

Managing Geopolitical Risk: A Strategic Imperative for Real Estate

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What is geopolitical risk?

The trajectory of key determinants of successful real estate development and investment, such as construction costs, rents, capitalisation rates and prices, can be substantially altered by geopolitical events, for example, elections, sanctions, wars, and resultant hydrocarbon price spikes. This is as true in the Gulf as anywhere: the Gulf is structurally exposed to geopolitical risk because of hydrocarbon-linked liquidity cycles, expatriate population dynamics and, as demonstrated so clearly by the present conflict, regional security architecture. The present conflict has exposed the degree to which Gulf real estate is entangled with regional security dynamics, making geopolitical risk management no longer optional but foundational.

In the midst of the present conflict in particular, it is important to bear in mind that the extent to which real estate market variables are influenced by geopolitical crises is often exaggerated¹, as real estate markets are resilient and often anticipate the end of crises even as they develop.² During the pandemic, for example, real estate markets served as an excellent hedge to globalised effects on other markets.³ But even so, there is no doubt that geopolitics is an important factor that Gulf developers and investors ought to bear in mind in their decision-making and management processes. This is especially the case since, as has already been observed, real estate firms and Real Estate Investment Trusts (REITs) with sophisticated geopolitical risk frameworks will likely outperform their competitors.⁴ Yet, the absence of coherent geopolitical risk management strategies on the part of developers and investors globally is striking. Why is this?

Taking geopolitical risk seriously

Several factors explain why organisations focus and spend far more on geopolitical risk than on legal, environmental, insurance and contract risks. First is a prevalent but incorrect perception that geopolitical events are both impossible to forecast and intrinsically unmanageable. Understandably, this perception strongly influences developer and investor attitudes to geopolitical risk. Second, geopolitical crises are less frequent than real estate cycles, and therefore they often recede in the public and corporate imagination. The third factor is the potential deal-breaking consequence of managing geopolitical risks: whereas legal risk, for example, involves improvements and constraints in how projects are launched and managed, geopolitical risk management may directly affect whether they are conducted at all, even which jurisdictions are included in strategy. Geopolitical risk management is therefore potentially more of a constraint on management freedom of action than other risk management tools. The fourth, which is a problem with the entire corporate environment, is the management tendency to procrastinate and avoid difficult decisions, which explains the prevalence of ostrich-like behaviour among both developers and investors when confronted with serious risks, whether geopolitical, macro-economic, or purely local market-based. The combination of these factors has led to geopolitical risk living its life in the shadows of real estate decision-making, often relegated to private conversations and rarely formalised as part of due diligence or strategy.

Geopolitical risk consultancies and experts within real estate sector are also rather reluctant in promoting their own success. They do not provide examples of where they have correctly

predicted crises, or where popularly imagined crises have failed to materialise. This may be for fear of revealing their sources, or perhaps because they would not be believed. Arguably, however, they should be much more vocal about their demonstrated capacity to out-forecast amateurs in boardrooms and on social media.

This in turn has meant that specialised geopolitical risk consultancies do not enjoy the same kind of privileged access to the senior levels of real estate developer and investor management as, for example, chartered and quantity surveyors. Rare is the real estate adviser that employs professionals with a geopolitical risk management background. This is despite the fact that developers and investors are far from helpless in the face of geopolitical risk. With the right advice, they have several options that can be brought into play to enable them to navigate such risks successfully.

Strategies for managing geopolitical risk

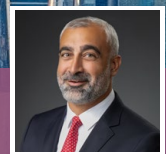
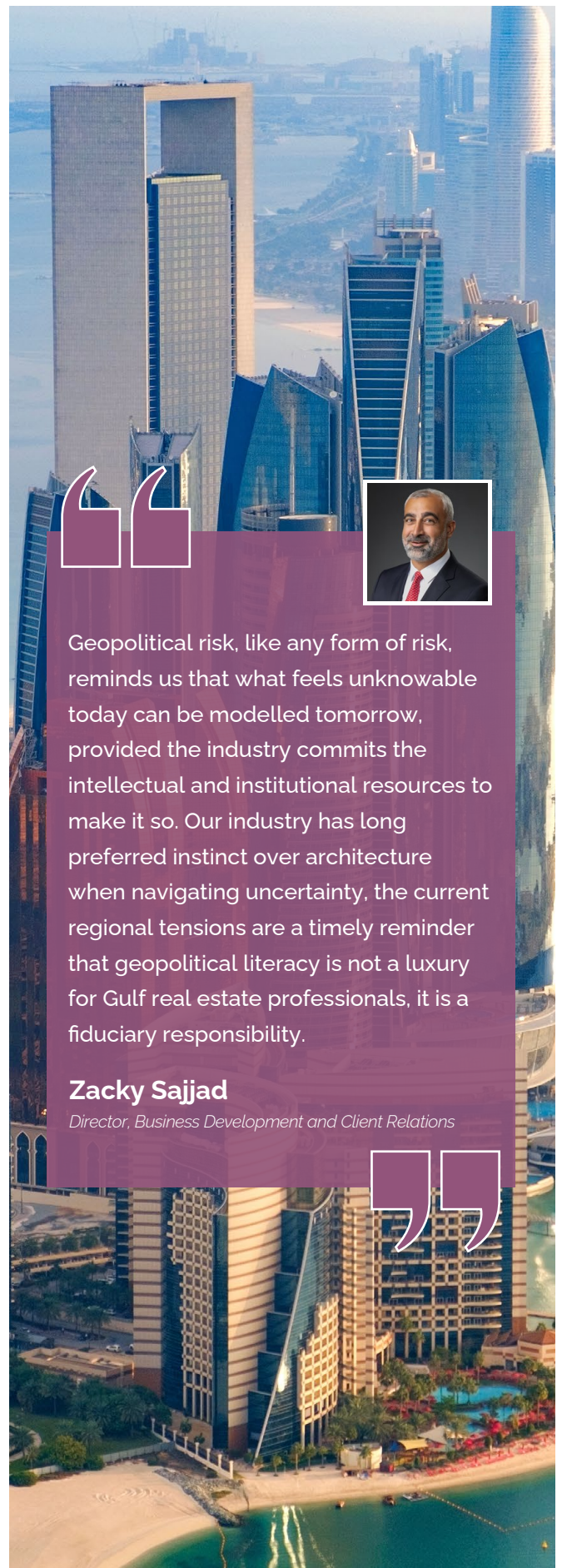
The first strategy is the rational use of intelligence. Effective risk management begins with accurate forecasting. Geopolitical risk today occupies the same conceptual space that climate risk did twenty years ago. Since then, climate risk has moved from the realm of the 'unknowable' to the 'modelled' once probabilistic forecasting and scenario-based planning became the norm. Geopolitics is now finally undergoing the same transition. The question is not whether we can predict geopolitical events with certainty, but whether we can integrate their probability distributions into investment decisions. The answer, as with climate, is yes, but to do so requires systematic expertise, not informal judgments. Equipped with forecasts and models, developers and investors are better placed to incorporate geopolitical risk management into their strategy. Effective strategy for the Gulf should incorporate, at a minimum, crisis scenario modelling; at best, it should anchor those scenarios around an NBCR (neutral, balanced, central and reasonable) forecast that incorporates crises for which there is a high confidence. Each scenario should include the resultant hydrocarbon prices and fiscal implications. NBCR forecasting does not eliminate uncertainty; it disciplines it.

The second strategy is diversification. Conventional portfolio management strategy focuses on the correlation of historical returns between markets. Self-evidently this does not reflect future risks of qualitative change. Gulf real estate markets are heavily correlated, but geopolitical crises may affect them differently. Green and conventional real estate may similarly exhibit different performance during a geopolitical crisis,⁵ although research is as yet insufficiently extensive to draw a universal pessimistic conclusion. Diversification may also include indirect investment, such as REITs, that provide both liquidity and local expertise in markets that are being introduced into the portfolio for specific reasons of diversification.⁶ Perfect diversification is not what is needed: for obvious reasons no one wants equal exposure to a market that performs in an exactly opposite way to the Gulf. Diversification seeks low correlation, not negative correlation: the goal is to preserve upside, not neutralise it. A strategy advocated by several international investors is 'barbell diversification',⁷ which pairs the Gulf with a low-correlation, income-driven market, for example multi-family occupation in the USA, Germany or Japan.⁸ Pairing maturing markets with low-volatility, income-driven sectors such as Tokyo or German multi-family reduces drawdowns without eliminating upside.

Third is the use of derivatives. Property derivatives have had a chequered history, from their early beginnings in London last century through to their implementation on US and European derivative exchanges and occasional Over-the-Counter (OTC) trades in Asia and the Middle East.⁹ Today, the ability to hedge real estate using derivatives is still only partial, but there are workable – if imperfect – hedging architectures using a basket of indirect, macro and proxy instruments that Gulf developers and family offices can actually use when geopolitical risk spikes. They can short bundles of real estate stocks such as the Morgan Stanley Capital International (MSCI) Saudi Real Estate 20/35 Index¹⁰ and the MSCI UAE Investable Market Index (IMI) Real Estate Index¹¹ using an option or a synthetic mechanism such as an OTC Total Return Swap. Derivatives of this kind can also serve to minimise the capital and local expertise required for diversification. Currently the performance of these indices appears to be relatively closely correlated with what we know of how Saudi and UAE real estate markets are behaving through the current conflict, although full real estate market reporting is only monthly at best and historically both of these indices exhibit less than perfect correlation with real estate itself. Gulf developers and investors can also short individual listed REITs and equity index futures locally and in the USA despite the imperfect correlations between direct and indirect real estate. Perhaps even more decisively, they can buy call options on hydrocarbons, specifically Brent oil futures – prices will rise in times of crisis as they have done this time – and interest rate and sovereign bond hedges predicated on rising borrowing costs when geopolitical tensions rise. These instruments hedge the economic drivers of Gulf real estate – liquidity, sentiment, funding costs and oil – rather than the assets themselves. Taken together, these derivative strategies provide price protection for Gulf developers and investors – not perfectly correlated with their own portfolios, but good enough, and certainly worth availing.

Fourth is the implementation of insurance policies. Insurance complements hedging and diversification by protecting against the physical and operational consequences of conflict. Whereas derivatives hedge valuation risk, only insurance responds when a missile, drone or act of political violence damages a development or interrupts rental income. Insurers themselves emphasise that real estate assets will always remain vulnerable without appropriate specialist cover.¹² Industry research shows a staggering potential quantity of global loss running into trillions of dollars, accompanied by a marked rise in demand for terrorism, political-violence and war-risk extensions, alongside expanded business-interruption and denial-of-access coverage.¹³ This evidence underlines that, in the Gulf, as elsewhere, insurance is not a compliance formality but a core instrument of geopolitical resilience.

Finally, the importance of transparency and networks. Concealment of information has often led to accumulated information reaching markets, generating disproportionate effects. While this is largely beyond the control of individual investors and developers, choosing markets that are transparent about geopolitical risks is evidently advantageous.¹⁴ Fortunately, the importance of this transparency for investor confidence has been firmly grasped by Gulf Governments in the present regional conflict.¹⁵ The UAE and Saudi Arabia have both adopted unusually transparent communication strategies during the current crisis, recognising that investor confidence depends on timely and credible information. Developers and investors who follow the example of their host Governments in tracking the impact of geopolitical crises on their operations will likely obtain commensurate benefits from their own transparency. Research also supports what many developers and investors feel instinctively: that continuous geopolitical monitoring, building financial reserves, fostering innovation and partnerships with Government and international organisations – in sum, fostering networks of stakeholders, including supply chains, regulators and investors – all serve their firms well in times of crisis.¹⁶



Geopolitical risk, like any form of risk, reminds us that what feels unknowable today can be modelled tomorrow, provided the industry commits the intellectual and institutional resources to make it so. Our industry has long preferred instinct over architecture when navigating uncertainty, the current regional tensions are a timely reminder that geopolitical literacy is not a luxury for Gulf real estate professionals, it is a fiduciary responsibility.

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| Conclusions

Geopolitical risk is omnipresent, worthy of constant and serious attention from both developers and investors. Managing risks of this kind is certainly possible, but to do so requires three changes. First, a step change in the importance given to geopolitical risk. Second, the recognition that expertise in this area is as legitimate as expertise in financial, environmental or legal risk, and therefore requires resourcing. And third, that as with other risk management tools such as insurance, effective approaches to geopolitical risk management may involve some sacrifice of raw returns. These changes are now likely to spread through the Gulf developer and investor ecosystem. Real estate advisers have a responsibility to help developers and investors implement them cost-effectively, in ways that balance risk and return while preserving competitiveness, particularly once the present crisis recedes into memory.



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