Real Estate
Sector Study

May 2023

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Real Estate

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Global | Overview

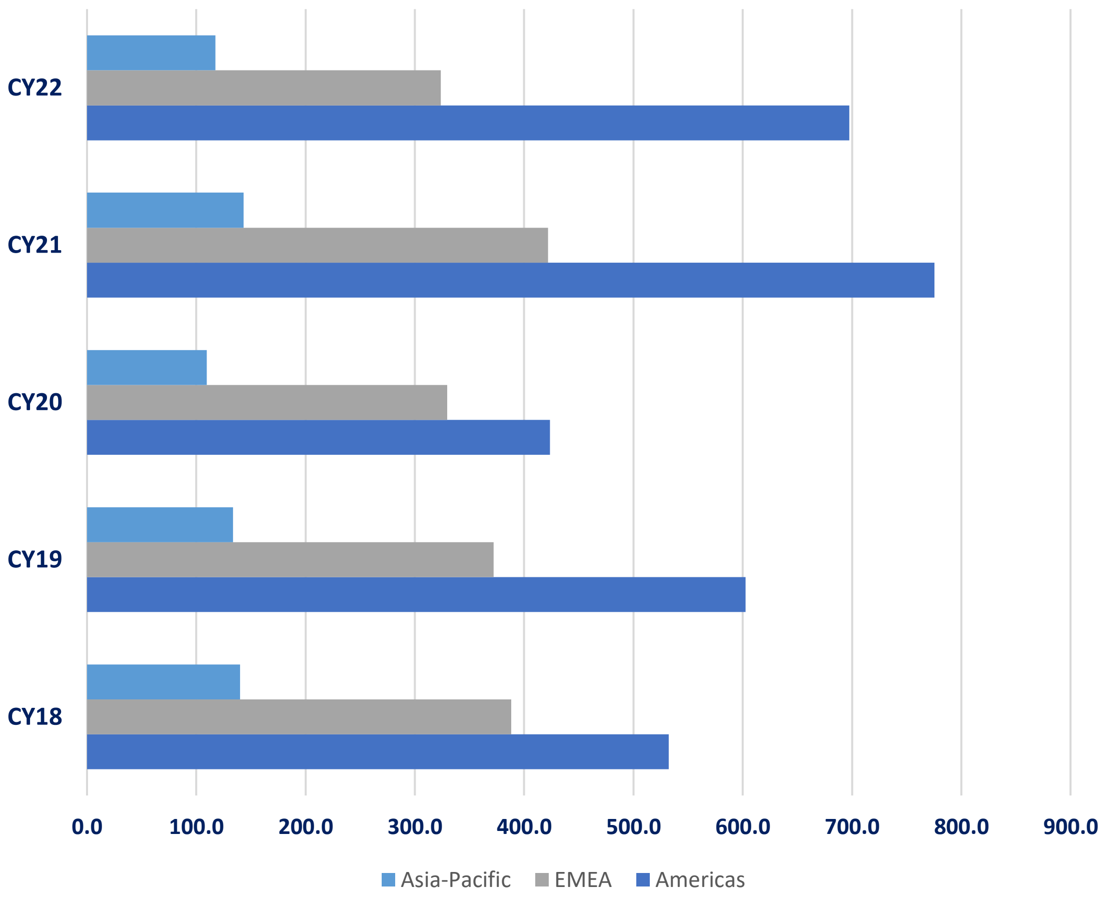
- Global commercial real estate investment volumes, in CY22, decreased by ~20% YoY to USD~1,139bln (CY21: USD~1,426bln), marking lower activity in the real estate market.

- In 4QCY22, investment volumes fell by ~60% YoY to USD~226bln. Region-wise, investments fell by ~63% in the Americas, ~62% in Europe and ~29% in Asia-Pacific (APAC), largely due to rising interest rates and deteriorating economic conditions.

- The real estate sector had previously experienced a record ~55% surge in investment volumes amounting to ~USD1.4trn in CY21. While the 1HCY22 recorded historically strong volumes, rising interest rates and worsening economic conditions weighed down on investment activity in the second half.

- With interest rates rising, inflation picking, and geopolitical uncertainty coming into play, the global real estate sector now faces a new set of risks. Real estate lenders are looking to mitigate their risk. This has led to an increase in cost of borrowing and has re-introduced focus on price determination.

Investment Volumes by Region | USD bln



Source: CBRE, JLL

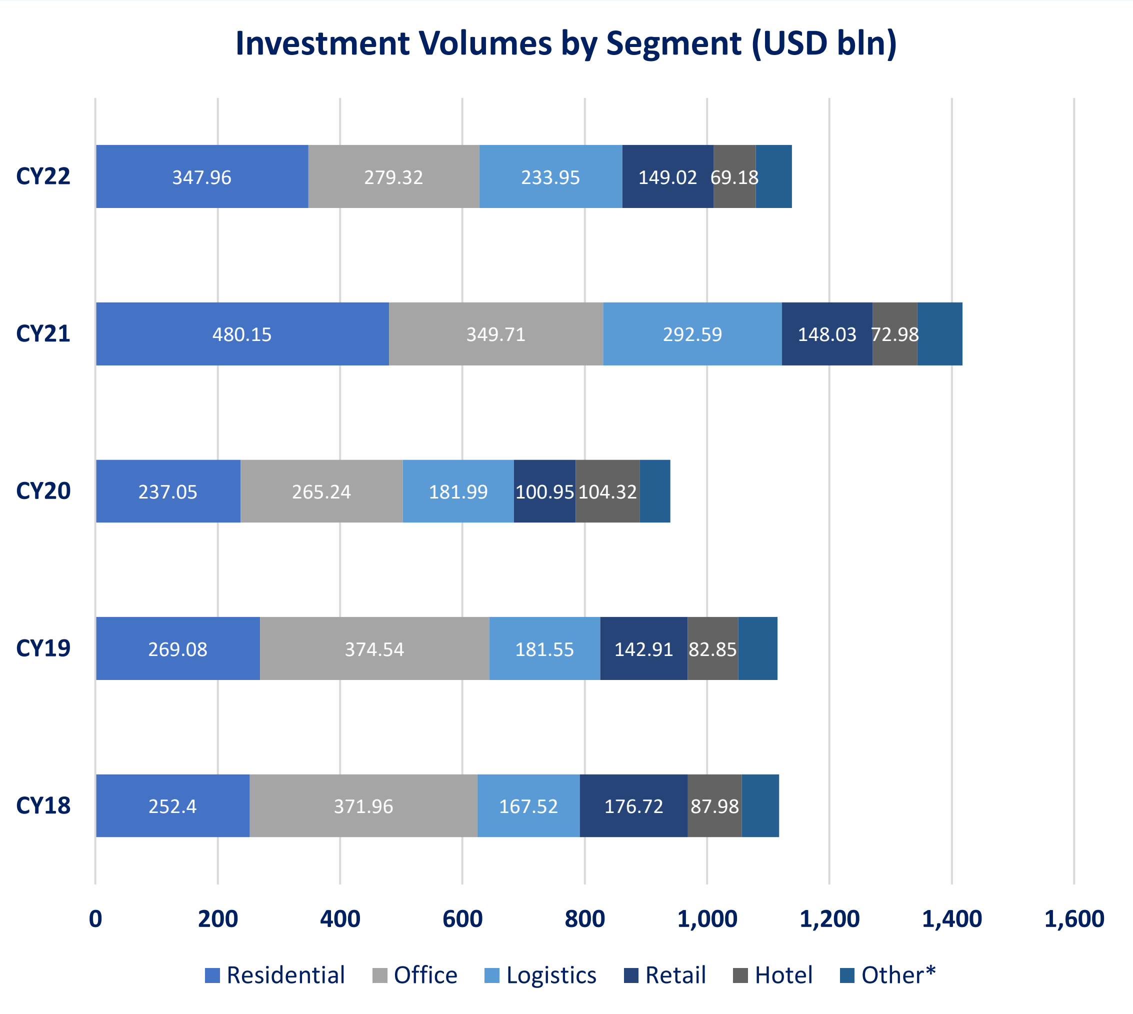
Global | Investment Patterns

- The real estate sector majorly comprises four segments: office, residential (or multifamily), logistics (or industrial), and retail. Of the four major segments, Residential was the largest by volume for the eighth consecutive quarter in CY22. The shares of residential, office, logistics, retail and hotels and others in total global investments are ~31%, ~25%, ~21%, ~13%, ~6%, and ~5%, respectively.

- Investment totals across all property segments fell YoY in CY22 except retail. Multi-family residential fell the most ~28% (grew by ~103% in CY21), while hotels registered the least decline of ~5% YoY (~30% decline YoY in CY21).

- In 4QCY22, multi-family residential remained the largest segment with USD~61bln in investment, down by ~72% from a year ago. Office investment fell by ~57% YoY to USD~56bln, while industrial investment fell by ~59% to USD~49bln. Despite remaining relatively resilient in the first three quarters of the year, retail investment fell by ~53% in 4QCY22 to USD~29bln.

- Investment volumes in the Americas fell by ~63% YoY in 4QCY22 to USD~131bln, as rising interest rates, tighter lending conditions and economic uncertainty took their toll.



*Other includes health care, mixed-use and alternatives.

Source: CBRE, JLL

Global| Sector Investment Patterns

- Global direct investment exhibited a slow start to the year, with 1QCY23 volumes declining by ~56% compared to the previous year, reaching USD~128bln. Over the past 12 months, global investment volumes have dropped by ~35%. This represents the slowest quarter since 2QCY20 and the slowest first quarter since CY12. Institutional investors have been cautious, leading to increased activity in private capital and smaller deals.

- Global office leasing volumes in 1QCY23 were ~13% below 4QCY22 and ~18% lower than SPLY, with leasing activity moderating across all regions. North America experienced accelerated occupancy losses, although Europe and Asia Pacific saw positive absorption during the quarter.

- The sector is marked with low vacancy rates despite healthy construction activities and relatively high completion rates in some markets. Even with only a modest uptick in vacancy rates, rental growth continued in 1QCY23, with YoY increases of ~21.7% in North America, ~12.2% in Europe and ~7.5% in Asia Pacific. Going forward, constructions costs are forecast to remain elevated, therefore, a heightened rental demand could become the driving force for the sector's performance.

- The hotel sector continues to flourish, with global Revenue Per Available Room during 2MCY23 surpassing the CY19 levels by ~6.8%. Recovery has been observed to be the strongest in the Middle East, followed by the Americas and Europe. Asia Pacific remained the only region to not yet have attained the pre-pandemic levels.

- In the U.S., the various operation rental classes, including but not limited to, residential, co-living and Build-to-Rent segments, are still resilient despite easing rental growth and pressure from interest rates. Transaction volumes during 1QCY23 were significantly lower than in the previous year. However, the high levels of available funds indicate potential demand once financing rates decrease, however, given the recessionary outlook for the economy, even in 5MCY23, the Fed is expected to keep a hawkish stance on its monetary policy.

- In Europe, the housing market is undergoing a demand-supply imbalance due to insufficient supply and an overall slowing market, resulting in declining investment volumes. The living sector in the Asia Pacific region continues to attract growing interest in the sector.

Source: CBRE, JLL

Global | Mainland China

- China's GDP growth is expected to rebound to ~4.9% in CY23, supported by a recovery in domestic consumption and expansionary fiscal and monetary policies, despite weaker external demand from regional economies like Europe and the U.S.
- Office demand is projected to stabilize and recover, with the finance, tech, and manufacturing sectors leading the way. New office supply is expected to reach pre-pandemic levels, while the decline in rentals will slow down. China's bank lending heavily relies on the construction sector, with ~30% loans going to house construction and ~60% loans backed by property as collateral. CBRE predicts that commercial real estate investment volume will grow by ~15%-20% YoY to RMB~250bln.
- The property market in China faced challenges in late CY21 and early CY22, with housing sales slumping by ~22% and house prices declining due to a crisis in the sector. The default of Evergrande Group on its overseas bond issues, along with the inability of other real estate developers to repay their heavy debt obligations, contributed to the market turmoil.
- Going forward, a resumption in real estate activity is expected in the country with consumer confidence recovering after repetitive nationwide lockdowns owing to the zero-COVID policy.
- The rebound in domestic consumption will also boost logistics demand, with warehouse net absorption in major Chinese cities expected to increase by ~30% YoY to ~6.4mln sq. m. by CY23. However, the addition of deferred supply from CY22 will result in higher vacancy rates, reaching a five-year high. Low interest rates will create a solid foundation for a rebound in the capital markets, and the active fundraising environment will provide liquidity for commercial real estate investment.

Source: CBRE, JLL, Manulife

Real Estate

Global | Outlook

- Rising inflation, increasing interest rates, and the war in Ukraine will impact investment volumes across the global real estate markets going forward into CY23. Investment volumes in the Americas fell by ~63% YoY in 4QCY22 to USD~131bln, as rising interest rates, tighter lending conditions and economic uncertainty took their toll.

- Similarly, European investment volumes fell by ~62% YoY in 4QCY22 to USD~64bln, largely due to rising interest rates and an economic slowdown. Europe very narrowly escaped a more severe downturn owing to a milder winter season which, in turn, caused a drop in energy prices.

- Asia-Pacific investment volumes decreased by ~29% YoY in 4QCY22 to USD~30bln. Activity in China and Japan began to rebound but increased financing costs caused investments in Singapore to slow down. For CY22, APAC investment volumes fell by ~19% to USD~118bln.

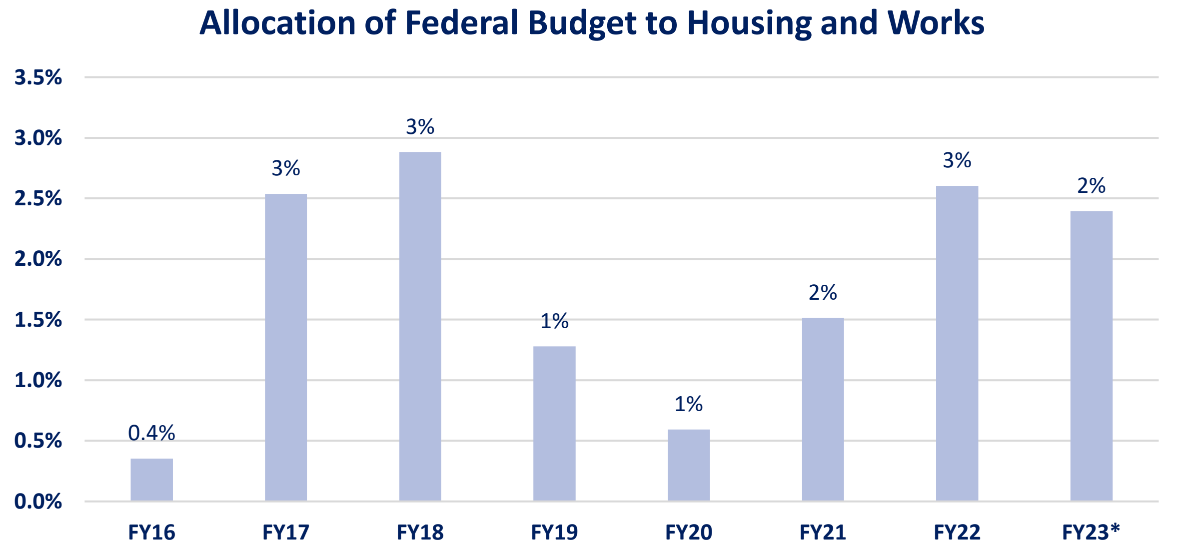
- A global recession which is expected in CY23 will weigh on real estate fundamentals and investment activity, given especially the interest rate volatility and monetary tightening across most economies. CBRE forecasts an ~11% fall in global investment volumes for CY23, with ~15% decrease in the Americas, a 5%-to-10% drop in Europe and ~5% decrease in APAC. A significant YoY slowdown in investment are expected to continue well into 2QCY23, followed by a healthy recovery in the second half of the year.

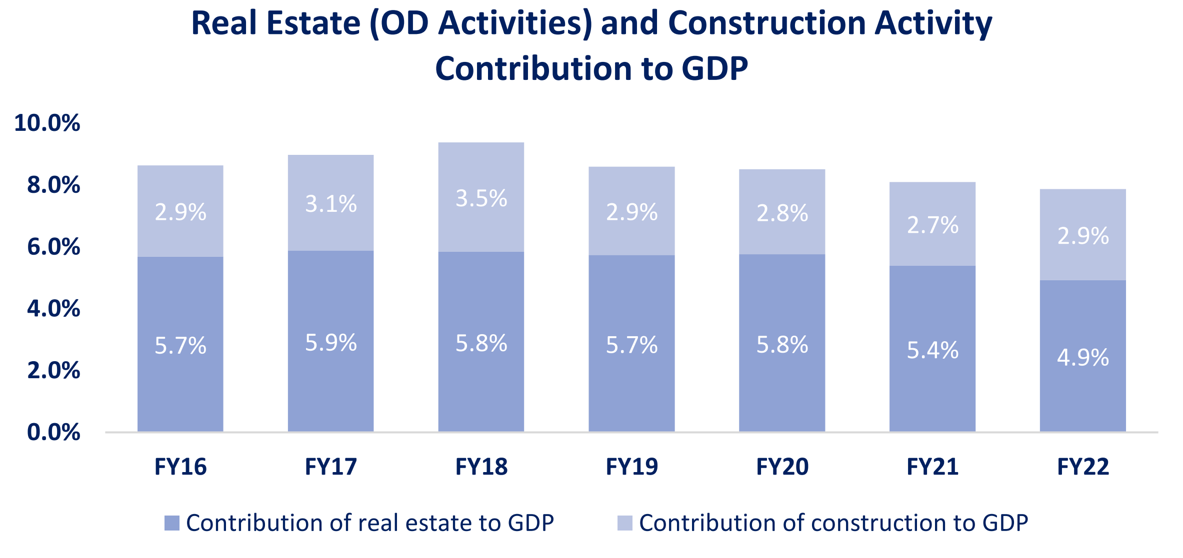
Source: CBRE

Real Estate

Local | Overview

- Real estate includes developed or undeveloped land, housing or commercial projects including commercial markets or multi-story buildings (both commercial or residential), shopping centers, restaurants, hotels, industrial projects, infrastructure development, and mixed-use buildings. The Sector comprises companies engaged in real estate development and operation. It also includes companies offering real estate related services and real estate investment trusts (REITs).
- Relative to construction activity, real estate has contributed a larger share to Pakistan's GDP over the FY16-22 period. During FY22, real estate's contribution to GDP was ~4.9% (FY21: ~5.4%). Similarly, where construction formed ~0.9% in the Gross Fixed Capital Formation for the Private Sector (at current prices), Real Estate activities formed ~17.6% during FY22, the second-highest after Agriculture.
- Housing and works (which includes construction of roads and refurbishment of public property and infrastructure development) received a slight decrease in budget allocation in FY23 of ~2.0% (FY22: ~3%).





Source: SECP, PBS, Ministry of Planning, Development and Special Initiatives

Real Estate

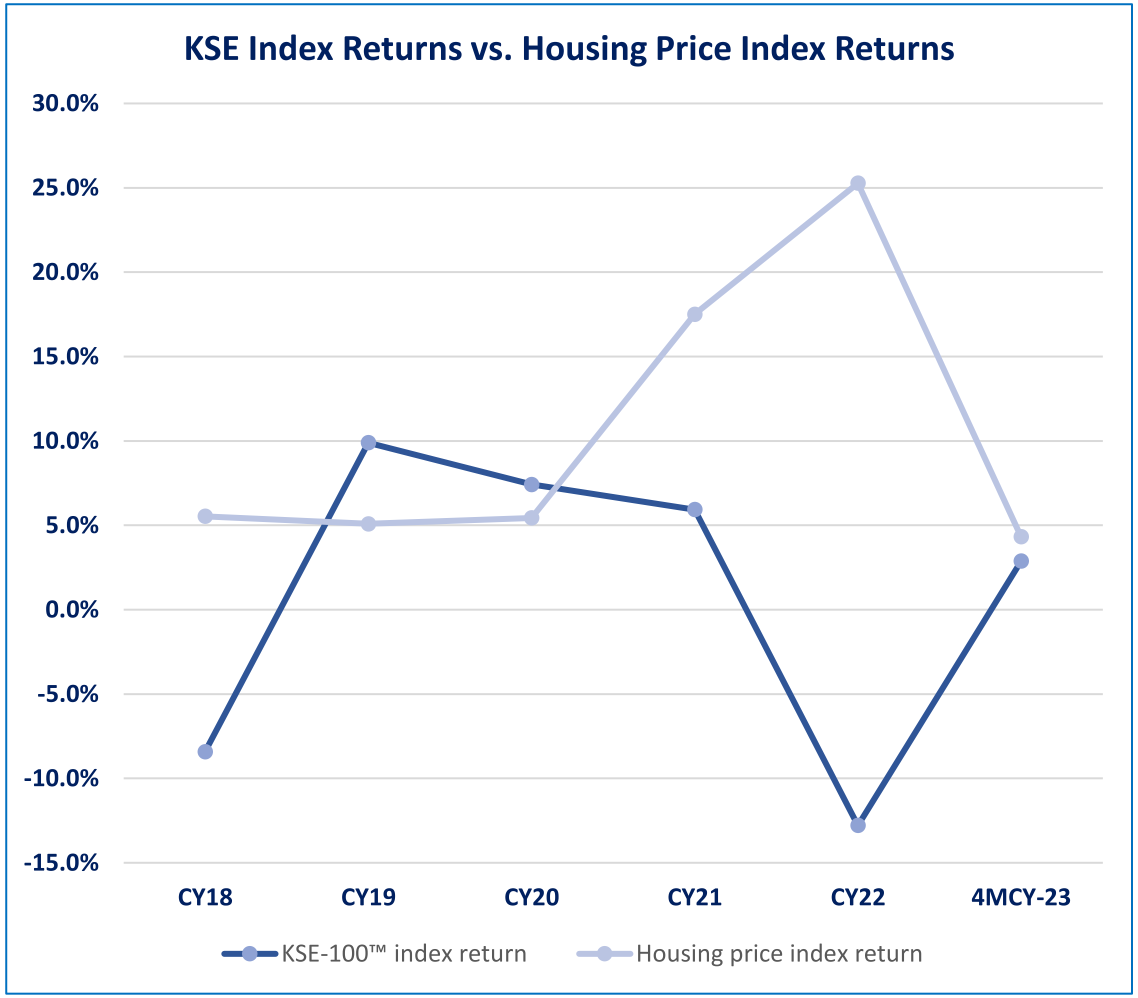
Local | Portfolio Returns

- Over the CY18-4MCY23 period, the KSE-100 index returns exhibited substantial volatility relative to the housing price index. Volatility in returns offers more opportunity for rewards and losses.

- From CY20 onwards, prices were rising due to higher demand for residential real estate following the introduction of government schemes for builders, developers, and aspiring homeowners.

- However, for the period CY20-4MCY23, the housing price index also remained buoyant. Where real estate activity picked up during CY22, it registered a significant slowdown during 4MCY22, which could be attributed to lower overall investments in the sector.

- During 4MCY23, the trend of housing price index was observed to be on a lower end (at ~4.3%) as against the upward trajectory during the previous year (CY22: ~25.3%). This likely resulted due to the discontinuation of government housing schemes and the overall high levels of inflation in the country (house rents form ~19.3% in Urban CPI and ~8.6% in Rural CPI).



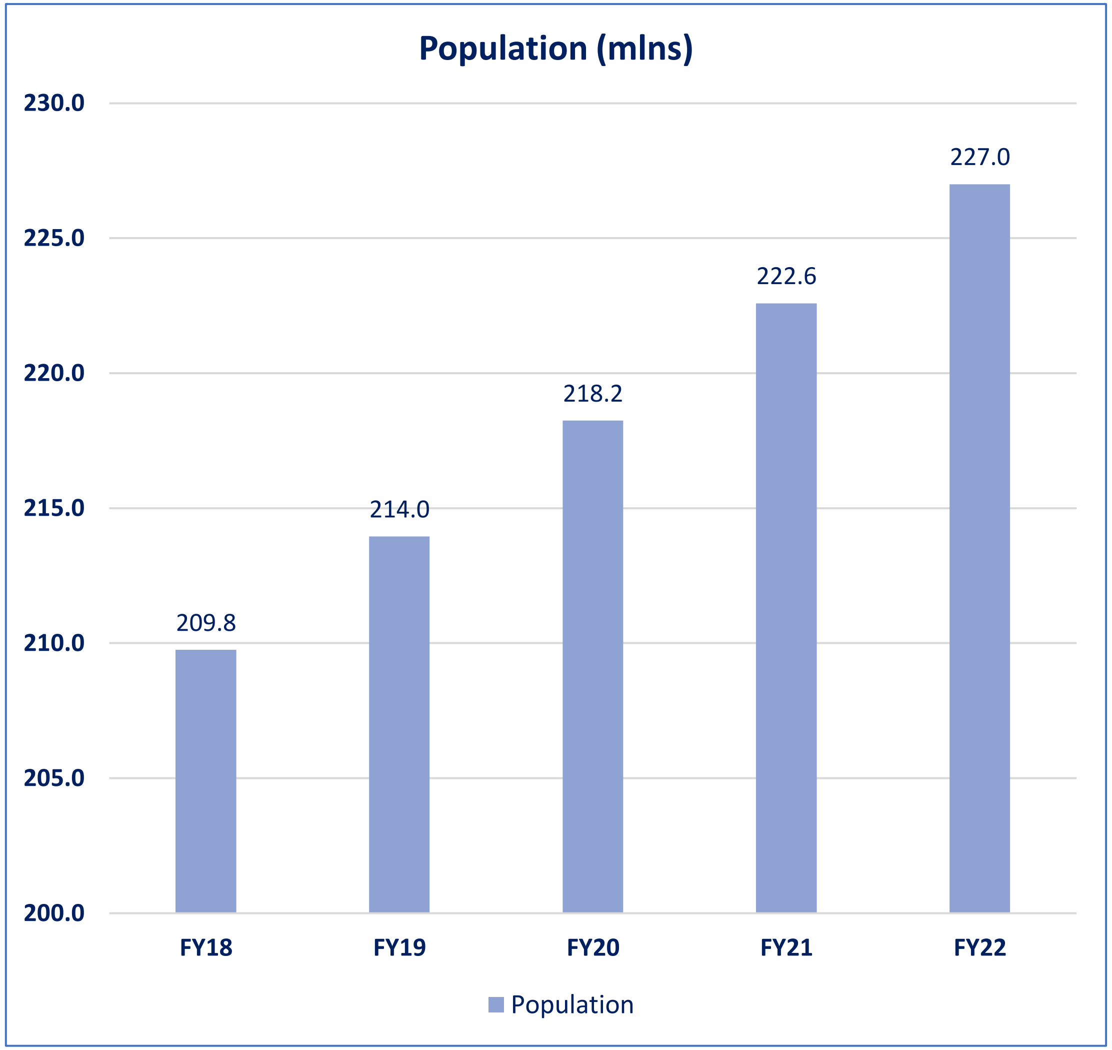
Local | Housing Demand Drivers

- Pakistan's population has grown at a CAGR of ~2.0% over the FY18-22 period and by ~1.98% in FY22. If this trend prevails, the national population will grow to ~231.6mln in FY23. A growing population is generally linked with increased demand for housing, although more significantly in urban centers.

- Based on the Pakistan Social and Living Measurement (PSLM) CY19-CY20 survey, conducted by the Pakistan Bureau of Statistics (PBS), the number of occupants per housing unit averages ~6.56. Using the same PSLM survey, findings show that occupancy of dwellings is ~82% whereas rented space is ~11% in Pakistan (in both rural and urban areas).

- Housing demand in Pakistan in FY22 increased largely due to the two markup subsidy schemes launched by the SBP, Mera Ghar Mera Pakistan (for country residents) and Roshan Apna Ghar (for overseas Pakistanis). The former has been suspended since Jun'22, leading to a falling financing trend in housing division (covered later).

- In addition, the tax amnesty scheme, lower interest rates and tax incentives were the key drivers behind the surge in commercial and residential real estate activity in FY22.



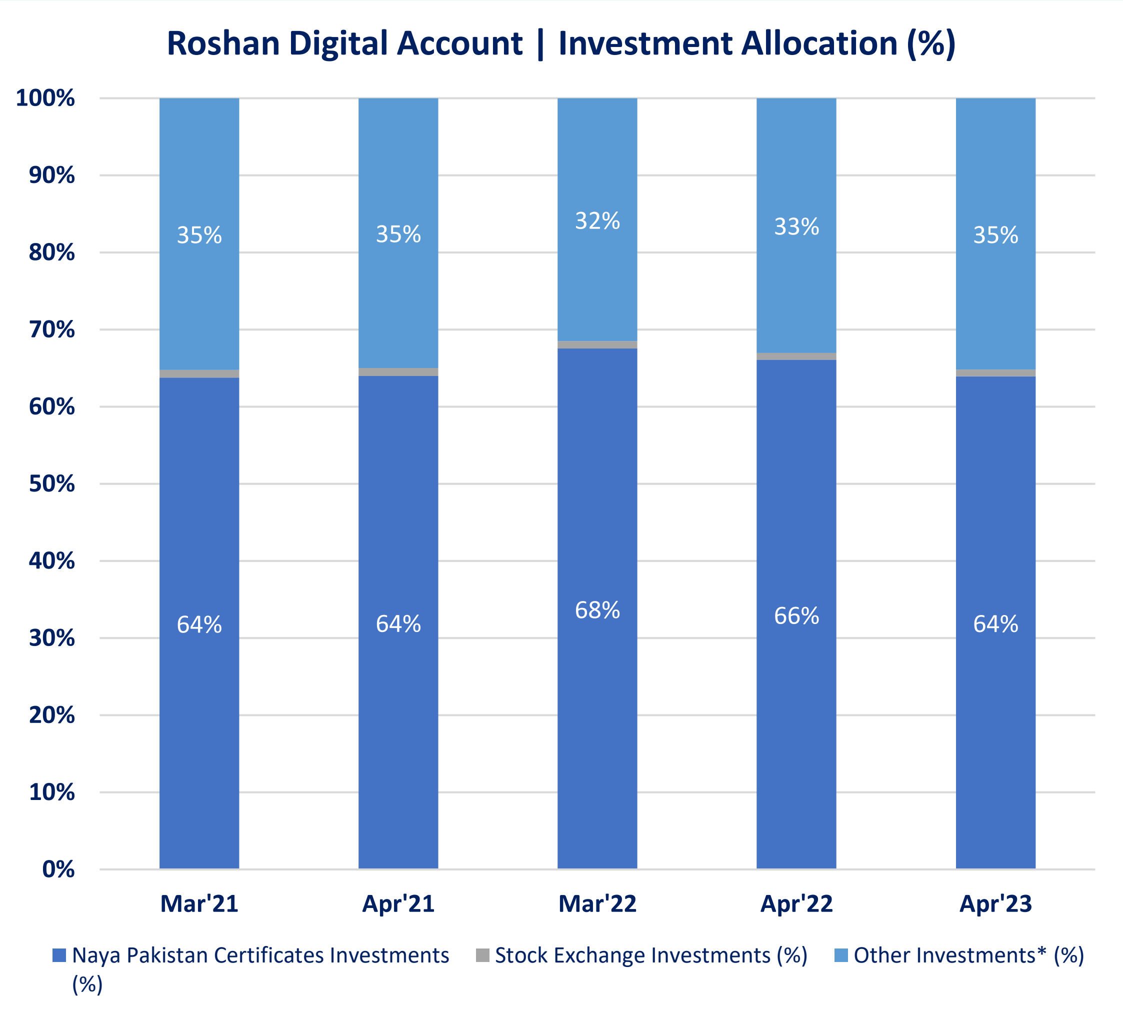
Local | Roshan Digital Account

- Launched in Sep’20, the Roshan Digital Account (RDA) is an initiative taken by the State Bank of Pakistan in collaboration with Pakistan’s commercial banks. The scheme provides innovative banking solutions for millions of non-resident Pakistanis who seek to invest, bank and/or execute payments in Pakistan. Account holders are given the opportunity to open a digital account remotely.

- A record of USD~5,966mln were deposited into RDAs in Apr’23 (Feb’23: USD~5,811mln; Apr’22: USD~4,167mln). The total number of accounts opened as of Apr’23 are ~561,617 (SPLY: ~403,750).

- Of the total RDA inflows, Naya Pakistan Certificate Investments formed the largest chunk of ~64% during Apr’23, amounting to USD~3.8mln (Apr’22: USD~2.8mln). Other investments formed ~35% in April’23 or USD~2,101mln (Mar’23: ~36% or USD~2,168mln; Apr’22: ~33% or USD~1,376mln).

- The Roshan Apna Ghar scheme, launched by the SBP in CY21, made it easier for non-residents to digitally purchase property and build or renovate a home.



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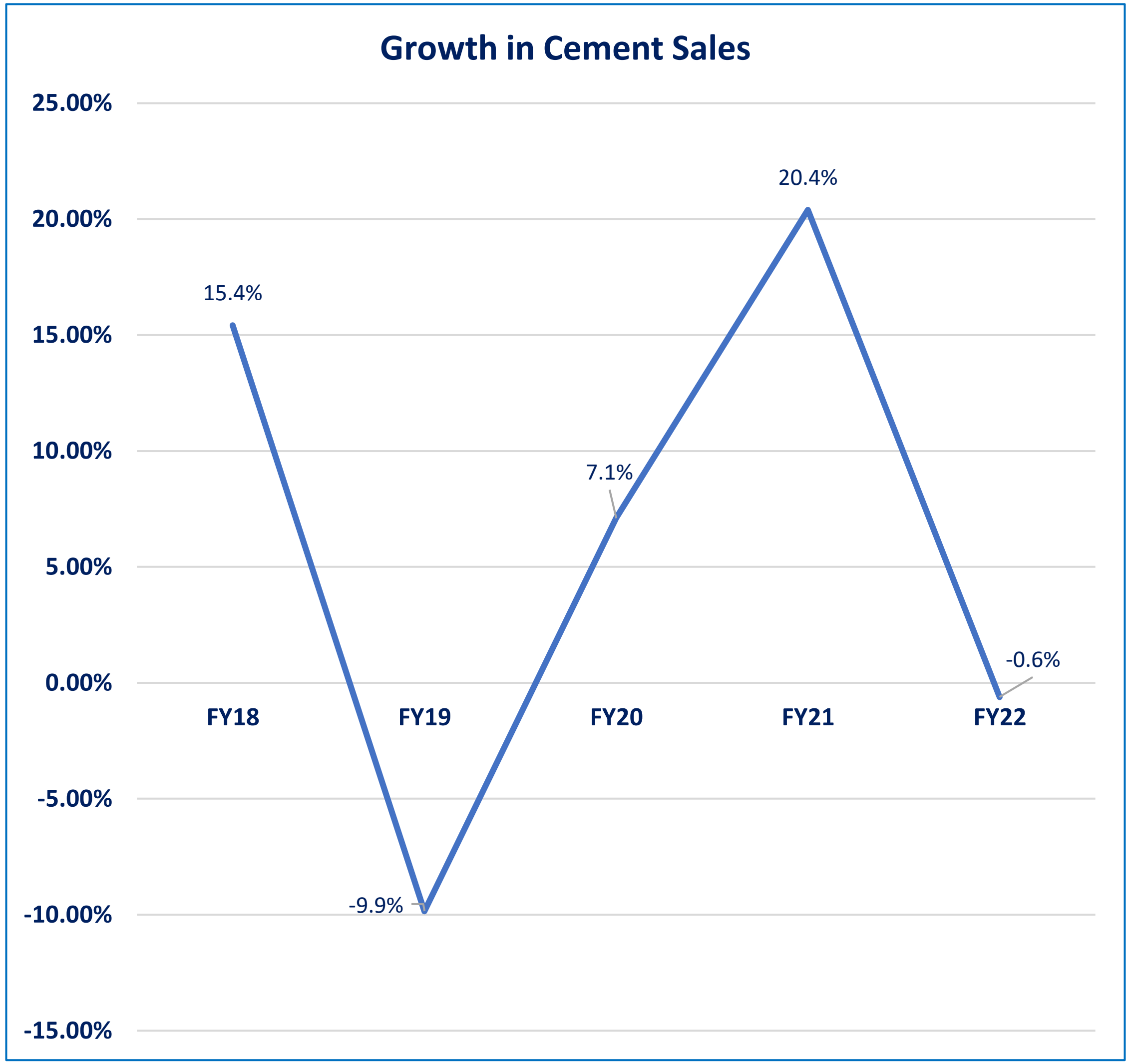
Local | Cement Sales Trend

- Cement is a key construction input for commercial and residential real estate. Growth in cement sales is a leading indicator for real estate development activity and supply.
- In the FY22 period, demand for cement plummeted by ~0.6% from SPLY, clocking in at ~47.7mln MT (FY21: ~48.0mln MT). This likely underpins a slowdown in construction and development activity owing to rising input costs, including those of coal and steel.
- The prices of cement have also grown exponentially in FY22. The average prices of cement increased by ~30% in FY22 (FY21: ~4%). This likely resulted from a YoY increase in global coal prices of ~154% in FY22. At the same time, prices of steel rebars reached PKR~206,225/MT during FY22 (FY21: ~121,548/MT).
- APCMA attributed the negative growth of cement industry import restrictions (which were put in place in May’22) and subsequently the difficulty the manufacturers had to face while opening Letters of Credit (LCs) with the banks.
- Going forward, the prices of cement and steel are expected to maintain an upward momentum, owing to non-availability of raw material, price dynamics in the international market and the steep PKR devaluation.



Source: APCMA, PACRA Database

Real Estate

Local | Supply

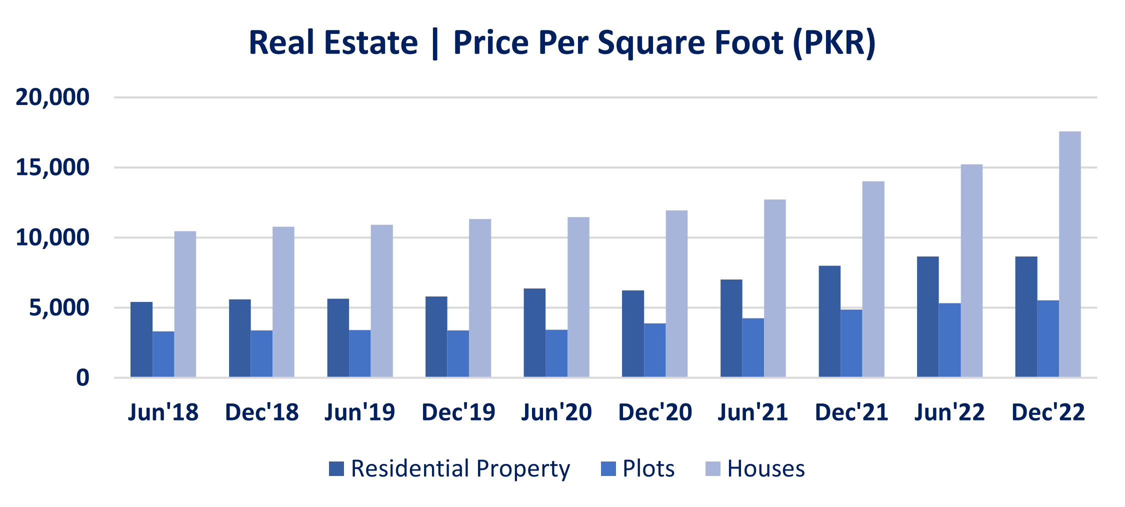
- The supply side of real estate comprises mainly offices, plots, residential property, infrastructure projects, and houses. The concept of vertical cities and mixed-used buildings is also increasingly becoming popular.

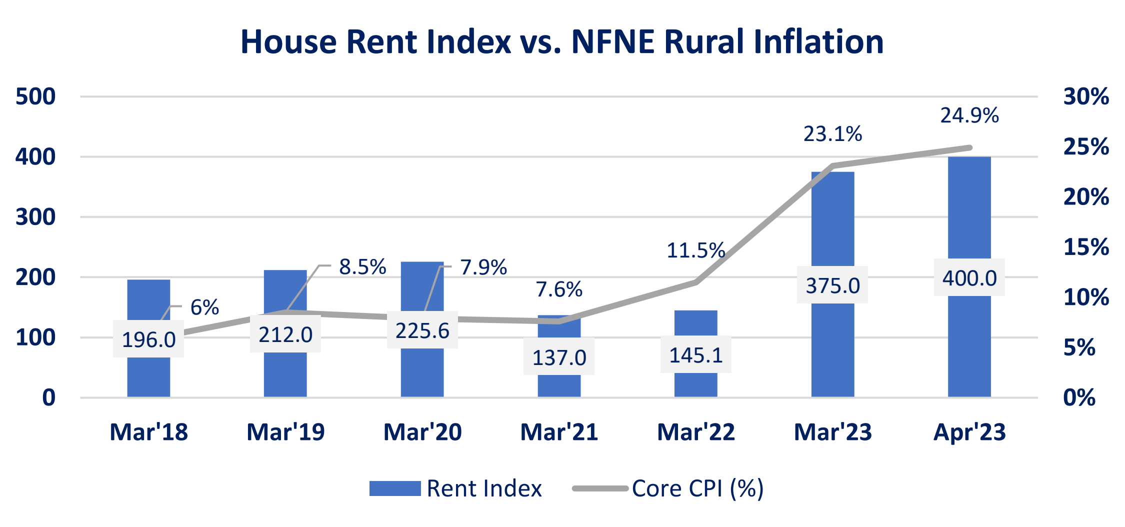
- In addition, currently popular real estate investment trends include hotel/service apartments, townhouses, and real estate investment trusts (REITs).

- Due to increasing demand for real estate in FY22, property prices registered a significant surge. From Dec’18 to Dec’22, residential property prices have surged by ~54.5%; housing prices by ~63%; and plot prices by ~64%.

- During Apr’23, Rural Core Inflation was recorded ~24.9% (MoM change: ~7.8%, YoY change: ~128.4%). On the other hand, the House Rent Index climbed ~7% MoM during the same month and ~158% YoY, clocking in at ~400 points. The difference in MoM changes signifies the fast pace at which house rents are increasing, owing likely to high levels of inflation.

- Real estate construction activity was at its peak in FY21 due to incentives provided to developers and builders. This resulted in an increase in the supply of residential and commercial properties and the commencement of many development projects.





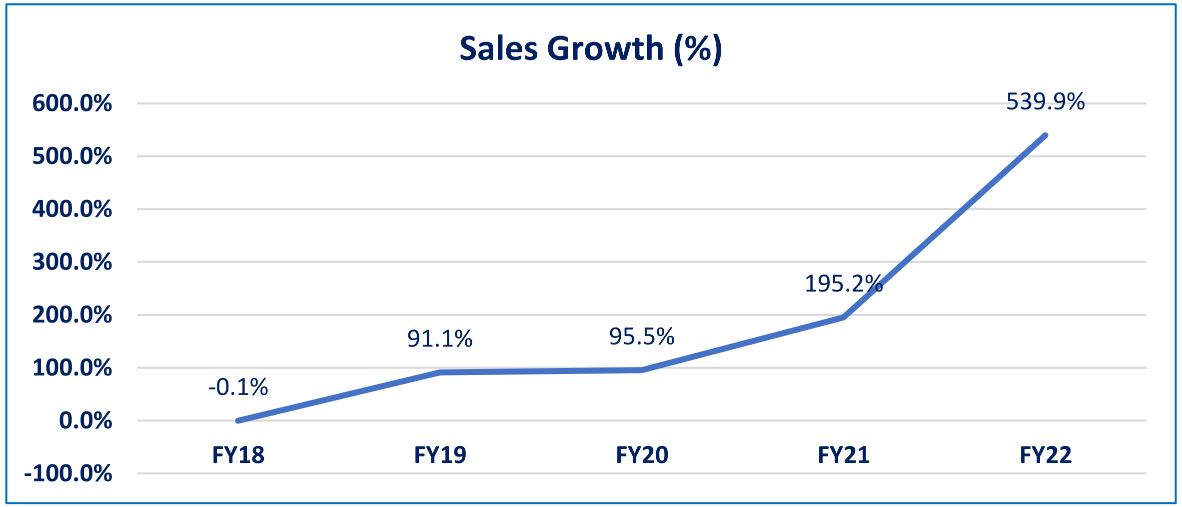
Local | Industry Performance

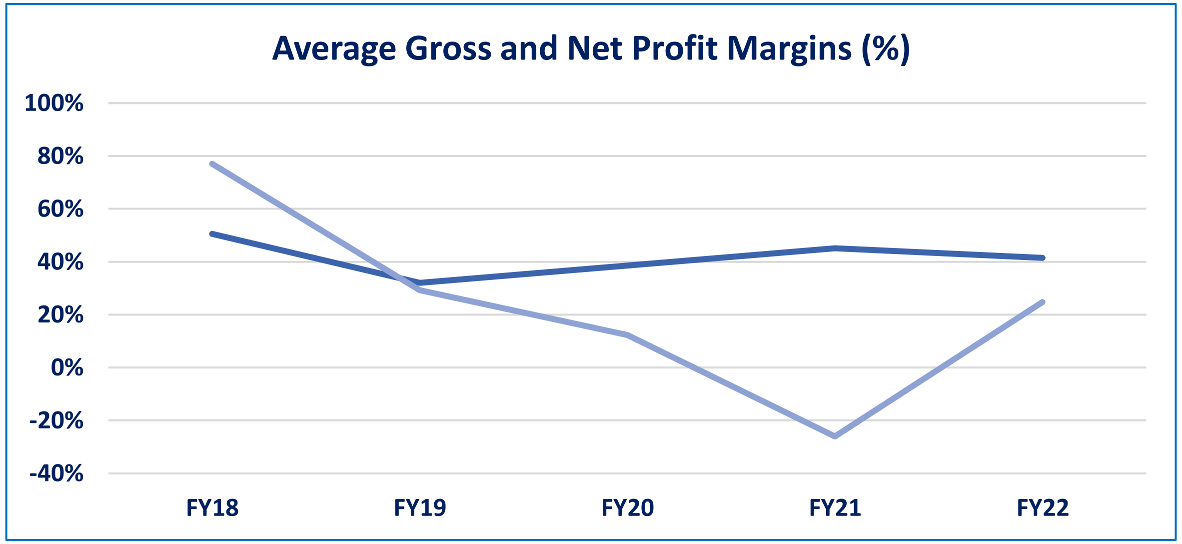
- Sales revenue surged to a whopping ~539.9% in FY22 (FY22: ~195.2%). In addition, the government's monetary and fiscal incentives were a major reason behind the surge in sales growth in FY21 up until mid-FY22.

- However, during 1HFY23, growth in sales plunged sharply to ~10% due to the overall inflationary pressures and lower demand. Suspension of the government housing scheme, Mera Ghar Mera Pakistan, has also likely come into play.

- During FY22, average gross margins decreased slightly to ~41% (FY21: ~45%). This likely came on the back of increased costs. The 1HFY23 witnessed a further decline in average gross margins to ~27%. Decreased sales have been a major driving factor behind this fall, whereas cost of sales have been slightly elevated due to higher development costs of properties sold owing to increase in construction costs.

- Average net profit margins, however, improved slightly in FY22 to ~25% (FY21: ~ -26%), largely due to income realized from the sale of a key revenue source for one player and more efficient working capital management as a result of reduced financing costs on short-term financing for others.



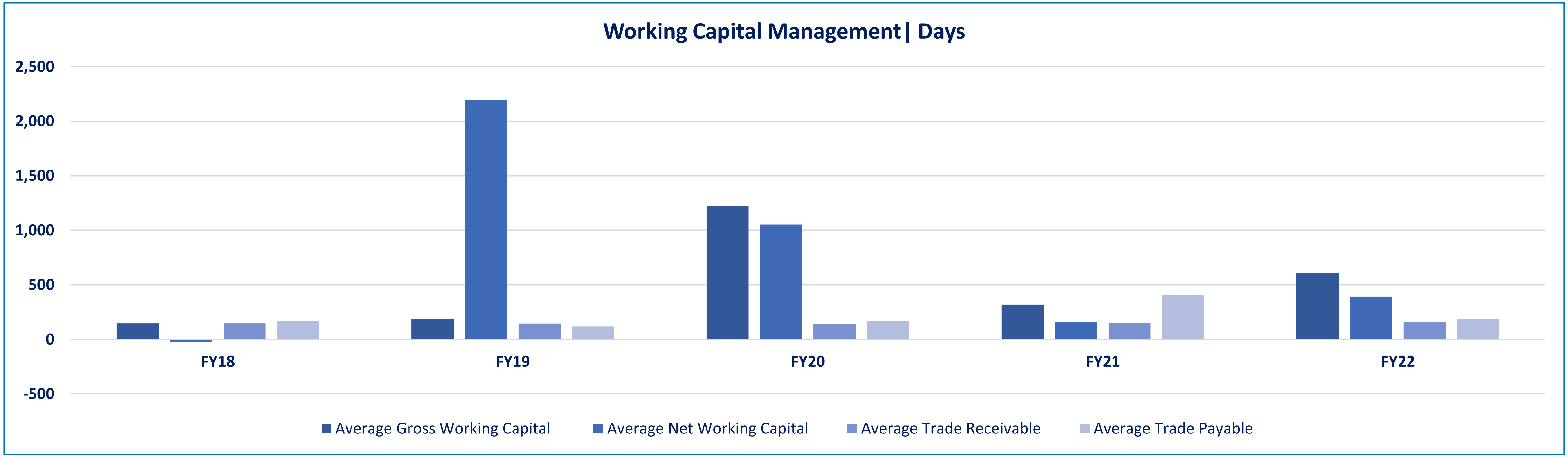


Note: Figures for 1HFY3 are reflective of two PACRA-rated sector players.

Source: Company Financials, PACRA Database

Financial Risk | Working Capital Management

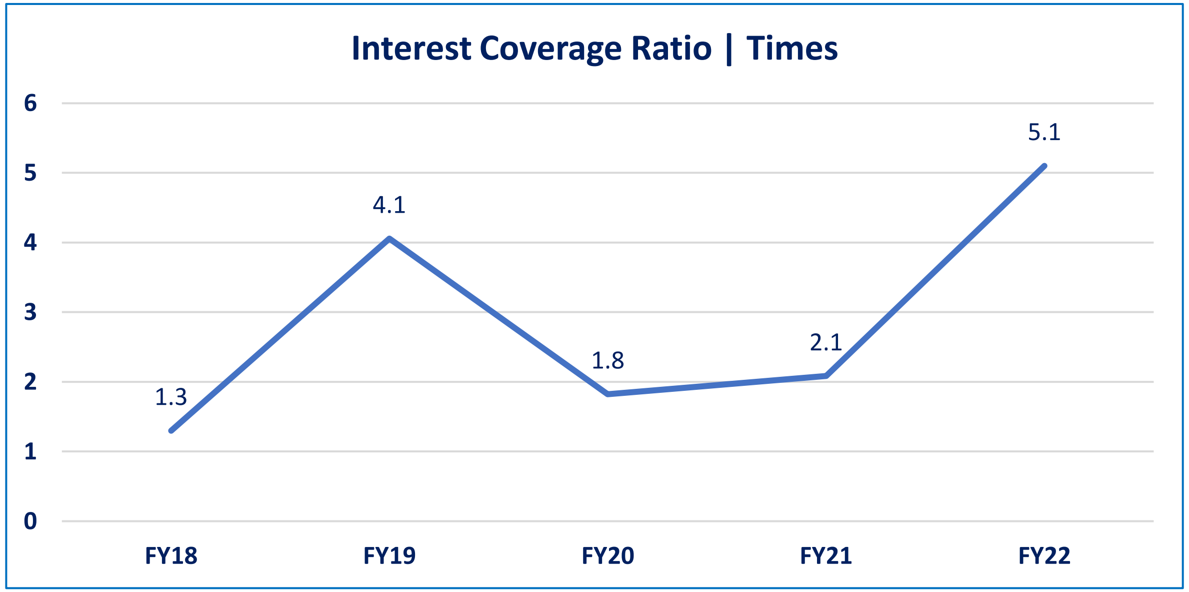
- The real estate industry's main components of working capital are advances from customers and suppliers as well as trade debts. Inventory is not a working capital component. Average gross working capital increased by ~610 days in FY22 (FY21 gross working capital: ~318 days).
- The Average Net working capital increased in FY22 to ~393 days (FY21 net working capital: ~159 days). However, average trade payable days decreased to ~189 days in FY22, from ~406 days during the preceding year, reflecting the sector players' ability to generate enough cash to pay back their creditors on time.

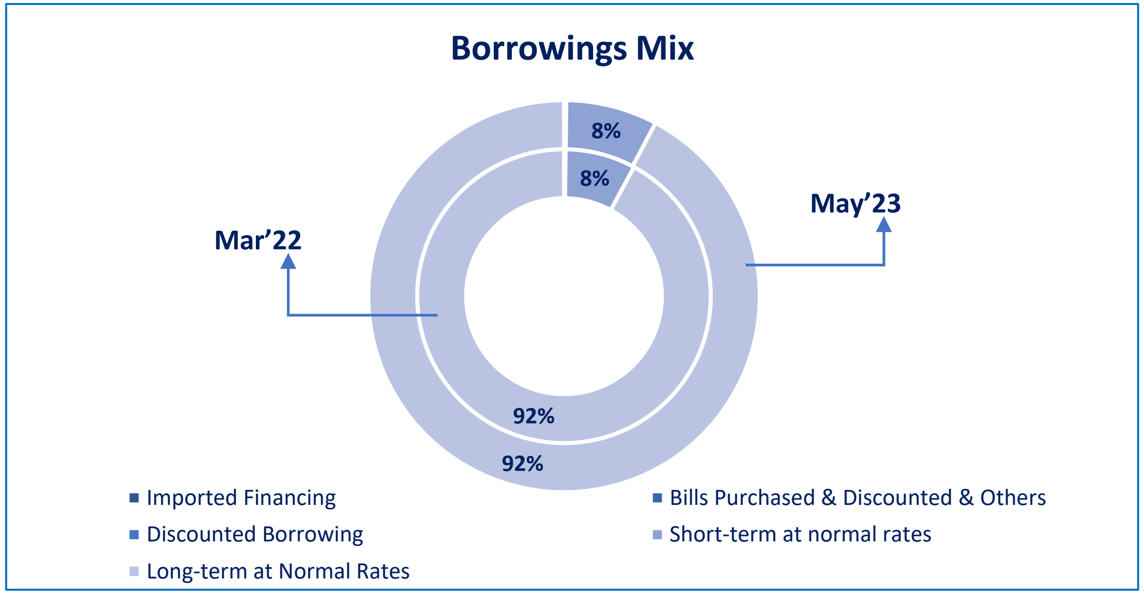


Financial Risk | Coverage and Solvency

- The sector players recorded an improvement in the interest coverage ratio owing to better expense management on short-term borrowings and efficient cash flow management. In FY22 interest coverage ratio clocked in at ~5.1x (FY21: ~2.1x). Going forward, it remains to be seen how well the sector weathers under SBP's monetary tightening, especially during the 2HFY23 period (the MPR increased by ~500 bps during 9MFY23, from 15% to 20%, and currently stands at 21%).

- The solvency position of the sectors remained stable during FY22 relative to FY21. The sector's average financing structure during the period comprised ~34% debt and ~66% equity (FY21 financing mix: ~33% debt and ~67% equity). The industry's reliance on borrowings has also increased between these two periods as developers seek to take advantage of attractive interest rates offered by the SBP and soft debt from an international organization.





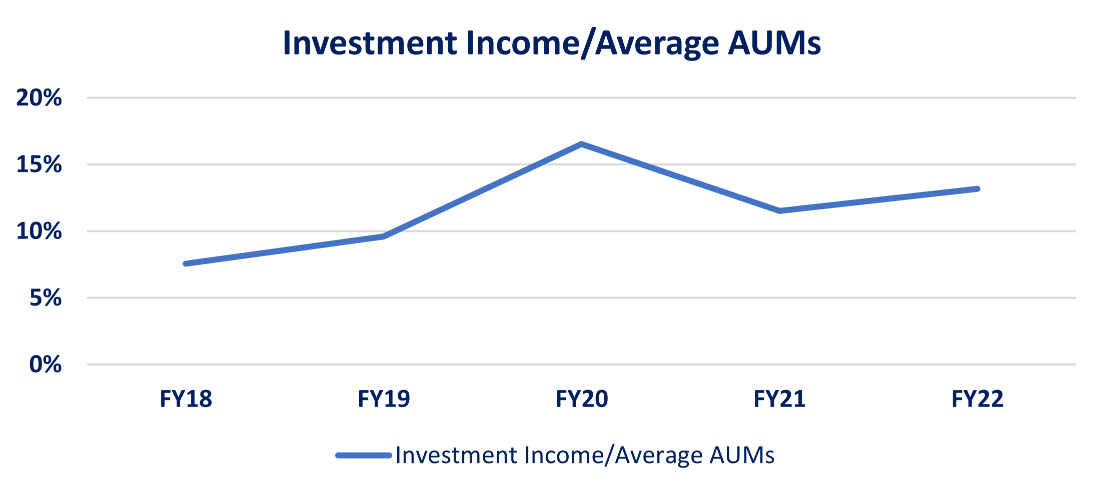
Local | REIT Management Companies

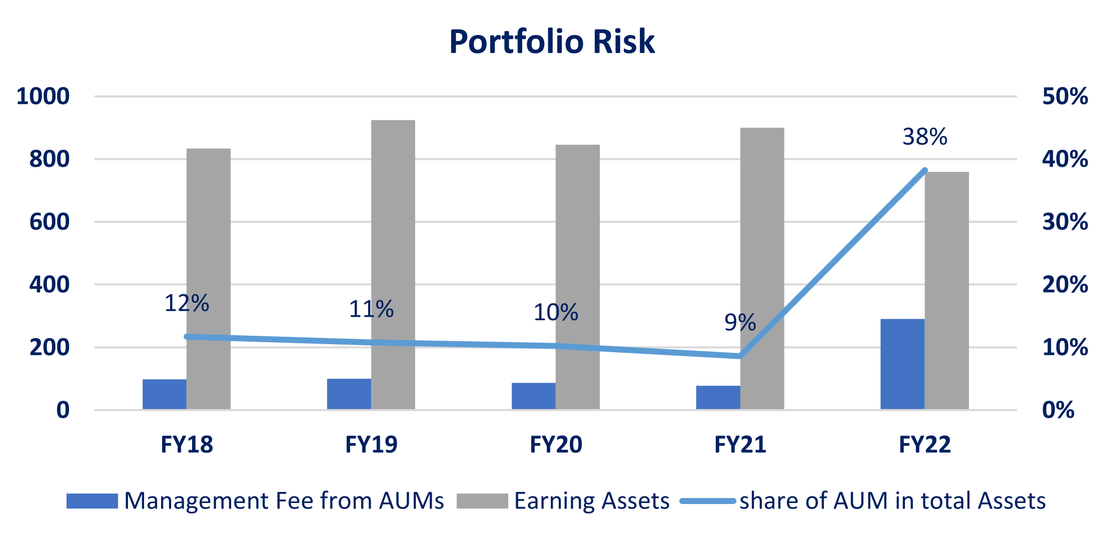
- REITs (Real Estate Investment Trusts) are an asset class that provide transparency with respect to the real estate sector and adds depth to the capital markets. These provide investment opportunities, like a mutual fund, and own, operate or finance income-producing real estate.

- In Pakistan, REIT Management Companies (RMCs) represent a growing market. Presently (Mar'23), ~18 RMCs are registered under SECP, with Total Assets amounting to PKR~9.0bln (~0.3% of total assets of the NBFCs in the country) (Dec'22: ~16 RMCs with PKR~8.9bln in assets and forming ~0.3% of NBFCs' total assets).

- The trajectory of average investment income relative to assets under management traced upwards during FY22, coming in at ~13.2% (FY21: ~11.5%). Investment income arising from management of funds to PKR~618mln in FY22 from PKR~198mln in FY21 of the RMCs, likely reflecting fairly good management of AUMs.

- Similarly, the average share of Assets Under Management to Total Assets has sharply increased in FY22 to ~38% which was only ~9% in FY21. On the other hand, the average Management Fee has also escalated in FY22 to ~290mln (FY21: ~77mln).

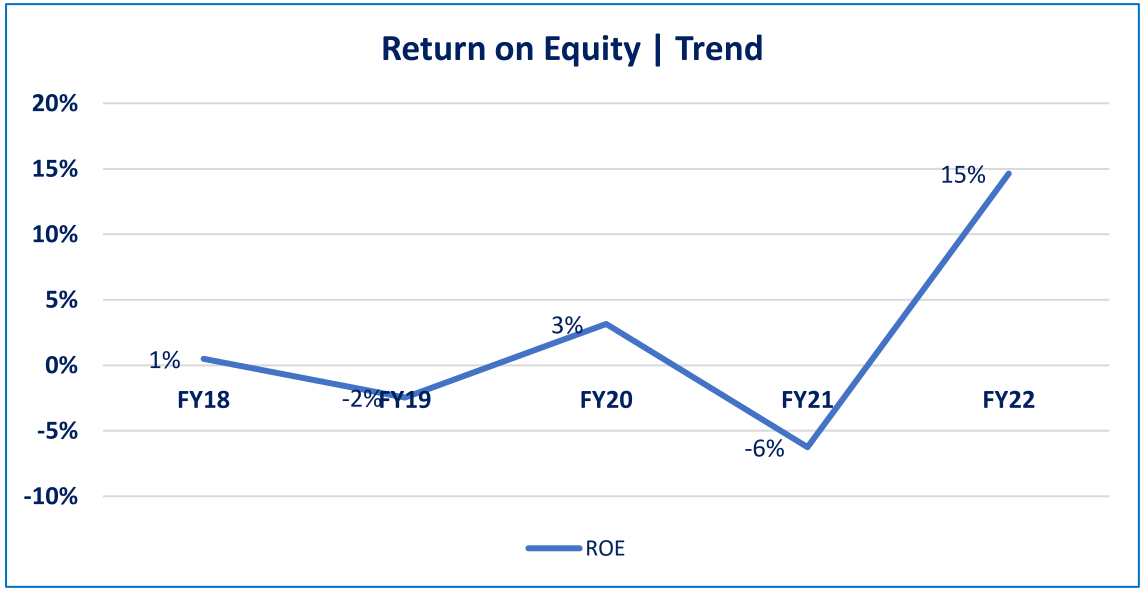


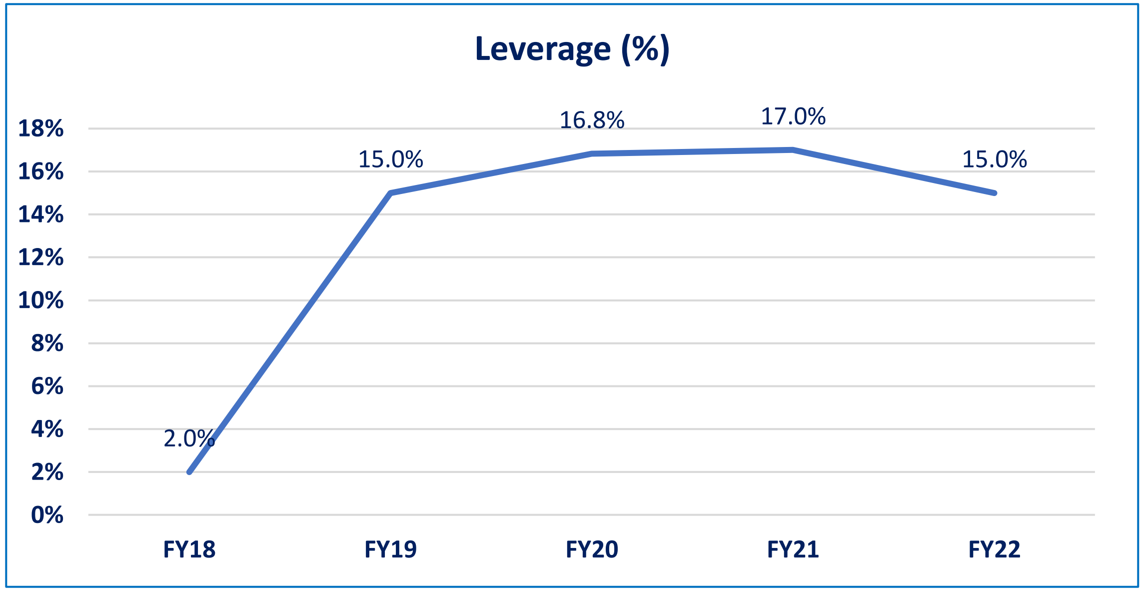


Local | REIT Management Companies

- The segment's leverage ratio has declined to ~15% in FY22 (FY21: ~17%), representing a decrease in total borrowings for REIT Management Companies as against shareholder's Equity. This signifies the segment's lower reliance on borrowings, thereby, minimizing its exposure to interest rate movements. Over the past five years (FY18-22), the ratio has stayed on average at ~13.2%.

- The segment's Return on Equity has displayed an inconsistent trend over the past five years (FY18-22). After dipping to ~ -6.% in FY21, the returns have improved in FY22, clocking in at ~15%.





Note: Figures for Leverage ratio is reflective of one PACRA-rated RMC.

Source: PACRA Database

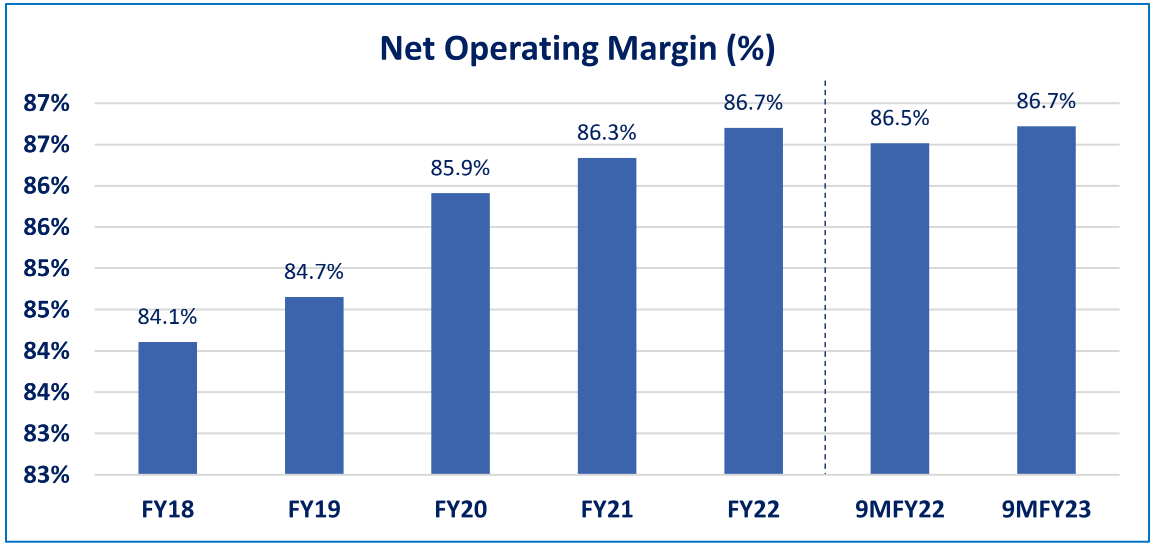
Real Estate

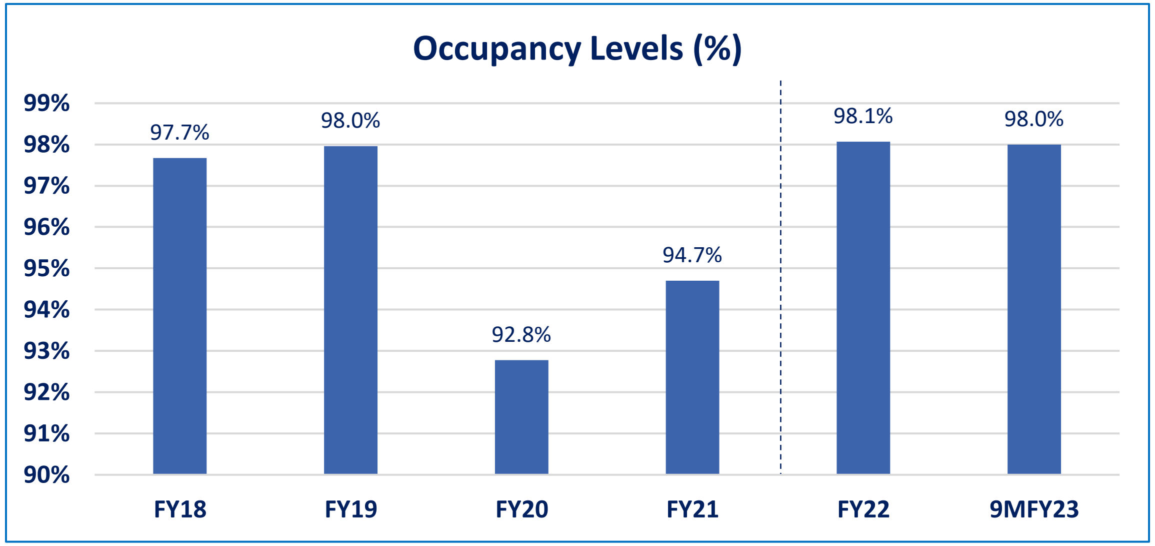
Local | Rental REITs

- Where Development REITs involve investing in construction of refurbishment of residential, commercial or industrial properties, Rental REITs are schemes that invest in residential or commercial properties for the purposes of generating rental income.

- In FY22, occupancy levels for Rental Real Estate Investment Trusts (REITs) experienced a significant increase ~98.1% (FY21: ~94.7%). In the 9MFY23 period, the overall occupancy levels remained stable to ~98.0% as against ~98.1% in FY22. Tenancy remains stable with the mall and office space both operating at optimal occupancy.

- During FY22, the net operating margins of the segment showed an increase of ~0.4% compared to FY21. Likewise, there a slight increase of ~0.20% in net operating margins was observed in 9MFY23 (9MFY22: ~86.5%). Recently, a gradual recovery has been observed in this segment led mostly by smaller commercial offices and retail options in housing schemes.





Note: Figures are reflective of one sector player..

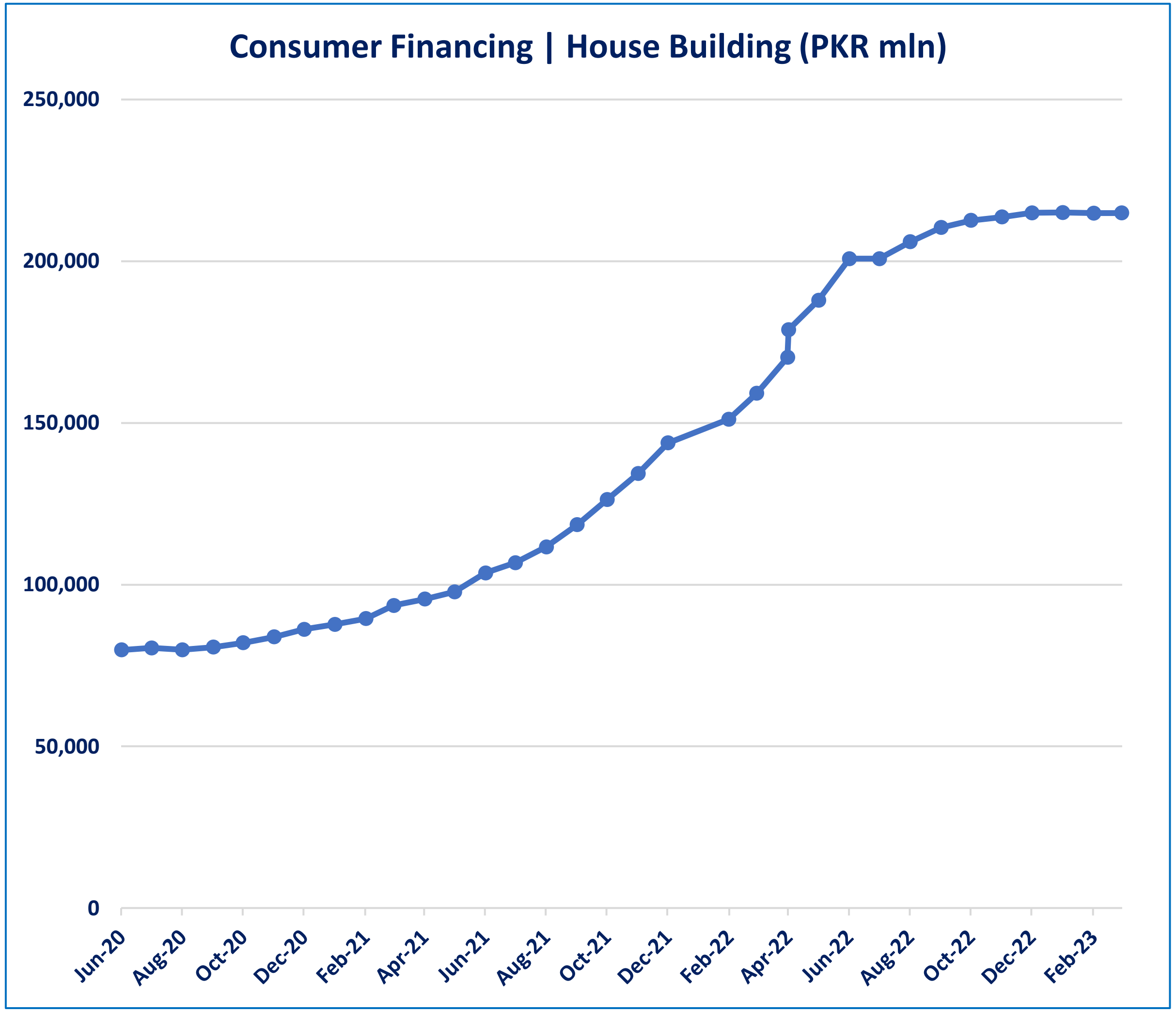
Source: Company Financials, BoI

SBP | Financing Initiatives for Homeowners and Developers

- During Dec’20-Jun’22, the trend of consumer financing in household building remained quite steep. Consumer Financing rose sharply by ~94% YoY in Jun’22, clocking in at PKR~201bln, indicating increasing demand, most likely on the back of Government’s markup/ subsidy schemes, including Mera Pakistan Mera Ghar (MPMG) and Roshan Apna Ghar.

- The Schemes, launched by the SBP in CY20 for local and overseas Pakistanis, provided house financing on subsidized rates; financing was also available in Shariah and conventional modes. As of Jun’22, the total amount disbursed under MPMG stood at PKR~99.8bln (Jun’21: PKR~5.2bln). However, following FY22, the scheme has been suspended.

- However, the growth in consumer financing has plateaued at ~0.5% during the period Aug’22-Feb’23. After increasing to PKR~206bln in Aug’22, the overall financing as of Feb’23 stood at PKR~215bln.



Source: SBP

Tax Structure

1. Earlier, the gain arising on the disposal of immovable property after the holding period of 4 years was exempt from tax. Now the holding period concession will separately apply which for open plots is six years, for constructed property is four years and for flats is two years. The Capital Gain Tax structure is as follows:

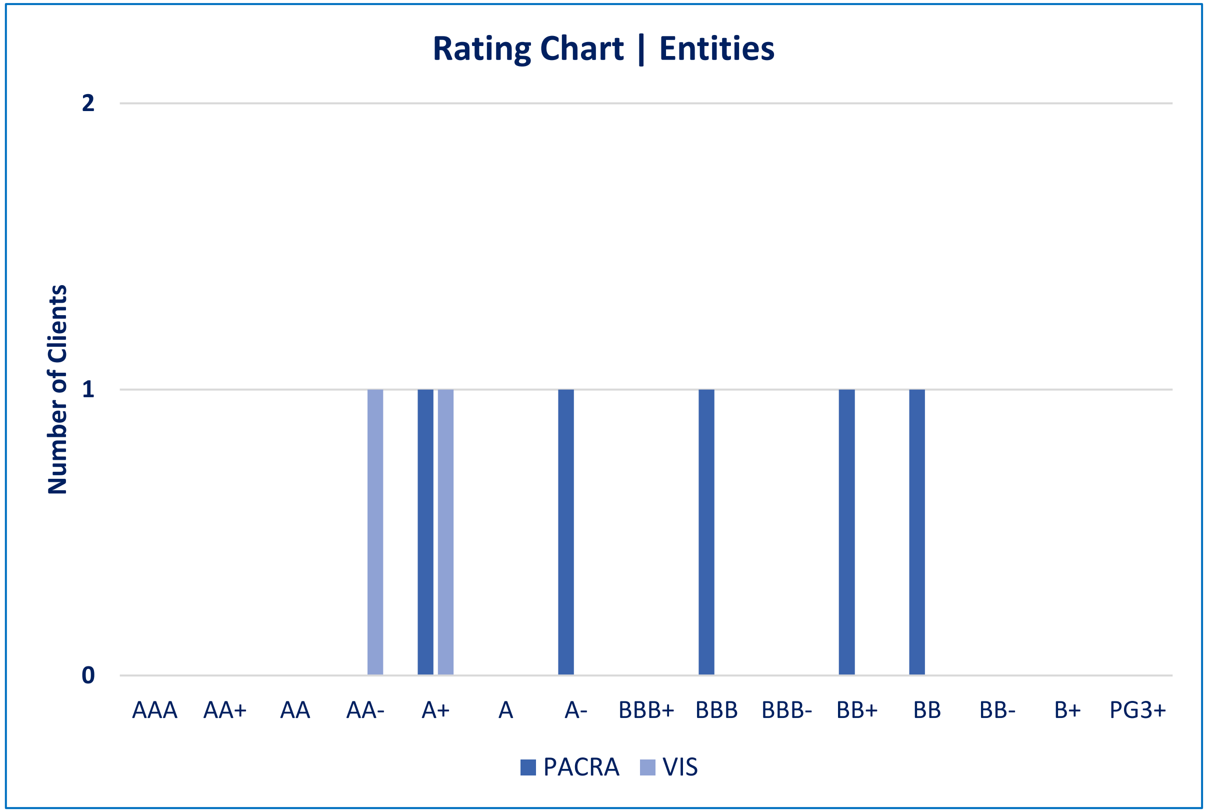
    - Where the holding period is < 1 year: Plots/ Files 15%, Constructed Property 15%, Flats 15%.
    - Where, 1 year < holding period < 2 years: Plots/ Files 12.5%, Constructed Property 10%, Flats 7.5%
    - Where, 2 years < holding period < 3 years : Plots/ Files 10%, Constructed Property 7.5%, Flats -
    - Where, 3 years < holding period < 4 years Plots/ Files 7.5%, Constructed Property 5%, Flats -
    - Where, 4 years < holding period < 5 years : Plots /Files 5%, Constructed Property -, Flats -
    - Where, 4 years < holding period < 5 years : Plots/ Files 2.5%, Constructed Property - , Flats -

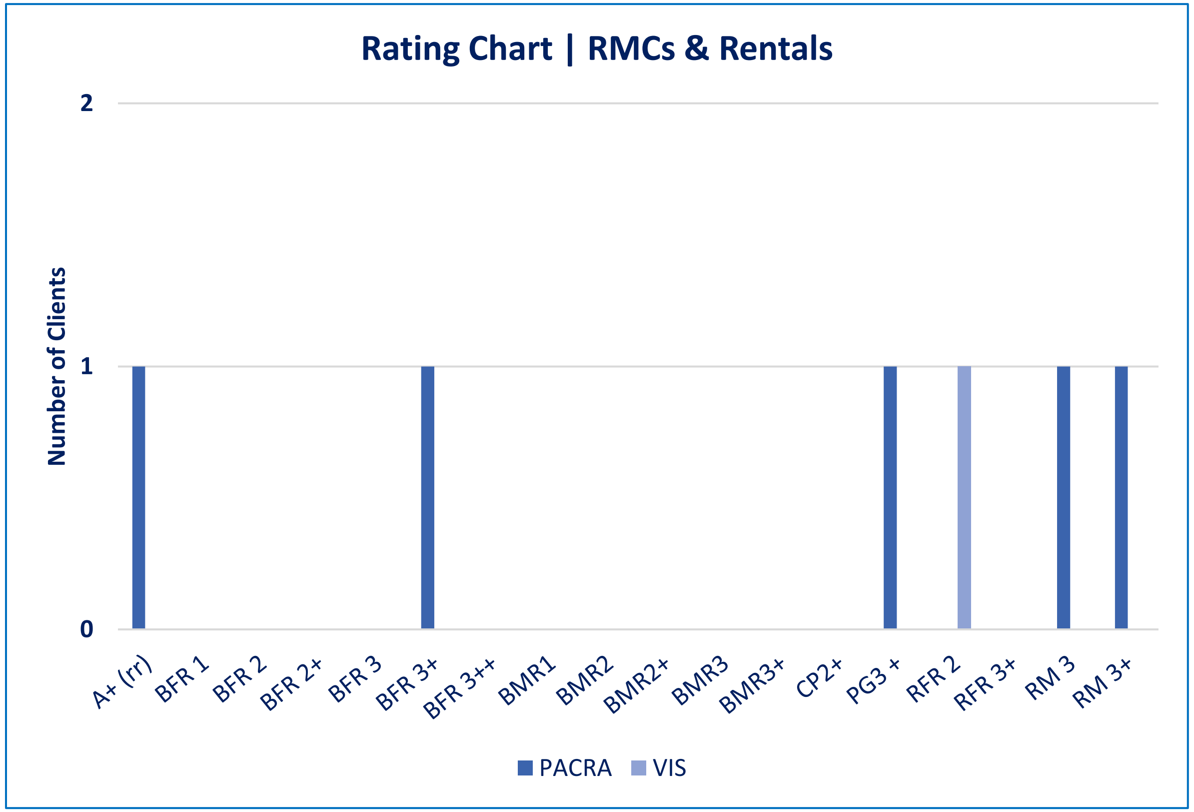
2. The Withholding Tax structure, as applicable from July 01, 2022, is as follows: Plots/ Files: 1% ; Construction: 1.5% and High-Rise Apartments: 2%.

Source: FBR, Arcaa

Rating Chart

- PACRA rates Six Entities, Three RMCs and One Rental in the real estate sector.





Source: PACRA Database

Real Estate

Outlook: Stable

- In FY22, the Real Estate sector contributed ~4.9% to the country's GDP (FY21: ~5.4%). In comparison, construction contributed only ~2.9% to the country's GDP. Similarly, where construction formed ~0.9% in the Gross Fixed Capital Formation for the Private Sector (at current prices), Real Estate activities formed ~17.6% during FY22, the second-highest after Agriculture. This reflects high investment flows towards the country's Real Estate sector.
- During FY22, the sector's performance remained fairly satisfactory. Sales revenue surged to a whopping ~539.9% in FY22 (FY22: ~195.2%). Average gross margins, however, exhibited a slight downtick, clocking at ~41% (FY21: ~45%). This likely came on the back of increased costs. Average net profit margins improved slightly in FY22 to ~25% (FY21: ~ -26%), largely due to income realized from the sale of a key revenue source for one player and more efficient working capital management as a result of reduced financing costs on short-term financing for others. The Sector's total borrowings rose slightly to PKR~3,7645mln during FY22 (FY21: PKR~3,5567mln), depicting a ~6% YoY change. The major chunk of the borrowings is long-term borrowings forming ~92% of the total borrowing mix, while the short-term borrowings comprise only ~8% of the borrowings mix during the same period.
- During the same period, a considerable upswing was observed in the Housing Price Index Returns, which shot up to ~25.3% in CY22 from ~5.4% in CY20. Simultaneously, it outpaced the KSE-100 index returns by ~38.1% during the said period. However, the House Price Index dipped to ~4.3% during 4MCY23, indicating a slowdown in the country's real estate activity.
- The spur in demand during FY22 can also be corroborated by the increasing trend in consumer financing, which went up to PKR~201bln in Jun'22 (Jun 21: PKR~104bln), a period-on-period increase of ~93.2%. This also cements the effectiveness of SBP schemes including Mera Pakistan Mera Ghar and Roshan Apna Ghar. As of Jun'22, the total amount disbursed under the former stood at PKR~99.8bln (Jun'21: PKR~5.2bln).
- Over a two-year period (Dec'18 to Dec'22), residential property prices have surged by ~54.5%; housing prices by ~63% and plot prices by ~64%. House rents, too, remain elevated, seeing as the House Rent Index climbed ~7% MoM during the same period and ~158% YoY, clocking in at ~400 points during Apr'23. At the same time, Rural Core Inflation was recorded ~24.9% (MoM change: ~7.8%, YoY change: ~128.4%). On the other hand, The difference in MoM changes signifies the fast pace at which house rents are increasing, owing likely to high levels of inflation.
- Following FY22, the Government's housing scheme, Mera Pakistan Mera Ghar, was suspended. Thereafter, the growth in consumer financing for Housing has stagnated at ~0.5% during the period Aug'22-Feb'23.
- Going forward, the sector will face headwinds in the form of higher construction costs. However, various sector players have now established REITs, a growing market in Pakistan incentivizing further investments in the sector. The underlying imbalance between supply and demand will likely come into play and determine the sector's performance, especially in the face of a slowing economy National Accounts Committee forecasts ~0.29% slowdown in GDP for FY23).

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