Off-Plan Development

What Now For Sales?

Executive Summary

- Off-plan sales is a tool that if used appropriately can help to mitigate and distribute the risks associated with real estate development
- During boom times the spread between prices of off-plan and completed properties diminished considerably, which meant the market did not price adequately the risk of construction
- As the real estate asset bubble burst, trust in the off-plan market was lost and few off-plan sales occur
- Deficiencies in the process and structure of the market included buyer exuberance, little developer equity, an incomplete contractual framework, and increased developer leverage
- More developed markets have not been immune to off-plan sales issues, but have coped better due to certain structural enhancements and experience including lenders acting as underwriters to ensure a project is viable, larger deposits from buyers, more robust contracts, a transparent legal framework with numerous precedents to inform market practice and developers injecting larger amounts of equity
- For the off-plan sales market to recover, buyers must trust developers and the contractual and regulatory framework again, which means better information from developers and greater recourse against poorly performing developers
- Developers need to take stock of their projects, ensure they have the right people in the right jobs, reduce sales to speculative buyers, and show a coherent real estate development strategy, which includes realistic and robust cash flow analysis
- Regulators can help with more expedient legal and approval processes and a reduction in hidden or new costs post design approval
- During the current economic malaise, off-plan sales are difficult and all stakeholders will have to come together through a transparent process to understand the best way forward

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1. Introduction

This report looks at off-plan sales of real estate developments and will be of interest to developers looking to sell off-plan units, end users or buyers of off-plan properties and other relevant stakeholders including regulatory authorities involved in the real estate development process.

We look at how the 2008 crash affected buyers' confidence in the off-plan sales market

We explore how Dubai off-plan real estate sales went from being very active to stalling in mid-2008. Off-plan properties were being sold at similar prices to completed property, ignoring the inherent development risk of buying property that was yet to be built. After the downturn, trust in developers was eroded and very few off-plan properties could be sold at any price.

Other markets provide some insights

We look at how UK off-plan sales have coped with the global credit crunch and its aftermath and explore the Spanish framework for development loans that can reduce development risk, whilst acknowledging that it is not a remedy for over-construction.

We give some strategies for the current market

Finally, we look at strategies that could stabilise distressed off-plan markets, and steps that would help avoid market practices that foster cycles of off-plan boom and bust.

2. Crash in Off-Plan Sales in 2008

During periods of asset bubbles, prices rise to levels without sound economic justification. Traditional valuation approaches are discarded and participants justify new higher prices with recent comparable market transactions and price inflation, creating a self-reinforcing feedback loop.

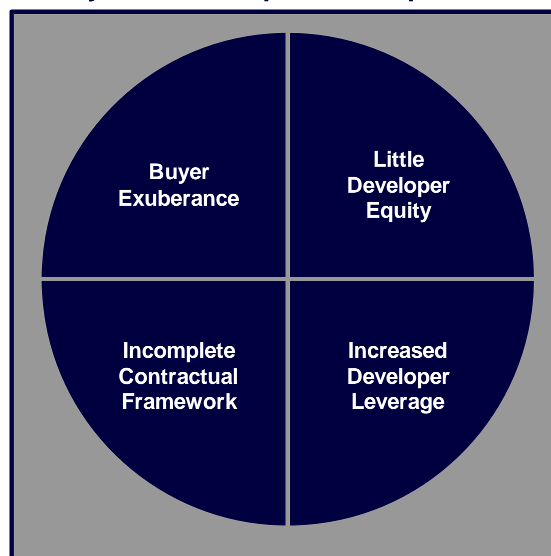
Off-plan sales help prices rise and rose to levels equal to completed property prices

One of the peculiar characteristics of the recent real estate asset bubble in Dubai was the protagonist role of off-plan sales and how practices related to off-plan sales reinforced an upward spiral in prices. During that period, the spread between off-plan properties (properties that are yet to be completed) and completed properties fell as investors' risk aversion diminished. In Dubai at the peak of the real estate bubble, the price of off-plan properties was indistinguishable from completed properties, which meant there was no spread. However, the spread is important. It demonstrates to buyers the market's view on the risk of construction. In the UK, where spreads also compressed, the traditional spread has been 15-20% according to market commentators. When it falls to zero, essentially the market is saying there is no construction risk. This is obviously not the case, which has become abundantly clear in the current economic malaise.

We look at four areas that helped spreads between off-plan and completed property prices diminish

A number of factors precipitated spreads to compress, which were mainly associated with the lack of perceived or real risk taken by investors and in turn driven by investor greed. We identify four key areas that helped to reduce spreads between completed and non-completed properties. These four areas, depicted below, are not an exhaustive list of factors, but can be considered influential.

Key Factors In Spread Compression



Source: Isthmus Partners

Buyers were lured by small deposits and the promise of large rewards

The first key factor, Buyer Exuberance, was reinforced by the practice of putting down relatively small deposits, in the range of 5% to 10% of the total off-plan property price. In a market where investors flipped off-plan properties aggressively, this likened investing in property to acquiring an

option where the deposit was akin to an option premium. However, the difference here is that buyers did not believe that prices would eventually fall or even that there was a ceiling for property values. The real risk of losing the deposit was ignored and ignorance was compounded by the small deposit requirement combined with a promise of large returns. Also ignored was the requirement to pay the remainder of the payments in the payment schedule. A larger deposit of say 15-40%, which is more usual for off-plan properties, would have tempered, but probably not eradicated this behaviour, as larger deposits ensure investors think more about the real risks involved.

Speculative buyers bought in bulk straining supply to real buyers

Speculative investors, buyers who bought properties in bulk for resale to end users, started to buy up floors or even entire off-plan properties, which served to reduce the spread between off-plan and completed properties further. Real end users would therefore have to pay high premiums for apartments or office space if they wanted to buy. A number of companies found it difficult to buy office space to house their staff during expansion periods, which meant they bought into the off-plan real estate bubble, as properties for rent were just not available.

Weak contracts provided little conflict resolution or rights

The second key factor, Incomplete Contractual Framework, saw little thought given to the framework of contracts between off-plan buyers and developers. Many weak contracts were put together, which sometimes were fairly one-sided to the benefit of the seller. Even worse were booking forms that provided no real protection or indeed much in the way of conflict resolution or rights. As delinquencies increased, many market participants started to look at their contracts for the first time and only just realised the extent of the risks they had taken. Contract risk is real, but if the market shuns this risk to gain access to otherwise unavailable investments, that risk is compounded, as the contract is not improved either by individuals or through market mechanisms. Additionally, poor contracts between a developer and an EPC main contractor compounded issues when problems surfaced later on.

Developers designed properties with very little or no equity

The third key factor, Little Developer Equity, saw a number of property developers try to carry out developments with little equity, leading to most or all of the development risk being pushed to off-plan buyers as opposed to being shared. Where equity was invested (usually for the purchase of land) some of this equity was taken out once off-plan buyers paid their initial instalments. By no means was the whole market operating like this, but good developers have become tarred with the same brush, which is unfortunate.

Less well capitalised developers tended to spend a small amount of capital to develop an initial design, buy a show model, and start selling. In markets with little regulation this behaviour becomes easier. They expected to build the development with money that came from off-plan buyers. In general terms this seems reasonable, as forecasted profit can seem to act as a buffer for any unanticipated contingency. However, a number of issues arose; not least was the lack of adequate forecasting of project cash flows. With solely an initial design and little development experience, it is nearly impossible to understand the amount of cash flow required at each stage of a development. The timing of cash outflow requirements for contractors was not at all matched with the cash inflows from off-plan sales. Little consideration was given to the impact of

delinquencies or cost inflation and in the end many developers were puzzled how their development approach failed. Even today, many developers still look to try to resolve their cash flow issues through static models, which do not take into account future risks, time delays, delinquencies and uneven timing of cash flows.

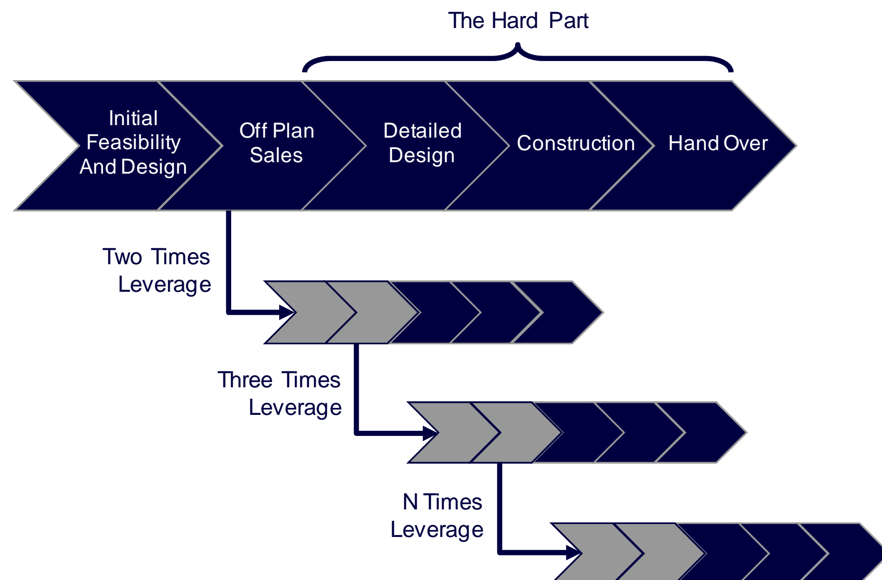
Real estate construction is complex and risks can be under appreciated by new developers

Development is a complex process with many inherent risks, which most experienced developers will confirm requires day-to-day handling. Without real equity behind developers, many of them tried to circumvent certain key job roles. Many developers did not hire development managers, a role usually carried out by the developer in-house. Lack of in-house experience led developers to leave developments entirely in the hands of project managers, who have competing interests and do not look at risks in the same way as developers. Project managers continue earning monthly project management fees even if construction is delayed and they do not lose any capital if the project fails. Their risk is limited to reputation damage, which is less valuable in a region that values inexpensive delivery higher than quality and experience. Also, project managers, quite rightly, expect the developer to resolve cash flow issues and have no visibility of how off-plan sales cash inflows affect the developer's ability to pay its commitments.

Using capital from one project to buy into other projects increased leverage

The fourth key factor, Increased Developer Leverage, saw developers buying more land parcels for development. Not withstanding the above issues, many developers extended themselves further by buying plots of land for more developments, essentially increasing leverage on their already small or non-existent equity. Off-plan sales funds from one project were used to buy land for future projects, which then went through the same cycle, as depicted in the diagram below.

Off-Plan Sales Driven Development Strategy



Source: Isthmus Partners

The more complex part of the development value chain, i.e. detailed design through to construction and hand-over, was a periphery concern in predominantly sales-led developer organisations. Many times, incomplete

or no feasibility studies were carried out before land purchases, as developers clambered to supply more promises of future real estate to a market that was hungry to buy.

Developers without equity become managers with no ‘skin in the game’

The behaviour of developers demonstrates a clear example of an agency problem. Developers are meant to be shareholders in any development because they have real equity invested in the project they are carrying out. However, in many cases, little or no equity relegated developers to the role of marketing agents that, in an exuberant market, looked for short term positive cash flows to bolster their near term profits. Many developers could use these short term profits to justify dividends and purchases of more land parcels without looking at both the financial and operational liabilities they were incurring.

Some regulatory changes helped to soften the landing

It should be noted that the introduction of escrow accounts in Dubai in 2007 helped to dampen practices that were leading to an upward price spiral. Without escrow accounts we argue that the asset bubble would have been more accentuated and it’s bursting even more damaging. However, since escrow accounts limited the amount of off-plan instalments that could be used for non-construction costs, it seemed that, for some developers, it increased the urgency to have access to new projects to sell off-plan.

The market lost confidence in off-plan sales very quickly

Once the market turned (literally overnight), investors and buyers quickly lost confidence. Many speculative investors either could not pay instalments, as they were unable to off-load their risks due to the lack of interested takers. Buyers started to see the price of their properties fall below the remaining amounts to be paid on their off-plan properties, so defaulted. Other buyers wanted assurances that developments were going to be complete before investing further, which developers could not provide.

The lack of equity is evident in these situations, as there is no buffer cash on the balance sheet to continue with construction so many developments stop or run at a snail’s pace, which simply exacerbates the problem. Essentially real estate development without equity does not work.

The market will continue adjusting, but the correction may prove a difficult time, as we have seen in Dubai. With escrow accounts, registration of properties and better oversight of developers, hopefully buyers will gain confidence in the system again. And hopefully, the off-plan sales market can be revived.

3. Lessons from Other Markets

Little off-plan regulation can be found in other jurisdictions, but they do have institutionalised experience

The first thing to note is that there is no real regulation elsewhere, developed markets or otherwise, for off-plan sales. Caveat emptor ("let the buyer beware") is the market doctrine for buyers of off-plan units. However, other markets have institutionalised experience of construction over many decades. Market participants are more cognisant of the risks inherent in buying and selling off-plan, and regulations are imposed on developers to ensure that capital is segregated for specific developments.

Developers are judged on prior project quality and delivery

Developers are expected to have track records of successful developments, which can be viewed demonstrating not only the ability to complete a development, but also quality. Newer developers are expected to provide greater discounts due to their lack of experience, but this is a market mechanism that can fail in boom times.

Final product quality can differ and variations within limits are allowed by contracts. With the information available to customers, buyers are expected to carry out their own due diligence and understand how market movements affect their ability to purchase the property.

Insurance can offset some of the risk of developer default

Buyers may have recourse to insurance funds in case developers go into bankruptcy. The National House Building Council (NHBC) in the UK is a not for profit organisation that provides insurance to developers, and in case they are unable to complete a development would pay the off-plan buyer a portion of the sales price. NHBC profits are used to raise standards within the industry.

More off-plan sales are carried out once the project has begun

The bulk of off-plan sales are generally carried out during the latter stages of a project development and rarely at the concept stage, and developers invest real equity into projects. Developers provide completion dates, but these dates are not guaranteed; instead they are estimates, and most developers and buyers know that initial estimates are subject to slippage.

Contracts are stronger and have case history behind them

Contracts have been developed through market practices over time. The tested legal framework and experience in conveyance has helped buyers understand better what risks they are taking on. With a deeper market, legal costs are lower, which has helped make legal advice more pervasive and standardised. Clauses such as conflict resolution, penalty interest and cancellation rights are more readily found.

The court system is decisive, transparent and swift. With more robust contracts and precedence, the courts have better guidance on rulings, which are binding. The precedents also help buyers and developers alike understand where they stand on conflicts.

The safeguards of other jurisdictions did not stop issues arising

With the above in mind, buyers in developed markets still fell into the same Buyer Exuberance traps as buyers in Dubai; though to a lesser extent. The price discount for off-plan sales compared to completed property, especially in a rising market, is attractive and lures buyers. Therefore, there are numerous cases where the buyer is unable to pay for the off-plan unit. For instance, in the UK, Ballymore Properties took legal action against 120 customers after they reneged on contracts and refused to pay for purchased off-plan properties. Half of the customers have agreed to rearranged payment schedules, while two judgements were

found in favour of the developer, where the court imposed financial penalties, and ordered the buyers to pay the balance due on the off-plan unit with interest and legal costs. Some developers are more amenable to rearranged payments than others dependent on their own cash flow situation, and future strategy.

Lenders have not helped by withdrawing mortgages on properties that have dropped in value

The problem is exacerbated by lenders, who have either withdrawn mortgage offers or asked for bigger deposits after revaluation of the property to be mortgaged. Lenders retain the right to revalue properties before funding. This leaves many buyers with the task of finding capital to fund off-plan properties that are likely to be in negative equity, which can cause personal bankruptcies.

In Spain there is a mature market for development real estate loans. The standardisation of practices and contracts and the depth of the market have even allowed the securitisation of portfolios of real estate development loans.

In Spain, development financiers act as a sense check on the viability of a project

One benefit of a development real estate loan is that there is a source of financing that will ensure that the project is completed avoiding half-built constructions that are detrimental to the surrounding market. But the key benefit is that the lender acts as an underwriter of the development project, ensuring the project's business plan is feasible, the developer has good title to the land, sufficient equity is available, project design has been completed to acceptable standards (project designs need the approval of the official college of architects' local chapter), and the developer and main contractor have the credibility and track record in delivering on real estate projects. The development lender does not want to assume undue development risk and the loan officer usually has many years of experience in the real estate market. It is noteworthy to point out that independent third party appraisers have a relevant role in the development loan process and appraisal activity is regulated by the Spanish central bank.

Nevertheless, in Spain the gate-keeping role of the development loan did not prevent the recent over-construction and associated real estate bubble that subsequently burst, and the damage to development lenders. The balance of real estate supply and demand is essentially a role for government real estate planners, using instruments such as zoning and licensing (a balancing act much easier said than done). However, what the development loan does help to prevent is the legitimate off-plan buyer left without his off plan property and ugly abandoned construction sites.

In conclusion, Dubai has many of the checks and balances available to off-plan property buyers elsewhere, but it has a developing legal system that naturally lags in standardisation and precedents compared to more mature markets. Many of those checks and balances have been put in place after a number of developers started to sell off-plan and building properties. Add to this, buyers' enthusiasm for Dubai real estate during the asset bubble period and we can see how confidence in the off-plan sales market has withered from initial high spirits.

4. Strategies for a Stable Off-Plan Market

Off plan sales are a vital part of the real estate development process

Off-plan sales is a legitimate tool in the development of property and its return is vital to the real estate construction industry. Its ability to help developers reduce equity requirements and provide cash flow to projects ensures returns are attractive enough for development investors to bear the risk of building new properties. However, trust in the off-plan sales market has diminished and now we must look for new ways to build up that trust again.

Economic cycles come and go and investor memories are short-lived. However lessons from the asset bubble need to be used to shape future business practices and the regulatory environment in emerging markets. We envision that developers will be expected to have real equity in projects, greater transparency will be demanded and expected throughout the whole construction value chain, and buyers will be aware of their need to carry out proper due diligence on the risks they are taking on board and really understand the contracts they are signing.

In this section we look at what the buyer and developer look for in an off-plan sale and how those conflicting requirements can be met. We also look at the glut of off-plan properties currently on sale and how to best manage that situation.

<u>What the buyer looks for</u>

Buyers need to be able to trust developers again

Trust in the developer and the market is fundamental. Stories of poorly treated buyers, who have little legal recourse and few updates from developers, or even absconded developers abound. Restoring trust will obviously take some time, but price stabilisation will certainly provide relief. From that point, developers need to be more transparent and show they really can complete projects in a timely manner and according to pre-agreed specifications.

Developers need earn buyers trust by being transparent

Part of the transparency will come from developers that provide appropriate and accurate development updates. This will not include updates on financial stability or cash flows of the developer because developers are private enterprises and as such should enjoy some form of corporate privacy about revenues, profits, etc. However, real information about milestones being reached, variations made and advance warnings of future customer payments should be a minimum requirement. The accuracy of these items is paramount. The days of a few pictures taken from a different angle from the month before are gone. Omission from the minimum information requirements should signal to the market that a developer is not performing well.

This type of information should be readily available to all developers on all their projects. Developers that are unable to provide this type of information are obviously not on top of their developments and should be punished by the marketplace.

Buyers must understand that off-plan sales are risky investments

Residential property buyers will want a relatively safe investment that can be financed. There are two parts to this statement. First real estate property is not guaranteed to be a relatively safe investment. It is a highly leveraged investment for most buyers that constitutes a large portion of

their personal wealth. This cannot be seen as a relatively safe investment in the short-term. In the medium- to long-term, real estate acts as a good inflation hedge and has good investment qualities, but short-term cash flow issues must be catered for. Owners around the world are discovering this. The second part of the statement pertains to financing. In this market, it is difficult to see credit recovering in the near future. Banks that have appetite currently finance completed property at considerably lower loan to value ratios and abstain from the off-plan property market. Therefore buyers of off-plan units will have to resolve themselves to finding equity to pay for their purchases and demanding very low prices.

Commercial property buyers will need some assurances that developments will be completed in time for the office space to be occupied. This is especially important for corporate planners in expanding companies. However, with the excess of office space in Dubai, it looks unlikely that interested companies would entertain buying off-plan unless there were huge discounts and assurance of completion available.

What the developer looks for

The foremost reason for a developer to exist is to make profit from construction projects. Without the promise of profit, no one would build anything. Nevertheless, in order to make profits, developers need to entice buyers and offer them fair value on properties they build.

Developers need help from the authorities with clear and stable processes

Developers would like to see support from local authorities to ensure projects run on time and without hindrances. This means better and timelier co-ordination of approvals and utility connections, fewer hidden or additional charges appearing post design approval, such as utility connection charges or interim registrations, etc. and more expedient default procedures that are actually carried out.

Developers need to sell to end users not speculators to reduce their default risk

Developers should also focus more on end users than speculative investors or intermediaries who distribute to end users. Speculative buyers, as we have seen in Dubai, just store up problems for a developer in downturns.

Developers should use experienced ‘in-house’ development managers

Developers want to see progress on their developments, but need to ensure they hire the right people to make that happen. No longer can they afford to ignore the in-house development manager role. Without an experienced development manager, developers are left to tender contracts through project managers without really understanding what they are buying. Having a non-expert hire an expert is inherently risky, especially when the expert’s incentives are different.

Developers may need financing, but this is difficult to come by in this market

Finally, developers would like to see financing for projects, which is difficult to achieve in this market, and where viable it is very expensive. To find financing, developers need to have done their homework, which means possibly carrying out the feasibility study they may have skipped at the beginning that includes calculating cash flows over the term of the development and an exit strategy. If financing is obtained, the lender must be kept apprised of progress, whereas the lender should be expected to be professional in its approach to a project and ensure processes are laid out up front and so not continually changing and committed amounts are forthcoming.

How to resolve competing needs

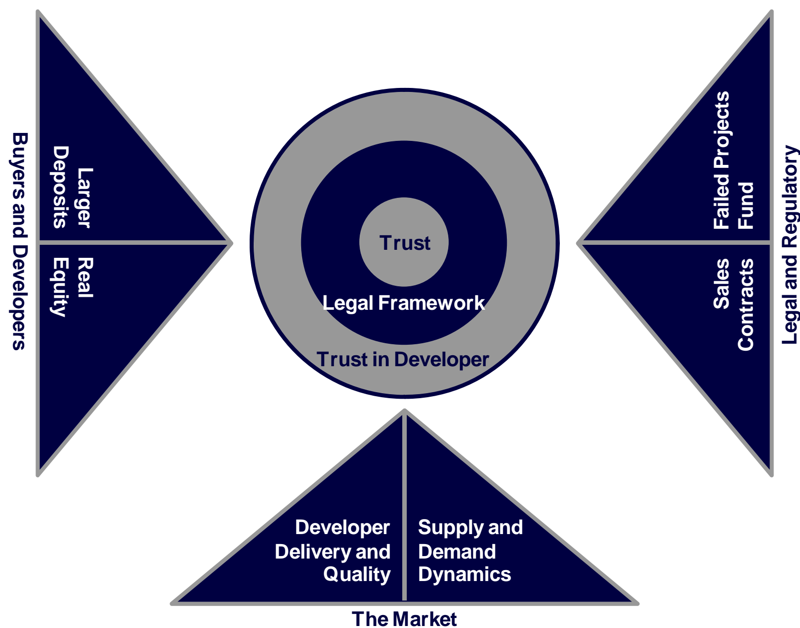
Before looking at how off-plan sales could be handled in Dubai for properties already under construction, we look at more Greenfield site approaches, which would cover more jurisdictions that are less affected by the economic downturn. Such jurisdictions would include Saudi Arabia and Libya for instance.

Essentially, we are trying to find a way of selling an item that does not exist. Therefore, at the centre of any system of off-plan sales has to be trust. We have seen once this trust is eroded, buyers just disappear and no real market exists.

Trust is central to a robust off-plan sales model

In our model illustrated below, we look to build that trust through the legal framework for a jurisdiction that protects both the buyers and developers, which is followed by trust built by developers. If the legal framework is in place, it will be easier for developers to build that trust as buyers understand that developers are regulated on how the capital provided to them is used and that they have legal recourse in case of fraud, misappropriation or any other misconduct.

Framework for Off-Plan Sales



Source: Isthmus Partners

Stability in regulations will help reduce market anxiety

Regulations that are put into place must be fairly stable. Of course, as the market learns regulations are changed, but constant flux within the rules are a source of market anxiety. In addition, the fair, consistent and expedient application of the rules would help build trust, which may mean allowing bankruptcies if required.

Reducing the number of off-plan sales will increase the need for equity

Regulation may need to look at the number of off-plan units that can be sold at different stages of the project. The initial units sold would command greater discounts by the market due to the greater amount of risks involved. Constraining the amount of units sold would lead to real equity being required and proper feasibility studies being carried out that

look at cash flows in a dynamic not static sense.

With this foundation at its core, the system can then build mechanisms that would entice buyers into purchasing off-plan properties. These mechanisms would include:

- Market analysis to determine supply and demand dynamics
- Market views on the delivery capability and quality of developers
- Well regulated escrow account regulations and practices
- Funding for development projects and an underwriting role for development lenders
- Better contracts – both between end users and a developer, and between a developer and the main contractor
- Larger deposits or down payments – makes investors more aware of the risks involved and limits the ability of speculators to influence the market
- Real equity

The market has to self-regulate to some extent by carrying out better due diligence

The market has to do a better job at carrying out due diligence and understanding the risks involved with buying off-plan property. Dubai has seen what happens when valuations are purely based upon comparable transactions and inflation trends. Supply and demand, delivery likelihood and quality all have to be factored into a fundamental model, which takes into account the cash flow generating ability of the property net of costs. And developers need to understand whether selling to a few speculative buyers is good for their cash flows in the long run considering the concentration in risk of delinquencies.

Strong and well tested contracts can help all stakeholders

With a trusted stable legal framework in place, developers should write equitable, consistent and complete contracts. Buyers should read them or have legal representatives read them to ensure they understand the risks that are being taken. A “cooling-off period” of two weeks will help mitigate the impact of high-pressure sales tactics. Buyers who disregard contracts will always be susceptible to poor judgement calls, and the market is likely to punish them.

Insurance providers can provide some checks and balances

Funding for failed projects could take many forms. For instance, if banks fail to provide a market of competitive development loans there could be a market based approach where insurance can be introduced for projects that do not go ahead. If a project fails, a buyer could recoup some of their capital outlay minus a deductible from an insurance claim. This type of insurance would need a helping hand in being set up, as it is likely to be expensive for developers to obtain initially until there are economies of scale, which would mean either government subsidies to start such insurance or a push for all developers to have such insurance through regulation. Buyers would look at developers with such insurance more favourably as their risk is somewhat mitigated. Also, the insurance company would act as another check on the viability of a project as premiums would reflect the risks that underwriters believe exist in a development. The insurer will take the “underwriting” role previously mentioned carried out by development lenders in Spain.

Equity is a must for developers and buyers

Developers and buyers both need to understand that there is no free lunch. High leverage means high risk. So buyers putting down small

deposits and developers having little or no equity mean projects that have little protection against adverse conditions. Developers without equity do not really have "skin in the game", and are purely managing a process, but this is not how developers should work otherwise it is easy for them to walk away when projects fail. This may mean a smaller off-plan market, but at least it will be a sustainable one.

Off-plans sales can reduce the risk financiers face lowering cost of funds

Finally, it is worth noting that the off-plan market serves a valuable mechanism to reduce risk and ensure properties being built are actually required. Off-plan sales ensure buildings are built with less leverage ensuring lower cost of funding and greater buy-in from end users. Lenders can see that they are lending to viable projects and are likely to draw comfort from sales on a development that would otherwise be purely speculative.

Off-plan sales provides a feedback mechanism for developers

Buyers will only buy off-plan properties if there is a need for those properties and if those properties are designed to meet market requirements at the right price. Therefore, off-plan sales provide feedback to developers about supply and demand, their design and sales prices.

What can be done about the current malaise

The idea should be to increase the size of the pie for all stakeholders, not to quibble over crumbs

The real estate market is difficult for everyone, so all stakeholders will need to pull together to get out of it. Negotiations about who gets the biggest slice of the pie will just serve to reduce the size of the overall pie. It is natural for stakeholders, who feel hard done by to want their slice back or for others to take the pain. Where there is a legitimate case, possibly some people should receive their slice back; however, in this market we have to look at what are now considered sunk costs and where we can move from here. Entrenched or no negotiations and poor transparency has not helped matters.

The main stakeholders we look at include the developers, buyers, contractors, lenders and regulatory authorities. Each has something to offer to start the off-plan market moving again.

Developers must start the process as they are central to the whole process

We start with developers, as they are at the centre of each development and as such will need to co-ordinate stakeholders coming together. Developers must start by taking stock of all the stakeholders in each project, and decide whether they are the best people to take the project forward. For instance, are the project managers driving the construction process forward and informing the developers about progress, or are they simply moving along with the process hoping eventually the development will be completed? They also need to look internally. Does the developer have the right development manager to make sure the project is efficiently run and who understand the risks and issues and cash flows? If the right people are not available, they need to be hired and if the wrong people are involved, they need to be replaced. Developers are left with some stakeholders, such as lenders and buyers, so they will have to involve them in the process early.

A robust financial model with adequate cash flow modelling is required

Developers need to come up with a financial model, which they are prepared to share with all stakeholders. Being coy about a development at this moment, hoping prices will come back is just burying your head in the sand. Things will look the same when you come up for air. This model needs to take into account sunk costs, future costs and liabilities and

forecast cash inflows from current payment plans and future sales. The risks of each component of the cash flow needs to be determined through detailed sensitivity and scenario analysis. From this model, a strategy needs to be put into place. It may be that there is no money to be made once the analysis is complete, but so be it. Then the stakeholders at least have a base line from which to understand what to do next and have real data on which to base decisions. On the other hand, it may be the information buyers require to have confidence enough to continue to make payments and will certainly provide some much needed transparency to all stakeholders.

Buyers should form groups to negotiate with developers

Buyers should try to form groups to negotiate on their behalf and developers should aid this effort by helping buyers contact each other. Numerous buyers are not only a distraction to developers, but they also do not control much power at the negotiating table. A unified group will at least be able to provide a single voice and a better information dissemination mechanism. Buyer groups can vet the developer's strategy early and provide guidance on the constraints buyers may insist upon. In turn buyers must come to the table with a view of completing their payments, albeit on a potentially different schedule. Without this commitment, developers have little reason to ensure buyers are kept at the negotiating table.

Lenders must realise they are in developments until the end or write-off or sell their loans

Lenders have a difficult position in that foreclosing on developers will not necessarily ensure they are repaid and doing nothing makes life uncomfortable. To ensure they have a seat at the table, they must come with a view that they may not see a repayment of full principal. Making loans is a risky business and when things don't go well write-downs are inevitable. In addition, lenders must ensure they are not hindrances to the process. Many lenders are also the escrow bank for a development, so when legitimate payments must be paid from the escrow account, the bank should not delay payments using the pretext of altered processes or incomplete paperwork. Delaying payments will inevitably only delay projects and adds to general mistrust. Nevertheless, lenders will have to remain involved until the end of the construction process and distributions of cash flows.

Contractors may have to forgo their profit margin until the end of a project

Contractors have cash flow businesses so it is understandable when work stops or is delayed as subcontractors cannot be paid. Running the supply chain requires capital, which is in short supply, but running the supply chain in a leaner fashion and possibly arranging for profits to be paid at the end will help complete the building, which is when the final cash flows can be released and everyone can realise final payments. If the developer is forced into bankruptcy due to no progress being made, the contractor will soon find itself with bigger problems. If cash flows are squeezed late in the construction cycle, contractors may be better off negotiating a stake in the building in exchange for work rather than walking away. In fact, many of the other stakeholders may find they have to take equity stakes in the project in lieu of remuneration or payback during the negotiation period.

Regulators can help push stakeholders to find solutions

Finally, the regulatory bodies can have a big impact on all the stakeholders to ensure the above processes are carried out. It is not fair to force private entities to the negotiating table without cause; however, if a number of buyers are continually complaining about a particular

developer's reluctance to move forward this provides a legitimate cause. As a part of forcing developers to the negotiating table, developers must be encouraged to show some financial transparency. If a developer is purely smoke and mirrors, they must be weeded out; though a lot of that has probably happened over the last couple of years. RERA has started to perform some audits and have provided information about projects online, which is an encouraging sign.

Areas that could be improved include how the development process is handled, defaulting buyers, legal transparency and public relations. Throughout the development process, good developers should be supported, and new costs which just take cash flows away from developers should be avoided. In a time when developers are short of cash, adding new costs and fees only propounds the problem and encourages non-compliance.

Though there is an off-plan property buyer default process, which is fairly clear, its implementation could be improved. Jurisprudence and actions by groups of investors would help with market certainty More expedient rulings would also help the market move forward more rapidly.

Dubai currently has a PR issue, which needs to be addressed

Once the above is implemented, a good public relations programme is required to communicate how Dubai has changed and the steps taken to consider all stakeholders. There will always be some disgruntled stakeholders, but the overall improvements should be highlighted.

The distress that the real estate market is currently feeling could be with us for a few years to come. The less transparent the process, the longer the timeframe for decisions to be made and the more compromises made to ensure poor developers stay in business and buyers can string out payments without recourse, the longer this period of adjustment will be.

Without the implementation of at least some of the above proposals, we feel customers are unlikely to have confidence in Dubai to buy off-plan. The longer it takes to clean up current transactions, the longer it will be before new buyers will venture forward.

About Isthmus Partners

Isthmus Partners is a UAE based consultancy that offers consultancy advice on real estate and private equity assets. It was founded and is owned by three partners with a wealth of principal finance and structuring experience from 25+ years in investment banking and management consulting.

In the real estate sector, Isthmus Partners advises on and structures deals in the late stage development segment. The partners have worked on restructuring a number of real estate deals in Dubai including The World, Sports City, The Marina, and The Waterfront.

In the private equity sector, Isthmus Partners focuses on new ventures, expansion capital and buyouts for SMEs, and equity and debt financing of medium sized firms. The partners have worked on a number of new venture proposals based on product and materials manufacturing across the GCC, tourism and software. They have also worked on expansion financing and buyouts for an interior design firm and in the alternative energy sector. Isthmus Partners also works with a number of institutional funds to provide equity and debt financing for more mature companies.

Isthmus Partners' services include investment project health checks through financial due diligence, feasibility studies, monitoring of ongoing projects to ensure greater control through cash flow monitoring models, and advice on sources of financing.

For more information and to find more of our available reports please visit our website, www.isthmuspartners.ae.

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