Land of the mega deal

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Kamal Hideib discusses the challenges of manoeuvring mega deals and valuation in the Middle East

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Real-estate deals in Qatar tend to be larger than in many other countries as the sector consists of larger developers, with immense liquidity in the market. Enormous development projects worth hundreds of millions of dollars span multiple asset classes and cover vast areas. But the unique nature of the market can make transactions problematic from a valuation perspective.

I have experienced how these mega deals unfold, working on $1.4bn worth of real-estate transactions in the region, the largest single one being $393m for a 40-floor tower on the Pearl Qatar Island.

State of the market

The Qatar real-estate market presents some stark contrasts in performance. Due to a depressed oil price in recent years, the residential and especially the office market have been underperforming, experiencing decreased rental rates and higher vacancies. Conversely, the price of land in the country has risen substantially in recent years along with the appetite for income-producing buildings of more than $100m in value.

Land trades at prices well above its intrinsic value, in part due to the lack of supply in certain areas of Qatar?s capital, Doha, but also a result of real estate being the asset class of choice in the region for ultra-high net worth (UHNW) investors. As a consequence, land values have reached levels that make developments unfeasible.

Many of the buyers in these mega deals are therefore UHNW family offices. The amount of liquidity they hold and their relationships with banks allow them to close deals quickly, and with a shorter due diligence period than would be customary in mature markets. Mega deals are not usually brokered, but are frequently closed as off-market transactions between the seller and distinguished target buyers. When deals are openly marketed, there are usually several bidders competing for the same asset, which tends to push up the bid price and has compressed cap rates, that is, yields. Buyers have been closing deals at cap rates as low as 4.5% to 5.5% on income-producing assets in the prime residential market.

The buyers in these mega deals tend to have a long-term view of the market. They like to acquire prize assets, in the belief that these will always hold value through future market cycles.

Closing mega deals

The pool of buyers for mega deals is attracted to prime assets domestically, and is also especially interested in acquiring in major foreign markets such as London, New York and

Paris.

A recent mega deal was for a $393m 40-floor office tower on Pearl Qatar Island; the tower was a greenfield development project that we initiated, and for which we obtained funds through a Sharia-compliant financing facility at a local Islamic bank. We then constructed the tower, and on completion sold off the asset to a buyer here in Qatar.

Valuation challenges

Unlike more developed markets, land prices in Qatar are based mainly on the plot area itself and not solely on the allowable building area, or built-up area. This contrasts with neighbouring markets such as Dubai, where all land trades on the allowable built-up area. This approach has unfortunately caused the valuation of land in Qatar to become extremely difficult; however, it remains market practice to consider the plot area.

At a fundamental level, however, the value of any parcel of land is directly proportionate to how much you can build on it, and therefore the size is less relevant for the purposes of valuation. Valuers in Qatar are forced to use comparable land transactions as their basis, and at times without enough appreciation for the differences in allowable built-up area.

Another complexity valuers face is the direct result of soaring land prices in recent years. This has caused a massive variance between the market value, based on comparable transactions, and residual values, found when conducting a feasibility study. Ideally, the price of land in the market should be in line with the latter, and therefore feasible for a purchaser to develop that parcel and benefit from adequate investment returns. These residual values are considerably lower than the amount buyers are willing to pay, and consequently buyers are potentially overpaying massively.

The business of real-estate valuation services in Qatar is fragmented. International firms such as DTZ and Colliers follow best practice, but at the other extreme, some local consultancies regrettably do not use International Valuation Standards and are easily manipulated by the client to influence the outcome of the estimated value. This is one reason why some market participants do not fully appreciate the valuation process. These issues collectively make a chartered valuer?s job in the region much more complex.

Measurement standards

There are currently no officially adopted guidelines in Qatar with regard to measurement standards for property. This poses a challenge, as professionals from many countries working in the sector are accustomed to differing standards. As global organisations are aligning their practices to be congruent with one another, embracing the International Property Measurement Standards (IPMS) would certainly improve the situation in the region. The Qatari government authority needs to commit formally to the use of IPMS throughout the market, and RICS? Qatar office is currently in discussions towards this end.

From a valuation perspective, it is crucial to be confident that a property?s useable area is accurately measured before estimating the value. Because there is currently no official standard in the market, a party runs the risk of over- or underestimating costs, useable area and values.

A discounted cash flow (DCF) method of valuation, where it is used, allocates a sale or lease price to the useable areas, which is derived from the value of the property. When conducting a DCF valuation, if the useable areas have not been measured according to the standard then the value will not be completely accurate as a result.

The failure to use a unified measurement standard can damage reputations in real estate ? certainly with respect to selling apartments to the public, as it seems the manner in which advertised sizes are measured is inconsistent and potentially misleading.

Ethics in valuation

Qatar is a developing market, and although there has been unprecedented growth, participants may not fully understand the importance of protecting the integrity of the valuation process. Accordingly, undue influence on valuers from vested interests is prevalent. As the market is not especially sophisticated, stakeholders have been known to lack understanding of the valuation process, and try to negotiate or put pressure on the valuer to influence the outcome to their advantage. Valuers must and are obliged to uphold their integrity.

The sensitivity of the DCF methodology to the assumptions made is an ongoing issue for valuers globally. A DCF valuation is prone to error and could be easily manipulated as the value is sensitive to the discount rate and other factors. Valuers should be cautious not to use these variables to sway the value to their benefit or suit their needs.

Adjustments to the assumptions in a DCF model may not conflict with International Valuation Standards ; however, if they do not represent the true market conditions, then this violates an RICS member?s integrity. If values are consequently inflated for these reasons, it may force an impairment in future years, which will affect the company?s recorded earnings.

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Further information

- Related competencies include Conduct rules, ethics and professional practice , Valuation
- This feature is taken from the RICS Property journal (October/November 2017)
- Related categories: Commercial valuation , Valuation practice/methodology , Ethics and professional conduct