

Year	Labour Force	Capital (mil.USD)	Growth Rate of Labour (%)	Growth Rate of Capital (%)
2010	5644707	70125.033	9.84	-0.48
2011	5947418	75604.08	5.36	1.64
2012	6133667	84205.58	3.13	11.33
2013	6232093	87559.70	1.60	8.09
2014	6302492	94745.54	1.12	3.77

Source: Author's calculations using data from the World Bank

Total Factor Productivity

The amount of output that cannot be explained by the inputs used in production is called total factor productivity (Comin 2006). The following formula has been used to calculate the TFP:

$$\mathrm{TFP} = \mathrm{G_Y} - (\mathrm{S_K x G_K} + \mathrm{S_L x G_L}) \quad (2)$$

The TFP was calculated using the following data:

Table 3. Total Factor Productivity calculation

Year	Gy	GL	Gk	Capital share (% GDP)	Labour share (% GDP)	Sk * Gk	SL * GL	Sk * gk + SL *GL	TFP (%)
2010	12.82	9.84	-0.48	25.67	74.33	-0.12	7.31	7.19	5.63
2011	21.84	5.36	1.64	22.65	77.35	0.37	4.15	4.52	17.32
2012	7.15	3.13	11.33	23.15	76.85	2.62	2.41	5.03	2.12
2013	3.69	1.6	8.09	23.19	76.81	1.88	1.23	3.1	0.58
2014	3.17	1.12	3.77	24.33	75.67	0.92	0.85	1.77	1.40

Source: Author's calculations

For example, in 2014 the productivity is:

$$\mathrm{TFP} = \mathrm{G_Y} - (\mathrm{S_K x G_K} + \mathrm{S_L x G_L}) = 3.17 - (24.33\% * 3.77\% + 75.67\% * 1.12\%) = 1.4\% \quad (3)$$

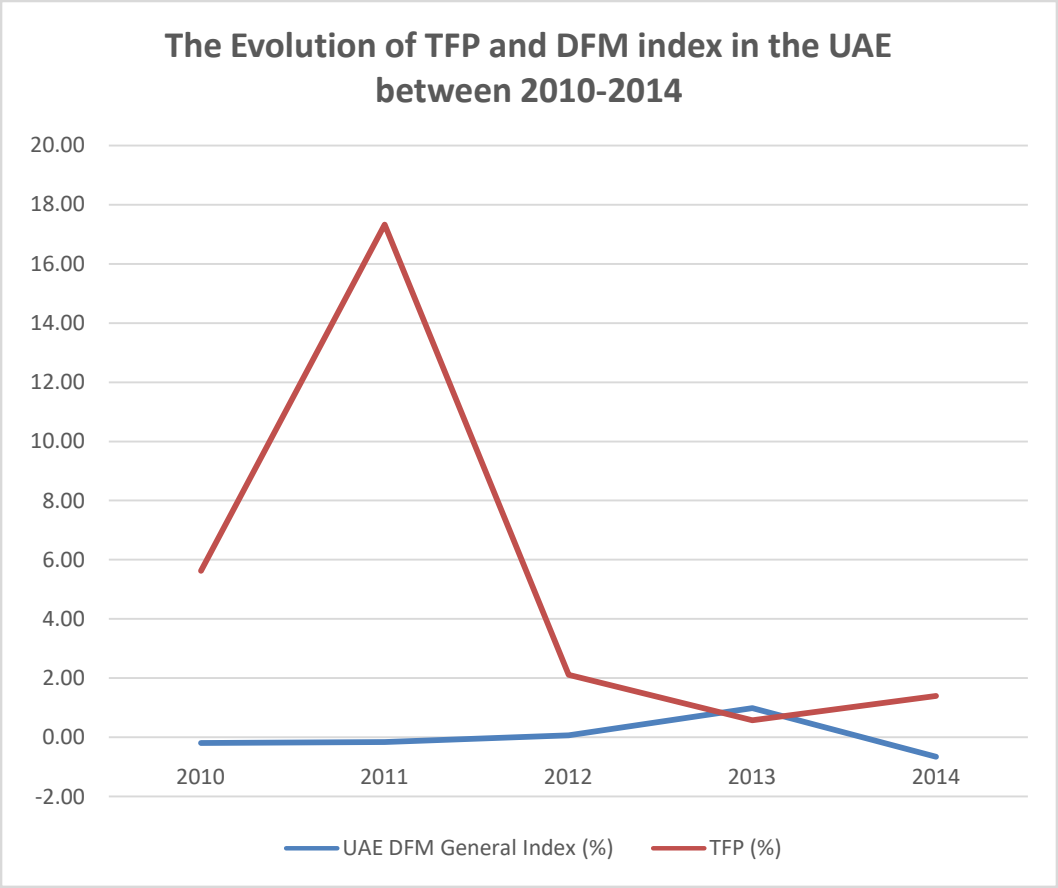
Total Factor Productivity and Stock Prices

The relationship between TFP and stock prices has been observed by analysts for centuries and most of their results conclude that a growth in the stock prices generates a growth in productivity on the long-term. So the shocks that have an impact on the stock prices and

stimulate companies to invest in new technologies affect productivity on the long-term because it usually takes time for the new technologies to be implemented and generate productivity (Comin et al. 2016).

The relationship between stock prices and total factor productivity is explored by plotting the productivity over the last 5 years and the evolution of the average annual growth rate of the Dubai Financial Market (DFM) index. The evolution of the two variables shows there is a weak negative relationship on the short-term between them so, we can say that the productivity numbers are not consistent with the stock prices.

Figure 1. TFP and DFM index



Source: Author's representation using data from the World Bank and DFM database

Looking at the evolution of the DFM index, we observe there was a concern of a stock market bubble in 2014 because the stock prices were driven very high. However, their expansion was followed in 2015-2016 by a relatively smooth contraction.

Figure 2. The Evolution of the DFM index in UAE 2012-2016

Source: Bloomberg.com

Corruption and Ease of Doing Business

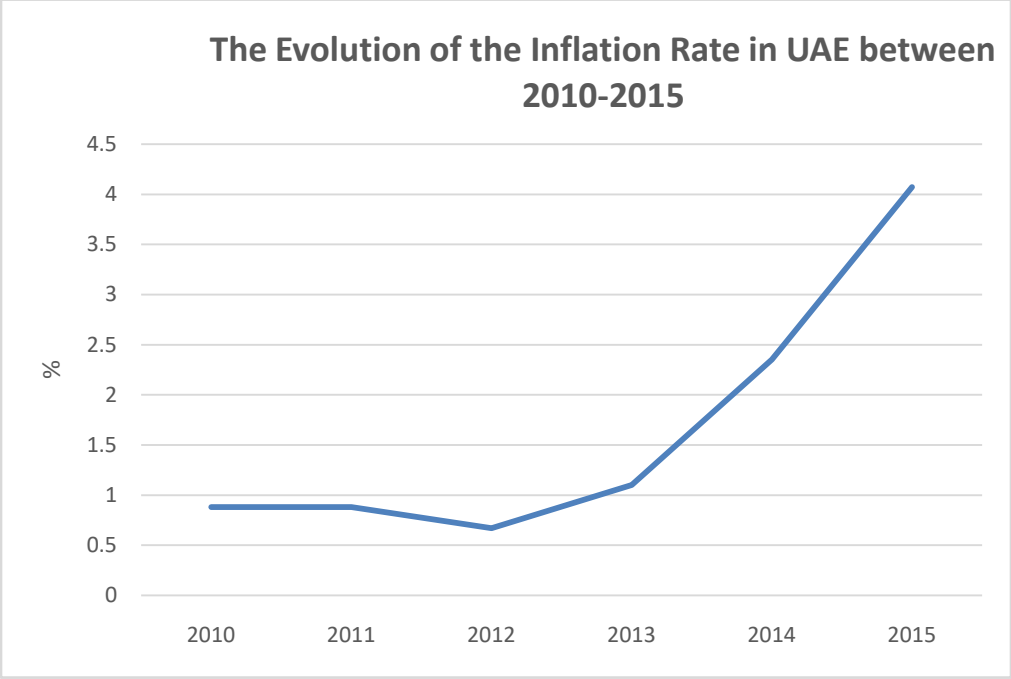
The UAE is the least corrupt countries in the Arab world and it was ranked 23rd out of 168 countries in 2015, according to the Transparency International Organization (2015). Official numbers show that corruption is not a high risk for companies in the UAE, the country offering a friendly environment for business. The ease of doing business index placed the Emirates on the 31st place out of 189 countries in 2015 and on the 1st place among Arab countries. However, it might be difficult for foreign companies to enter the market as they might have an uneven position compared to local companies due to the participation of the dominant families in the economy, which help facilitate sponsorships (HSBC Bank Middle East Limited & PricewaterhouseCoopers 2013).

Although the official numbers make the Emirates a safe business environment, it is still difficult to combat corruption due to reasons such as: the absence of anti-corruption units, almost no information on business corruption, unfair competition for foreign companies as they have to rely on local sponsorship, the difficulty to implement anti-corruption laws due to the lack of disclosure on corruption cases (Baum & Murray 2010).

Inflation Rate

The average inflation rate from 2010 until 2015 is 1.65%, reaching the highest value of 4.07% in 2015 and the lowest of 0.67% in 2012. There has been a significant increase in the inflation rate since 2012 from 0.67 to 4.07% (Figure 3).

Figure 3. The Inflation Rate



Source: Author's representation using data from the World Bank

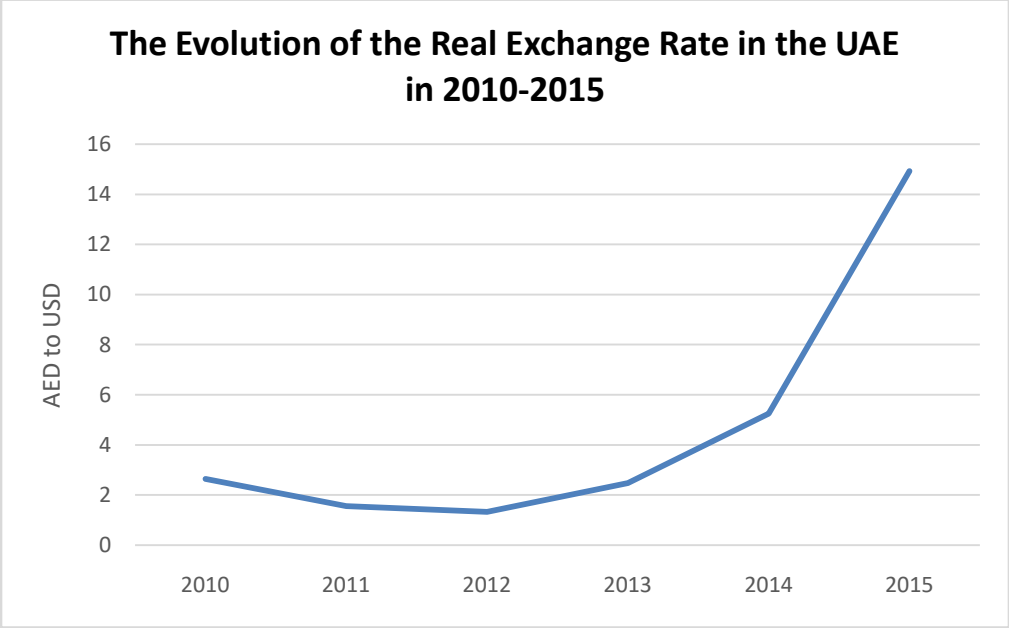
The inflation control process in the UAE is limited because of its dependency on the US Federal Reserve and because of a monetary policy characterized by an independent interest rate, fixed exchange rate and free capital flows (Bank Audi sal 2014). Therefore, it is not possible for the Emirates to fight inflation using the interest rate, but instead they set supply equal to demand by planning the capacity in the industries where the supply has declined. However, this approach is not as useful as setting interest rates because it affects both firms and consumers.

Real Exchange Rate

The price of the UAE Dirham has been fixed at 3.6275 since 1997 which represents the nominal value of the exchange rate. The real exchange rate has registered a slight decrease from 2010 to 2012, followed by a significant rise from 2012 to 2015 by around 10.16%.

While a pegged currency to the US dollar provides stability and offers confidence to investors, one of the main downsides is a high inflation because it increases the monetary supply (Ishfaq 2010). Taking into consideration the volatility of the oil price, the fixed exchange rate regime may be under pressure and it might be necessary for a change to be implemented. However, analysts believe the UAE economy will still be good economy for investments, having strengthened its non-oil sector (Bank Audi sal 2016).

Figure 3. The Real Exchange Rate



Source: Author's representation

The Bottom Line

If we summarize the positive and negative aspects in order to draw a conclusion whether the macroeconomic environment of the UAE is conducive to entry or not, we would say that overall, this is an attractive country for investments.

Positive	Negative
• Positive economic growth • Secure currency • Safe working environment • Low corruption • No legislation on corporate tax • Low financial risk on investments	• High contribution of the oil sector to the GDP (around 30%) • High inflation rate • Local sponsorship required • 51% local partners outside of free zones

REAL ESTATE INDUSTRY ANALYSIS

Market Structure

Further to the drastic fall of the oil prices in 2014, the pace of the economic growth in the UAE has slowed and caused the real GDP growth to fall to 2.7% in 2015 from over 4% in 2014 (JLL 2015). This had serious implications on the real estate market, which cooled down in 2015 after great expansions in 2013 and 2014.

The segments of the real estate market in the Emirates are: retail, office, residential and hospitality markets. The existing data regarding the ratio of each market are incomplete, so it was not possible to calculate the figures. However, based on some calculations performed using the "UAE Economic Report" (Bank Audi sal 2016), the investment in the residential market in 2015 was approximately 26 billion AED, while the value of the investments in the hospitality market was 65 billion AED.

Emaar Properties is one of the major players in the real estate industry in UAE, with a revenue of 1.38 billion USD in 2014. Another real estate giant is *Ezdan Real Estate* which has a market capitalization of 14.5 billion USD, followed by *Jabal Omar Development* with a market capitalization of 12.9 billion USD (Bank Audi sal Report 2015).

Market Boundaries

It looks like the real estate market structure is characterized by an oligopoly-although small firms operate in the market, there are a few large companies that dominate. New companies willing to enter the real estate market may encounter some entry barriers that are specific to oligopolistic markets such as structural, legal or strategic barriers. For example, the requirement of certain construction permits, economies of scale, product differentiation, limit pricing or control of certain technologies can be serious issues for new entrants.

Demand Analysis

The Emirates' efforts to help recover the real estate market after the difficulties experienced as a consequence of the global economic recession, have proved to be successful in terms of economic growth for Dubai and Abu Dhabi. However, Dubai is still characterized by a declining demand in terms of residential performance, rentals and volumes of property transactions.

The UAE real estate market outlook looks favourable, advancing towards economic growth on the long term. The growth of this industry is supported by the regulatory framework, UAE safety environment, improved projects, and the Expo 2020 increasing demand in the residential, office and hospitality markets (Deloitte 2016).

While there doesn't seem to be a threat of substitutes for the real estate industry and it is very difficult to evaluate the impact on profitability, the closest substitute might be the rehabilitation of constructions.

According to data from the Dubai Land Department (KPMG Lower Gulf Limited 2016), there has been a decrease in residential demand of around 30% in 2015 compared to 2014 and a decrease of 13% in residential prices in Dubai. Based on this data, the price elasticity demand is given by equation 4.

$$PED = \frac{\%change\ \ in\ demand}{\%\ change\ \ in\ price} = \frac{-30\%}{-13\%} = 2.3 \quad (4)$$

The result shows that the PED is elastic and that the price and quantity are positively related, so if the price increases, the quantity demanded will increase as well. PED help real estate companies find out how customers react to price changes in order to predict sales and set prices. In this case, a 10% price reduction leads to a 20.3% decrease in sales for firms in the real estate industry.

The residential real estate market in Dubai is characterized by a small number of landlords that have power over the market and tolerate low occupancy rates instead of decreasing their prices. According to a Residential Occupancy Rate Survey, Emaar Properties one of the largest companies in the real estate market, have an occupancy of 94%, compared to 70% of other developers. So it can be concluded that the residential market in Dubai acts like an oligopoly with a small number of firms having some market power.

Costs

After experiencing an unsustainable growth in 2013-2014, the real estate market growth is now slowing down both in Dubai and Abu Dhabi. The apartments' sale prices decreased by 7.6% in Dubai and 7.3% in Abu Dhabi in 2015, while the villas sale prices dropped 3.7%, respectively 4% in Abu Dhabi. Being one of the most volatile markets in the world, Dubai experienced a 53% house price crash after the economic and financial crisis in 2008/2009.

While some analysts are optimistic about the future of the real estate industry in the UAE, others expect property prices to fall by up to 20% in 2016. One of the pricing strategies firms in the real estate market use is the "99" strategy which makes the customer perceive the price as lower and more attractive. Apart from this, there are no official articles or reports discussing the different pricing strategies that real estate firms in the UAE might use.

Barriers to Entry

The downsides of opening a business in the UAE are less significant than the advantages, with low barriers to the real estate market entry the country represents a captivating market for foreign companies. One of the structural barriers that affect the entry to the real estate market is that foreign companies must have a local partner owning minimum half of the company if their business operates outside of an industry-specific zone.

Another disadvantage for investors can be that the Emirates are not an English law jurisdiction. Therefore, the threat of new entrants to the real estate market is proving to be

relatively weak. Abu Dhabi, unlike Dubai, has recently introduced new regulations that allow foreigners to own properties on a freehold basis. Therefore, it looks like the Emirates are willing to make significant changes in order to ease the foreign investors' entry to the market.

CONCLUSIONS AND RECOMMENDATIONS

While the UAE Government continues to invest in development and infrastructure projects, the country's efforts to support the non-oil industry by boosting the real estate sector have been successful for the two most important emirates. Therefore, with a careful recovery and a sustainable growth, the UAE remains a captivating market for both new entrants and current incumbents.

In order to protect their positions, the incumbents should start defending their customer base by predicting their behaviour in case of new market entries. Moreover, they should perform a customer segmentation to find out the vulnerable and the valuable ones that are worth fighting for. Finally, incumbents should react by increasing the barriers to entry, for example by reducing the price.

Despite the drastic fall in oil prices followed by the slowing pace of the GDP growth registered in 2015, the long term outlook for the real estate market looks favourable. Although the economy is confronted with the reality of even lower oil revenues, which clearly has a significant effect on market confidence, the maturity of the real estate industry and the regulatory framework are positive indicators of its stability.

Given the present state of the real estate industry in the UAE, this is an attractive market for new entrants, but it is recommended that they pay attention to some critical issues and considerations related to the legal system such as: free zone restrictions, foreign ownership restrictions, and profit transfer or taxation laws. Another recommendation for new investors is to pursue a price reduction strategy and enter the market with improved versions of the products, while aiming at new geographic areas.

For further analysis studies, it is important to make simulation analysis of UAE indicator in the future, in order to create a strategy analysis for choosing the moment when a company should enter the market.

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