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Trend setters

Institutionalized developers tower over the property market

There are two types of real estate developers: Highly organized, institutionalized developers undertaking large-scale, upper-end market projects, and traditional construction companies focused on middle- to low-income housing. For decades institutionalized developers were absent from the local real estate market. Today, with land prices more than quadrupling over the past five years, an average real estate development of 5,000 square meters requires up to a $100 million investment, meaning small- and medium-sized developers are mostly priced out of the market.

Real estate developers are growing as large as the towers they build. In the 1950s, state-of-the-art developments such as the Starco Towers and the Phoenicia Hotel stood as testament to the advancement of local real estate development. With the stock market having again proven to be a highly volatile investment vehicle, the tangible reality of real estate has rapidly grown as an attractive option for big money, particularly for local banks flush with recent inflows of cash deposits.

BIG MARGINS

The main reason big developers are becoming larger and larger lies in the issue of financing. "Only five years ago, land in prime locations used to cost around $3,000 per square meter. Now it is between $15,000 and $20,000 per square meter," said *Karim Ibrahim*, sales and marketing manager of local mega-developer Jamil Ibrahim Establishment. For a normal plot size of 5,000 square meters, this represents a colossal initial investment of between $75 million and $100 million. The stakes are so high that only the most financially sturdy investors can afford such a capital outlay. "It has become too capital consuming for small development companies or individual developers to operate, particularly in prime locations," said *Aboudi Farkouh*, assistant general manager of CGI, Audi Saradar Group's real estate arm. In prime locations, where the cost of the land amounts to such a large share of the total investment, it becomes financially unviable to build anything but the largest projects. The high cost of land requires that large-scale, sophisticated, top-of-the-line projects be developed, to optimize returns on investment, as high-end projects yield larger profit margins. The more the project costs, the more organized and affluent the developer must be.

SOMETHING SOLID

In a general international climate of distrust and confusion, where the preferred medium of investment – the stock market – has proven more volatile than gas, the local real estate market in particular has become an extremely attractive investment option. "Real estate is a good investment option because people can 'touch' their investment. In the worst-case scenario, they still have the ownership deed," said *Georges Abou Jaoude*, CEO of FFA Real Estate. More and more, the lines between real estate and finance are becoming blurred. Real estate is becoming a money matter – not about construction, not about development, not about urban planning, but simply about IRR (or the internal rate of return made on a given investment). With average price increases estimated at around 30 percent a year over the past several years, and a real estate market that has proven to retain its value – and indeed continues to grow – in spite of security shocks, political instability, and the uncertainty to which the economy has been subjected, investment in local real estate is a vastly lucrative business. Yields on the most aggressive stocks rarely reach such high returns, and if they do, they are certainly never as secure. Jamil Ibrahim Establishment, probably the largest developer in terms of turnover, currently is executing eight simultaneous projects amounting to a total between $700 million and $800 million. Although developers are extremely reticent about revealing profit margins or IRR figures, it is commonly circulated in the industry that profit margins in the high-end market bracket reached as high as 60 percent in 2008.

ATTRACTING THE CASH

Right now, it looks like the perfect match: Real estate requires huge sums of money to start up profitable projects, while local banks are threatened by drowning in their own liquidity. (See article on page 47) "The current excess liquidity that banks have on their hands could be much better employed if invested in real estate," Abou Jaoude said. With access to high-net-worth individuals looking for safe investment alternatives for their cash, banks can bring their own as well as their customers' money into the local real estate market. With hundreds of millions of dollars to invest, banks naturally prefer to take a direct role in managing their real estate portfolios. Real estate affiliates or sister companies have cropped up in many major banks, such as CGI at the Audi Saradar Group and FFA Real Estate at FFA Private Bank. For real estate bankers Abou Jaoude and Farkouh, it is only a matter of time before more and more banks jump on the real estate bandwagon, either by establishing their own real estate subsidiary or by joining forces with large, established real estate developers and contractors. "Banking groups have the further advantage of reassuring both investors and clients, as they represent financial solidity and transparency in their dealings," said Farkouh.

ECONOMIES OF SCALE

The single biggest added-value a structured developer has over its contractor counterpart is the organization of the building process. "Having the financial and development sides of the operation under one roof helps in optimizing cash flows," said Abou Jaoude. A structured development company offers checks and balances that a smaller entity would not have. *Karim Bassil*, CEO of BREI development company, believes that a structured development entity produces better quality work because of the internal checks and balances among its different departments and because of quality control at every phase of the development process. "There was a time when my father managed everything from plan development to construction site, but for one person to run our current several-hundred-million-dollar business alone would be unthinkable," said Ibrahim. The size of the projects dictates that a large structure be put in place to manage the complex work flow. In turn, because work becomes better organized and more systematic, it inevitably results in higher quality end products.

INTERNATIONAL PLAYERS

The entry into the market of international players, both investors and buyers, has spurred the emergence and development of big local developers. "The local market has of late become much more open to foreign investors and foreign buyers," said Bassil. To invest in an economy perceived as being highly volatile, foreign investors as well as foreign clients value the guarantee of a professional, organized, and established developer. International investors also come with expectations about what a real estate developer should be able to offer. "The model has been proven viable. It has been tried and tested globally," said Farkouh. The entry of international investors, attracted by a solid local real estate market that is still underdeveloped, is reshaping the profile of local development companies. "Many local contractors are currently growing into institutionalized developers by establishing joint ventures with international developers that possess the know-how," said *Joseph Mouawad*, chairman of Mouawad Projects. Mouawad believes that it was the arrival of Solidere on the real estate market that prompted the growth of professional developers locally. "Solidere set precedents in standards, planning, and execution that have forged a trend for other developers to follow," he said.

> The entry of international investors is reshaping the profile of local companies

BIG STABILITY

The effects of such developers on the real estate market are immediate and palpable. According to Abou Jaoude, institutionalized real estate developers lead to stability in prices. "Because projects created, executed, and promoted by professional real estate developers are expected to make a specified return, prices will remain stable throughout the life of the project," he said. With studies made before projects are launched about how much IRR investors should expect on their money, prices will be fixed at whatever level achieves this return. Unlike smaller development or contracting companies, large developers are not tempted to increase their prices with every successful sale they achieve. Being highly structured and obeying strict financial regulations and monitoring, real estate development companies tend to offer more stable prices. "Banks and investment companies are playing a role in keeping non-professionals out of the real estate market," said Mouawad. This is another indirect benefit institutionalized real estate companies bring, simply by making it harder for non-professionals to compete in a market that is very well studied and extremely well planned.

NOT SO NIMBLE

There are other effects institutionalized developers bring to the market that may not be so well regarded. With longer time lags between decision taking and execution, big developers may reach the phase of implementing a project at a time when the market is registering a slowdown. Also, some experts believe that because real estate developers are financially more solid (and often have the backing of a bank or another financial institution) they may be prone to taking more risks than an individual developer would on his own. Bassil seems to agree. "It's developers with a conviction who would last on the market. Investors may make fast money, but it's only in the immediate term," he said.

MARKET DIVIDE

Another indirect effect of big developers is to divide the real estate market between high-end and lower. Because developing prime land in hot-spot areas represents more attractive profits, institutionalized developers may become exclusively interested in developing prime projects for the upper-end market. "Being such a structured entity usually means higher overheads, which may render institutionalized developers too expensive a business to operate in the more price-sensitive middle- to low-end markets," said Bassil. Abou Jaoude agrees: "The project must be large enough and profitable enough to ensure that the developer (effectively the middle man in the construction process between investors and buyers) makes enough profits to render the whole enterprise worth his while," he said. With a market segregated between a high-end developer and a middle- to low-end local contractor, critics could accuse big developers of building housing only for the rich, meaning that the less well-off never benefit from the improved standards big developers might have brought to their end of the market. But this is the natural course of the economic survival of the fittest. Institutionalized developers are better adapted to deal with large-scale projects in up-scale locations, while local contractors, with a lower overhead, are ideal for competing in the middle- and low-end of the market, where every dollar saved is a dollar gained. The divide may also not be so clearly cut between the two markets. "More and more projects of some magnitude may require the services of a professional, institutionalized developer, be it a glitzy project in a chic part of town or middle-income housing apartments in the more popular suburbs," said Farkouh. Professional developers are more about size than subject matter.

> Professional developers are more about size

HERE TO STAY

While not new to the market, professional developers are becoming more numerous, bigger, and better organized. The scale of some projects are reminiscent of Dubai – Sama Beirut, for instance, is the first tower of its size in the country and BeitMisk is the largest gated community project in the country. (See article on page 80) In a country where land is becoming more and more scarce, where demand for housing is ever pressing, and where prices attract ever more investors, large-scale developments seem to be the inevitable trend. And large-scale developments require the existence of large scale, professional, institutionalized developers. "Structured development companies are here to stay," said Mouawad. The major advantage these entities have over traditional contractors is their ability to forecast the market. "The job of a professional developer is to see what is missing in an area and complement it," said Bassil. Developers study demand trends, look at the available supply, and study what the market will be missing over the next few years. And that's what they will develop. So what is coming next on the agendas of the mega-developers in town? Real estate projects with an added-value: "Tourist projects are sorely needed, as are projects coupled with service-oriented industries, such as wellness, hospitality, and so on," said Abou Jaoude. Mouawad's firm is planning along similar lines, with more hotels in its construction pipeline. The hard-core realtors will continue to provide high-quality, residential projects, as is the case with Jamil Ibrahim. Whichever type of projects developers dream up next, though, they are most certainly likely to keep growing in both size and budget.

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