Private equity and real estate in the Gulf

Three reasons to be positive

Introduction: Why private equity matters

Worldwide, private equity funds closed deals worth $124 billion in just the fourth quarter of 2023. Fully a quarter of all merger and acquisition deals last year involved private equity.[1] As concerns over inflationary headwinds, rising interest rates and general macro uncertainty diminish, markets such as the Gulf have become increasingly attractive. The prospect of even greater sums to be invested this year, including in real estate assets, has become very real. As a result, private equity has now become a topic of serious debate in Gulf markets. But what are the firms that are involved? And what constitutes 'private equity' exactly?

Private equity can be defined as capital employed by investors to buy shares, either in public companies to take them private ('buy-outs') or in private companies with the aim of developing them ('growth capital'). In each case, the objective is eventually to sell the stake at a profit (an 'exit').

Invested capital from private equity can be used in many ways: to strengthen balance sheets and allow for more borrowing; to introduce new technology or expand into new regions; or to restructure the business to generate more efficiency and achieve better financial performance. Private equity investment is normally organised into separate funds, each of which has a designated target sector, size and, often, geographical reach, and is directed towards a particular class of investor. Institutional investors such as pension funds, banks and insurance companies are familiar participants in such funds.

Worldwide, private equity amounts to just under 10% of the value of publicly traded equities. In 2021, that was around $10 trillion.[2] An amount of that size certainly matters, quite apart from the significance of individual deals. The financial firepower of major private equity investors gives them access to deal opportunities of exceptional quality. In real estate, one of the most well-known examples, and certainly one of the largest, was the purchase by Blackstone in 2018 of a chain of US warehouses – a highly prescient deal valued at $18.7 billion.[3]

In the Gulf, private equity grew steadily but then suffered severe setbacks. First there was a winnowing out following the Global Financial Crisis, which cut the number of private equity firms from almost a hundred down to a handful. Then there was the collapse of Abraaj in 2018, a seismic event from which the sector is still only in the early stages of recovery. S&P estimates that private equity flows to the region amount to approximately $20 billion annually.[4] According to Mergermarket data, this accounted for only 5% of deals in the UAE between 2020 and 2022.

The market presence of private equity is still vastly outweighed by government-related entities such as sovereign wealth funds (SWFs), family offices, corporates, and institutional investors.[5] Private equity in the Gulf is returning, however, built on much more secure foundations. First, the market has been more open to foreign ownership of UAE onshore entities after the enactment of Federal Law No. (32) of 2021 on Commercial Companies which relaxed foreign ownership restrictions.

Second, surviving regional players such as Gulf Capital, Riyadh Capital, NBK Capital, Jadwa and Sedco are now demonstrating a surer touch: more detailed due diligence, greater transparency to outside investors and, perhaps above all, a cautious, value-driven investment strategy that prioritises good dealmaking and value added in the construction of their portfolios across multiple asset classes. They are now backed by a tougher insolvency law brought in by Dubai in the aftermath of the Abraaj collapse,[6] as well as the readiness of the court system to involve itself in the case itself. [7]

Structuring private equity

In most cases, private equity funds employ some level of leverage, borrowing at a lower cost than their planned returns.[8] Hedge funds are similar, the main difference being that the capital raised is often employed to acquire and use generally riskier financial instruments and complicated portfolios.[9] Venture capital funds by contrast invest in high-growth companies that cannot themselves take on debt.

Over the past 20 years, private equity has delivered strong returns compared to other asset classes such as tradeable debt and public equity. Broadly, there have been two reasons for this success: skilful dealmaking, resulting in lower purchase multiples compared to listed companies, and the equally competent, if sometimes stringent, management strategies employed by private equity firms.

Most private equity funds worldwide are structured as limited partnerships, either 'open-end' or more traditionally 'closed-end', with a planned length of operation, usually around 15–20 years, and most with a specific target size.

In the UAE, however, where historically there have not been tax incentives to create limited partnerships, corporate structures have been more frequently observed.[10]

Either structure allows investors to unite on a scale they may be unable to achieve alone and, thereby, diversify risk by pooling. Fund managers are often paid both a management fee and a performance fee (or 'carried interest'), the latter usually based on achieved Internal Rates of Return (IRRs). If the fund proves successful, this will frequently become extremely valuable.

There are also two tax issues of fundamental importance for the value of private equity in real estate. First, tax neutrality, i.e. that the fund is 'pass-through' for tax purposes with tax only paid by investors and not by the fund itself.[11] Second, whether carried interest is to be treated as capital gains rather than income and, therefore, taxed at a lower rate. In most jurisdictions it is, although critics suggest that this is neither legally correct nor justified in policy terms.[12]

Private equity investment in real estate

For larger private equity firms, asset allocation is a major element of their strategy. Real estate is a longstanding investment sector for private equity, in contrast to either venture capital, which aims for riskier targets, or hedge funds, which may trade in real estate shares, funds and even derivatives, but rarely own the underlying asset.

Strategies have traditionally varied from 'core' – investment in offices occupied by Grade A rated tenants, for example – through core-plus, value-added, opportunistic, distressed, and debt, each exhibiting different forecast returns and commensurately higher levels of risk.[13] Predictably, research has found that private equity capital flows into real estate after periods of low return on fixed income assets (bonds).

Less predictable perhaps, but welcome news for PERE, has been the finding that liquidity considerations do not seem to play an important role in the decision to invest in real estate.[14]

There are many specifically real estate funds,[15] as well as a range of other PERE investment strategies such as joint ventures, the use of special purpose vehicles and co-investments. In the Gulf, for example, there has been the partnership between Gulf Capital and the US developer and investor Related in both Saudi Arabia and Abu Dhabi,[16] as well as the launch by Jadwa Investments, in partnership with other Saudi market players Tatweer Group, Numu Holding Company and Riyad Bank, of an $800 million closed-end, Sharia-compliant real estate investment fund specifically targeting income-generating properties in Saudi Arabia.[17]

Performance: How well has PERE done?

Regrettably, research into PERE is skewed overwhelmingly towards performance analysis at the expense of wider considerations of how the industry works and how it is developing. There are probably two reasons for this, one structural, the other an apparent paradox. The structural reason is simply that performance data are relatively easy to obtain, and there are plenty of different ways to analyse it. In recent years, for example, more PERE funds have offered daily liquidity and, therefore, pricing to their investors.[18]

Evidence shows that leverage plays a decisive role in PERE returns – not only in the obvious sense that debt is cheaper than equity, but in more complex ways, such as cash-flow waterfalls that enable individual investors to achieve risk-return profiles within the same real estate investment. Wise investors recognise that operational efficiency, market conditions, and industry-specific dynamics also play vital roles in influencing PERE profitability on a per-share basis.[19] Corporate governance issues, specifically the composition of the fund's board, have also become forefront in investors' minds, again largely because of the close correlation with financial performance.[20]

The paradox, though, is that despite the expertise involved, PERE has not outperformed real estate public market returns – in particular, from Real Estate Investment Trusts (REITs).[21] It has been suggested that this has been the result of greater REIT diversification.[22] Perhaps it has also had something to do with REIT strategy, and even their management quality.

Moreover, even the researchers who published the most comprehensive comparative review readily conceded that there are wide disparities between the top and bottom PERE quartiles in terms of IRR.[23] To assume that REITs will continue to outperform PERE, however, is to assume that the future resembles the past. With rapid technological and economic changes affecting real estate markets in a way that has not been seen for decades, it may be that the balance between PERE and REITs has begun to tilt in favour of the former.

The paradox for PERE is therefore this: many potential investors recognise this possibility and are eager, in principle, to commit capital to PERE funds.[24] Some major pension funds are approaching the 20% mark in terms of their real estate allocation strategies, PERE included.[25] But traditional investment strategies revolving around established real estate sub-classes in developed economies, such as offices and even warehouses, are failing to deliver high performance results. Repricing in developed markets is now widely anticipated and, in some cases, already under way.[26] In response, PERE managers have become increasingly selective in terms of where and how they invest. As a result, there is now a surfeit of 'dry powder' – capital already promised to PERE funds but not yet deployed.

| Route forward:

» Future PERE geographies

The first and perhaps most obvious change of course is with respect to the choice of jurisdiction. Unfortunately, two decades ago, PERE funds charged into China, arguably without proper due diligence. The results to this day have been on average less than impressive. So, with the Chinese real estate market still struggling to regain its footing, there is understandably an abundance of caution with respect to geographical diversification on the part of PERE fund managers based largely in the USA, UK and other OECD jurisdictions.[27] International private equity funds such as Blackstone, for example, have decided that the most appropriate way in which to enter GCC markets is via joint ventures with SWFs, but for the time being these have been more focused on mobilising capital for outward-bound investments than buying Gulf real estate itself.[28]

This may well change, especially with the express wish of Saudi authorities to see co-investments in major real estate projects in order both to spread their own risk and encourage foreign direct investment.[29] Other private equity firms are already more proactive – for example, the UK's Berkeley Investments and the US firm General Atlantic (which has invested in regional Prop Tech).

One notable aspect of PERE in the Gulf context is the willingness of international PERE investors to invest not only in existing real estate, but in development as well. Apollo Global Management, for example, has acquired a minority stake in a subsidiary of Aldar Properties in Abu Dhabi.[30] The factors driving success for new entrants are well known: the availability of Shariah-compliant investment strategies, transparency, a performance track record, robust risk management and alignment of interests. All of these are well suited to real estate investments.[31]

» Sectoral shifts in PERE investment

The second major change in PERE investment is sectoral rebalancing. There are exceptions but, in general, PERE funds have invested in traditional real estate asset classes, notably offices, retail, industrial, and multifamily housing.[32] More recently, there has been an acceleration of the gradual shift towards residential real estate. In 2021, private equity firms already represented no less than 85% of the largest acquisitions of multifamily property in the USA.

The argument in favour of PERE investment in multifamily property has been spelled out by its advocates very clearly: strong historic returns, reinforced by lower valuation volatility than commercial real estate driven by more predictable cash flows.

Real estate has also served as an effective hedge against inflation – in the USA, real estate performance has exceeded inflation in six of the last seven inflationary periods. In part, it has been argued, this has been due to cap rate compression, even during a rising interest rate environment.[33]

Finally, real estate has exhibited relatively low correlation with public markets. PERE multifamily housing assets have often matched or exceeded average returns in the S&P500 on an unleveraged basis.[34] As a result, individual deal sizes in this sector are steadily rising.

True, in developed countries, significant concerns have been raised as to the socioeconomic implications of such private equity ownership. At the same time, however, there has been recognition that through development, private equity has a vital role to play in increasing the supply of private rental housing.[35]

» The role of ESG in PERE investment

The evidence is plentiful that environmental, social and governance (ESG) considerations in general and sustainability in particular have now become a critical determinant of PERE investment. Most PERE funds include a sustainability professional as part of the team. The reasons for this are now clear.

First, there has been substantial adoption of and reporting to GRESB in the last five years, suggesting that reporting to GRESB is a form of table stakes for ODCE members.

Second, we now know that participating in GRESB, owning LEED (leadership in energy and environmental design) buildings, and construction according to Estidama and Mostadam standards are all associated with best-in-class total financial returns, mainly because of higher rates of capital appreciation. Third, European evidence now suggests that the Sustainable Finance Directive has also not had any adverse effect on performance.[36] Fourth, the fact that the relationships between fund returns and GRESB participation and scores are independent of local economic conditions is very attractive to PERE funds.[37]

With the rise of the International Sustainability Standards Board and new ESG criteria for real estate, the importance of sustainability is set to rise still further in coming years. PERE funds will be seeking ever-more sustainable buildings.

| Conclusion

Gulf jurisdictions have advantages across the board for PERE funds. First, for obvious reasons, fund managers are drawn to high-performing jurisdictions, and the comparatively superior post-Covid financial performance of Gulf real estate is now uncontested. Second, sectoral opportunities within Gulf jurisdictions are also plentiful, with developers having ample experience of the all-important residential Build-to-Rent sector. Third, aside from the existing benefits of location in zero or very low tax jurisdictions, the impact of switching carried interest taxation methods would be much lower than elsewhere.

Finally, because ESG issues are starting to take centre stage in the allocation of PERE funds, the sheer newness of Gulf real estate, and therefore the high availability of future sustainable real estate with low carbon emissions, high levels of energy efficiency and renewable energy generation will all militate strongly in favour of greater international PERE allocations to the Gulf.

Gulf markets as with all other jurisdictions have complexities in relation to regulation, taxation and, above all, market analysis. To ensure they secure best value for money in their investments, entrants into the Gulf real estate market will need to take advantage of the kind of expertise possessed by chartered surveyors like Cavendish Maxwell with track records in advising major regional players. Likewise, in demonstrating the projected returns of their assets and projects to potential private equity buyers, vendors must be prepared to offer high levels of transparency. Taking advantage of these opportunities requires a high level of advice and property management services.

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