ADVICE RE CAPITAL & CHARLES RUSSELL SPEECHLYS LLP|
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REAL ESTATE PRIVATE CREDIT IN THE GCC

The Future of Funding

The Potential of Private Credit for the Real Estate Sector in the GCC

Investors are increasingly concerned about inflation and rising interest rates and are looking for some form of yield to enhance portfolio returns. This need is further exacerbated by the pandemic induced volatility of the stock and bond markets. For an ever-increasing number of investors, this search leads them to the world of private credit.

Leading up to 2020, private credit emerged as the rising star among alternative investors. Though not as large as hedge funds or private equity, its growth trajectory in the decade following the 2008 financial crisis outpaced other alternative investment sectors, strengthened by demand from both borrowers and investors.

Private credit remains heavily undeveloped outside of North America and Europe. For investors looking to diversify outside of these regions and gain exposure to emerging markets, an early move into a rapidly growing debt market could be the key to securing superior returns. The Gulf Cooperation Council (GCC) could be the place to access the kind of rapid growth experienced in western economies over the past decade, with the real estate sector a clear standout candidate for private credit.

KEY TAKEAWAYS FROM WHITE PAPER:

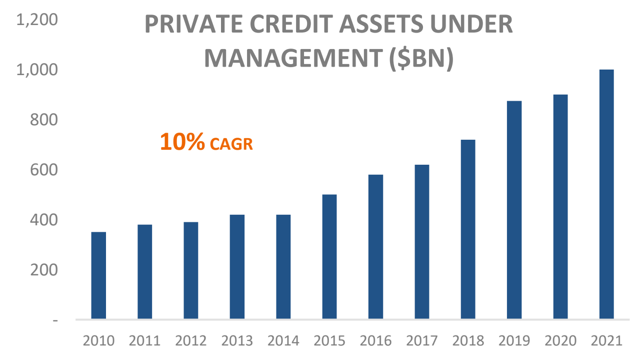
- Private Credit rise in the global arena
- The contrast of private credit and bank debt
- Advantages of private credit
- Type of private credit strategies
- GCC private credit landscape
- GCC real estate landscape
- Potential products to deploy private credit in GCC

WHAT IS PRIVATE CREDIT?

Private Credit (also known as Private Debt), refers to loans by non-bank lenders, typically private credit funds and specialty finance companies, which are not issued or traded on public exchanges.

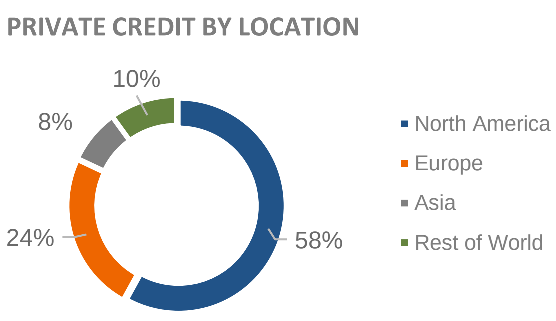
Private credit encompasses solutions to a range of capital or operating needs, including mid-market cash flow lending, leveraged lending for buyouts, asset-backed lending, venture debt and distressed debt. Private credit can be used in a range of contexts, from corporations that fall outside of traditional lending parameters, to young growth companies.

Private credit emerged from the global financial crisis of 2008/09 as a result of stricter regulations that led banks to reduce the size of their balance sheets. This led private credit lenders to fill the void left by the banks. The global private credit market was approximately USD $1.0T at the end of 2021.



Source: Preqin

Private credit has been dominated by western markets.



Source: Preqin

Private credit strategies can provide investors with the opportunity to outperform traditional credit markets whilst maintaining a stable income base.

COMPETITIVE ADVANTAGES

There are several compelling reasons to consider investment by way of private credit, noting that different credit strategies offer different benefits to investors. That said, there are some unifying factors that tend to be consistent across the private credit spectrum.

Diversification

Fixed Income is the most widely used diversifier in an equity investment portfolio, given its ability to provide contractual returns, generate a steady income, and to mitigate volatility in equity markets. Traditionally, investors have sought this diversification through the fixed-income markets, by lending to public companies and governments that can issue bonds to investors.

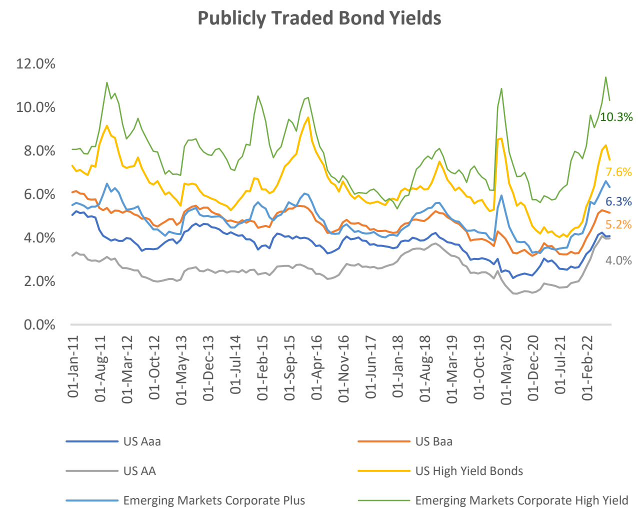
In recent times, due to the diminished returns available in public fixed-income markets, private credit markets have become an interesting proposition. Investing in private credit funds to access these underlying loans can provide higher returns to investors with the same diversification benefits as public credit.

Risk Adjusted Returns

Private credit funds have historically generated 2x returns when compared with conventional lenders and public credit (high yield corporate bonds), while requiring investors to take a limited, disproportionate risk. It would be misleading to compare returns with private equity as the risk and return metrics are drastically different. In fact, by way of example, during the period 2001–2016, the US private credit market registered an annualized loss rate of 0.70%, which could be said to be relatively low, especially when compared to other higher-risk investment strategies.

Private credit is more resilient during economic downturns relative to equity. Given their income yields and reduced overall volatility. most credit strategies tend to sit lower on the risk-return spectrum than equity. Accordingly, the launch of a credit fund in the current uncertain macro environment could provide the ideal risk adjusted returns to investors.

Investment in Private Credit Funds provide superior returns (>10%) as compared with publicly traded corporate bonds. The spread between the two is primarily due to an illiquidity premium. Private Credit Funds provide returns close to a CCC rated bond with a much better risk/return profile. Therefore, private credit is a lucrative opportunity to diversify an investor's fixed income portfolio by generating returns similar to a junk bond but taking on the risk of an investment grade bond.



Source: FRED Economic Data

Flexible Structures

Private credit usually follows transactions which are out of the realm of conventional lenders' appetite. Therefore, private credit lenders must be creative and flexible in creating debt structures that work for the investor and the borrower.

This could include subordinated debt or hybrid structures to ensure the returns match the risk taken by the investor.

Inflation Hedge

Interest rate risk and duration, which result from rising interest rates and rising inflation, are generally bad news for traditional debt instruments, such as bonds.

While traditional fixed income investors may find it difficult to obtain similar returns given the current rising interest rate environment, private credit typically consists of floating rate loans, which can be resilient to inflationary pressures and can help hedge against interest rate risk.

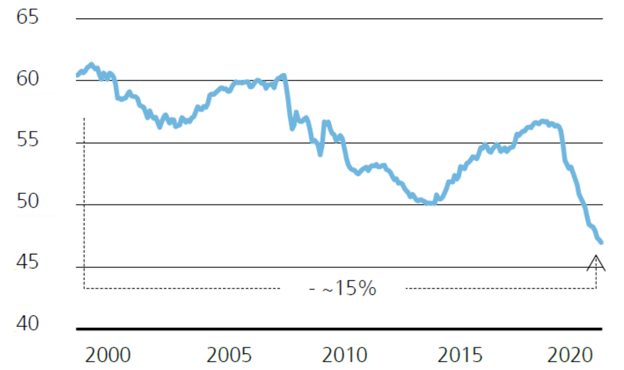
Time Efficient

As opposed to the bureaucracy of conventional lenders, private credit lenders are smaller players that have the ability to execute innovative and complex structures in a timely fashion, thus, providing borrowers with crucial liquidity for operations and opportunities on time.

Demand Driven

The demand for private credit has been growing in the western world ever since the 2008/09 global recession. We are also seeing that demand build up in MENA, particularly in the GCC. With the high interest rate environment and looming recession, the demand for private credit in the GCC is likely to rise in line with the western world.

Below is the US Commercial Loans Activity (% proportion of commercial and industrial loans relative to total assets for US commercial banks). This downward trend in lending has mirrored across the globe, leaving mid-market corporations hungry for private credit.



Source: Federal Reserve Data 2021 – not seasonally adjusted

TYPES OF PRIVATE CREDIT

There is a wide range of strategies that fall under the umbrella of private credit. Most of these strategies aim to match the return with their corresponding risk.

Direct Lending

Primarily consists of senior loans to SMEs or even large corporates. Direct lending represents the largest slice of AUM by private credit lenders. Direct lending is the ideal structure for private credit lenders as it provides a similar risk profile to conventional bank loans with a higher return.

Mezzanine Financing

Primarily consists of subordinated loans (usually only senior to equity) given to fill the last piece of the capital stack, or over levered companies in difficulty. Private lenders are more comfortable giving mezzanine finance to financially strong companies. The return can easily enter double digits for this sort of financing.

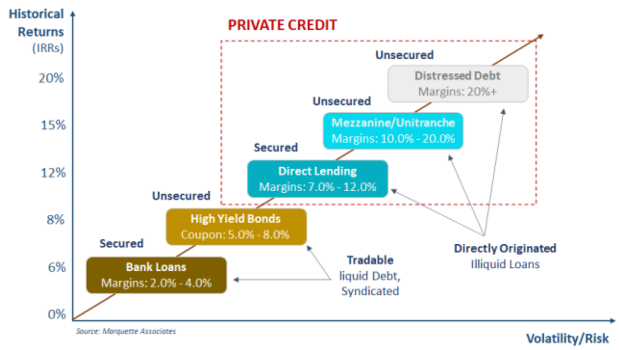
Hybrid Financing

A mixture of Direct Lending and Mezzanine Financing with senior and subordinated positions.

Distressed Debt

Represents the smallest slice of funding by private credit lenders. Highly risky debt for companies that are either on the verge of bankruptcy or already in bankruptcy. The private credit lender usually tries to buy existing debt at enormous discounts for profitable returns, usually through the liquidation process. The returns at times can exceed equity holder returns.

Below is a risk/return chart of Private Credit structures:



Direct Lending provides the lowest returns but sits at the top of private credit lenders priority, whereas Distressed Debt provides a niche opportunity for private credit lenders to earn an impressive return, at times exceeding private equity players.

Private credit and private equity have many benefits in common. The privacy element ensures that companies are able to shield their finances (which would otherwise have to be disclosed) from competitors, while managers are able to have closer relationships with the companies they are lending to.

THE CASE FOR REAL ESTATE PRIVATE CREDIT IN GCC

The GCC consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE, and was created 40 years ago to boost greater economic cooperation in the Arabian Peninsula.

Despite the global growth trends of private credit in the western markets, it is rather limited in the Middle East, with the vast majority of debt being provided by commercial banks. The lack of attention by regional investors is partly due to challenges with respect to foreclosure and bankruptcy laws (discussed further below), lack of market data and understanding of risk and reward metrics.

However, this trend is expected to change as market transparency and sharper regulations create a more lucrative environment for alternative investors.

Given the existing void that regional commercial banks have created for mid-market real estate developers, we believe the majority of private credit will be absorbed by the regional real estate sector.

Private credit in the real estate sector will be paramount to the following parties:

- **Tier 2 & Tier 3 developers**, who find it hard to access bank debt. This would ensure widespread availability to smaller and less well-established borrowers who currently struggle to secure traditional bank debt without providing a high-level of collateral as security.
- **Institutional investors**, such as family offices, fund managers, pension funds and insurances companies, which seek lucrative cash on cash yield through an interest only finance structure.

GCC Private Credit Market

The Gulf Corporation Council (GCC), within MENA, is a relatively tiny market for debt, particularly private debt. However, as the region looks to aggressively diversify away from energy revenue reliance, there is room for exponential growth in private credit, particularly in the real estate sector.

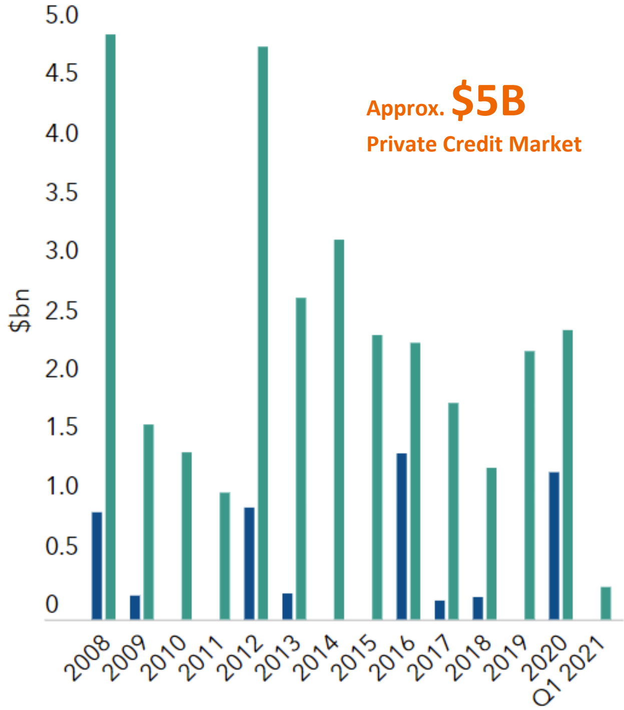
Historically, almost all real estate debt is sourced through commercial banks in the GCC, given the limited availability of alternative sources.

Private credit fund raising in the MENA region has not been consistent since the global financial crisis, with several years witnessing zero capital raised from private credit lenders.

Private equity has been more consistent over the past decade, although it is still relatively low, compared to western markets.

As witnessed in 2020, the market volatility due to the pandemic caused a surge of fund raising by way of private credit ($1.3B raised). Most of the private credit raised in MENA appears to be deployed in the GCC (mainly in Saudi Arabia and UAE), with the real estate sector being the biggest borrower.

MIDDLE EAST AND NORTH AFRICA-FOCUSED FUNDRAISING



Source: Private Debt Investor

Private Credit in Real Estate

Although, debt should be an integral part of the capital stack of real estate investment, historically, very limited use of debt has been deployed by GCC real estate developers as compared to their western counterparts. This is cultural in some regions but is mainly due to high demand for real estate (especially in UAE), where the majority of the capital stack is sourced through equity or receipt of end user proceeds during construction.

In 2018, developers began to introduce short post-handover payment for off-plan projects in order to meet sales targets. These payment plans extended since the pandemic to up to 5 - 8 years for some projects and appear to be here to stay. As a result, developers look to complete the project capital stack through bank debt in the form of construction financing or receivables financing. Such financing is only available for Tier 1 developers with strong financial backing, leaving Tier 2 and 3 developers scrambling for funding.

All the GCC economies have their currencies pegged to the US dollar. With the high interest environment and murmurings of an ensuing recession, the pool of traditional bank financing is going to get a lot smaller. As a result, private credit will be a necessity for smaller real estate players going forward, not just for greenfield projects but even for sourcing liquidity from operational assets.

Potential Size of Private Credit in GCC

As of 2021, approx. $150B of bank debt has been lent to the real estate sector in the UAE & Saudi Arabia only, making private credit approximately only 3% of debt in the real estate sector.

With local regulations surrounding private credit (i.e., Credit Funds) having come into being in 2022 in the UAE (discussed further below), and Saudi Arabia, it is not unreasonable to assume that the real estate sector has enough depth and breadth to absorb around 10% of bank debt, hence, tripling the private credit market to around a $15B, over the next decade.

DEPLOYMENT STRATEGIES

Overseas experience suggests that the majority of private real estate debt will initially come from institutional players such as pension funds, insurance companies and fund managers. Deployment will be limited to institutional real estate players (developers, family offices, PE firms, pension funds, insurance companies, fund managers, etc.) in the region who either operate income generating Build to Lease assets (BTL) or off plan sales of Build to Sell assets (BTS). Deployment strategies will differ for BTL and BTS products.

Deployment is likely to be across real estate asset classes including residential, retail, commercial, hospitality, industrial, logistics, healthcare, education, and data centers.

Build to Lease (BTL) products

The majority of these products will be bridge financing loans provided to institutional real estate players in a timely manner to take advantage of the market opportunity and to assist with company growth. Most loans will be secured, short term (3 – 5 years), and focusing on median margins (6% - 12%), bullet structures with optimal LTV covenants (50% - 70%). We expect these products to form the majority of deployment of private credit across the region in the coming decade. The products are relatively low risk, exhibiting similar underwriting risks to what a regional commercial bank would face.

- **Equity release** for income generating assets. Secured facility. Up to 5 years bullet.
- **Acquisition Finance** to acquire income generating assets. Secured facility. Up to 3 years bullet.

- **Sale & Leaseback** for a buyer to acquire income generating assets with a contractual lease in place with the seller. Secured facility. Up to 3 years bullet.
- **Construction Finance** to a developer which is unable to tap into commercial bank debt. Private debt would complete the capital stack and will be priced in double digits. Could be secured or subordinated facility. Up to 3 years bullet. Expected to be refinanced once operational.

Build to Sell (BTS) products

These products could be a combination of bridge financing or short-term loans provided to mid-market developers in a timely manner to assist with a project's capital stack. Most loans will be subordinated, smaller ticket size, and focusing on high margin (10% - 15%+) structures with low Loan to Cost (LTC) covenants (30% - 50%). The products are relatively high risk and will require thorough due diligence before deployment.

- **Construction Finance** for launched off-plan projects. Moratorium during construction with 100% repayment upsweeps thereafter. High margins.
- **Receivables Financing** for completed BTS projects with long post-handover payment plans. No moratorium. PDC secured. Mid to High margins.

LEGAL CONSIDERATIONS

Licensing

One major constraint on all real estate lending (both bank and non-bank) in the UAE relates to licensing. The laws of the UAE provide that a valid lender must be a bank, company or financial institution duly licensed and registered with the UAE Central Bank to provide property financing in the UAE. It is therefore generally accepted market practice for foreign (unlicensed) financiers to appoint a locally licensed security agent to act on its behalf and to be the mortgagee of record for the purposes of any mortgage registration.

In the Dubai International Financial Centre (**DIFC**), DIFC property laws and regulations apply to all real property located within the jurisdiction of the DIFC. Dubai real property laws are not applicable within the DIFC and the Dubai Land Department has no authority within the DIFC even though the DIFC is geographically located within the Emirate of Dubai. However, similar to its onshore neighbour, the latest version of the DIFC Registrar of Real Property (**RoRP**) *Registration and Related Services Handbook* provides that all mortgagees must be an approved bank listed with RoRP as a provider for property financing facilities. Notwithstanding this, in practice, banks (including onshore banks) holding existing property security registered with the RoRP will be able to register as a mortgagee without requiring separate registration and approval the RoRP.

Mortgage Enforcement

Onshore, any clause in a mortgage contract stipulating that when the borrower fails to pay the mortgage debt within the specified period, the lender shall have title to the mortgaged property or can sell the mortgaged property without taking the enforcement steps required under law (ie self-help), is void. The execution proceedings on mortgaged property foreclosure, provide for a streamlined Court driven procedure on default by the borrower. A mortgagee cannot sell or deal with the mortgaged property by any other means. The UAE courts can authorize the auction sale of the property with the proceeds of this sale being used to repay the outstanding debt. The enforcement process is however relatively protracted, and it could take more than twelve months for a borrower to receive repayment of their debt.

The DIFC property laws and regulations provide that a registered mortgagee is entitled to foreclose a mortgaged property in accordance with the DIFC property laws and regulations. In the event of a default under the financing agreement, the mortgagee can commence proceedings for foreclosure or for possession of the property in the DIFC court by filing a claim form in accordance with the agreed method of notice of court proceedings under the financing agreement.

One of the advantages of DIFC court proceedings is that under the Rules of the DIFC courts, there is a mechanism whereby the mortgagee (as the claimant) may seek an immediate judgment against the defendant if it believes that the defendant has no real prospect of successfully defending the claim and there is no other compelling reason why the case or issue should be disposed of at trial.

Insolvency Proceedings

Applying equally to both banks and private lenders, to provide distressed companies in the UAE a legal framework to help them avoid bankruptcy and liquidation, mechanisms such as consensual financial restructuring and composition procedures have been introduced under new bankruptcy legislation (UAE Federal Law No. 9 of 2016 on Bankruptcy (as amended) (the "**Bankruptcy Law**")) and UAE Federal Law No. 21 of 2020 on amending the Bankruptcy Law. However, creditors are reluctant to file bankruptcy cases and are being compelled to participate in bankruptcy proceedings triggered by debtors whether in a creditors committee (appointed by the trustee in bankruptcy) or ultimately in the liquidation proceedings of such debtor.

Under the Bankruptcy Law, the court can impose a moratorium on enforcement proceedings while the parties evaluate possible preventive composition or restructuring schemes, although it may still be possible to request the court to permit enforcement proceedings if the court agrees. A secured lender has priority over the secured assets.

There are presently no provisions in the UAE Bankruptcy Law to deal with cross-border insolvencies. The courts in the DIFC and Abu Dhabi Global Market free zone (**ADGM**) are perceived as more appealing fora, with common law procedures that are familiar to international players – even if getting the matter before those courts is not always straightforward. The DIFC's 2019 Insolvency Law incorporates cross-border provisions and benefits from a new "rehabilitation" procedure for DIFC companies that leaves directors in control while they seek to restructure debt with minimal court intervention. Evidence suggests that Administration Orders issued by the ADGM Courts (and the associated moratorium on claims) will broadly be enforced in the other courts of the UAE. The DIFC and ADGM courts provide a number of advantages in an insolvency process if jurisdiction can be established.

There is an additional complication in that the Amendment Law introduced the concept of an Emergency Financial Crisis (EFC), which can be used to suspend normal insolvency procedures. In January 2021, the UAE Cabinet declared an EFC occurred from 1 April 2020 until at least 31 July 2021, curtailing the ability of creditors to push companies into insolvency and introducing short-term uncertainty regarding the regime.

Ultimately, formal insolvency through the Courts is a last resort. Lenders (whether traditional banks or private lenders), are advised to look at other options. Early action and targeted remedies like payment orders will usually prove better options for creditors than pressing for insolvency.

Emerging Regimes

Real estate development/investment in the GCC has generated strong returns backed by growth in population and demand. These high returns have resulted in capital flowing in the form of equity, rather than seeking lower risk/ return approaches. However, the maturing UAE real estate market is resulting in more sophisticated players with experience of alternative financial structures such as private debt financing.

Until recently there was an absence of specific laws/regulatory framework in respect of non-bank debt. The DIFC's financial regulator, the Dubai Financial Services Authority (DFSA), has implemented a new regime for credit funds, which came into force on June 1, 2022. A Credit Fund is a collective investment fund that uses fund property (i.e., investors' money) either to originate, or to purchase, loans, or both.

Credit Funds are a specialist class of funds in the DIFC, in which investors' money can be used for the direct purchase of loans or purchase of loan portfolios. To be a Credit Fund, at least 90% of the Fund Property should be used for either loan origination or loan portfolio acquisition. These funds can be Exempt Funds or Qualified Investor Funds, but not Retail Funds. They can be set up as Investment Companies or Limited Partnerships (the Investment Trust structure is not permissible for Credit Funds in the DIFC).

> ***Credit funds have to be closed-ended, with a maximum tenure of 10 years, and cannot have leverage of more than 10% of the Fund's Net Asset Value.***

RISK & MITIGANTS

Below are some of the key risks for a Private Credit Fund while underwriting real estate transactions:

- **Construction Risk:** Unable to complete project;

  Mitigant: funding will only be deployed to construction projects with a Tier I contractor on board and high visible sales demand through Sales & Purchase Agreements (**SPAs**).
- **Security:** Inefficient security;

  Mitigant: Robust underwriting standards that capture the appropriate LTV, DSCR and coverage ratios. Mandatory equity cures (from the borrower or affiliate) to apply if LTV breached at any time.
- **Enforceability of Security:** Unable to enforce mortgage of a defaulted borrower;

  Mitigant: The funding will only be deployed where adequate mortgage regimes are present and implemented. This includes regions such as the UAE and Saudi Arabia, where non-banking financial institutions, such as a Private Credit Lenders/Vehicles, can register and enforce mortgages through a licensed or registered bank.

- **Interest Rate Risk:** Private credit valuations impacted due to rising interest rates;

  Mitigant: Unlike bonds, most private credit assets are deployed on variable interest rates structures. This results in consistent inflation hedged valuations. Private Credit tends to perform exceptionally well in a high/volatile interest rate environment.
- **Liquidity Risk:** Illiquidity of private credit assets

  Mitigant: To accommodate the potentially illiquid nature of private credit assets and ensure the orderly flow of investor capital into and out of these less-liquid securities, private credit funds often offer monthly or quarterly purchases and redemptions and may come with predefined hard or soft lock-up periods.

CONCLUSION

With the volatile macroeconomic environment and regional regulatory progress just ripe, coupled with the requirement for private credit in the regional real estate sector, private credit is on the cusp of exponential growth in the GCC.

Private credit will be ideal for investors who are seeking higher returns and diversification in their portfolio, and due to its limited application, they can have an early advantage in the GCC.

Whilst there remain challenges and limitations to overcome, the real estate markets are maturing quickly in the GCC. The sector has witnessed resilient growth over the past 2 decades, and with GCC economies diversifying away from energy reliance, the real estate sector will play a pivotal role in further growth in decades to come. This growth will require more creative and flexible debt structuring, especially for the mid-market real estate players. Sophisticated alternative finance providers that possess global experience of alternative financial structure, such as private credit financing, are also a fundamental requirement to enter the regional market.

ABOUT ADVICE RE CAPITAL

The Real Estate Platform and Management Team at Advice Re Capital combines over 50 years of banking and finance expertise, 30 of which have been dedicated to the Institutional & Corporate Real Estate industry both internationally and within the GCC. The team has structured, advised upon, and executed highly complex and technically demanding CRE debt, advisory, construction & development and Capital Market transactions.

Advice Re Capital can assist professionals across the Commercial Real Estate industry in developing and obtaining workable financing and structuring solutions. We are committed to simplifying complex financing and structuring requirements for our clients.

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Sajid Siddique is the Chief Executive Officer of Advice Re Capital.

Sajid has over 22 years of experience in structuring, advising upon and executing some highly complex and technically demanding CRE debt, equity, construction & development and Capital Market transactions.

At Mashreq, Sajid worked in Corporate & Investment Banking at Mashreq and led the CRE Structuring Team for Global Real Estate for over 14 years.

Prior to his tenor at Mashreq, Sajid was with the Real Estate team at the Royal Bank of Scotland and Bank of Scotland in the UK.

ABOUT CHARLES RUSSELL SPEECHLYS LLP

Charles Russell Speechlys is an international law firm headquartered in London with offices across the UK, Europe, Asia and the Middle East. We have been working with clients in the GCC region for over 30 years and operating on the ground in the Middle East for 15 years.

Our award-winning Real Estate team deliver a comprehensive range of property related services both locally and regionally to a range of clients and our key services include Urban Development & Regeneration, Acquisitions & Disposals, Investment & Property Management; Property Finance, Hotels & Hospitality, Real Estate Investment Trusts, Infrastructure Projects & PPP and UK Residential Property Investment. We pride ourselves in providing practical, commercial, and innovative advice which adds value and provides our clients with a competitive advantage.

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Rebecca Davies is a Legal Director in Charles Russell Speechlys Banking & Finance and Real Estate team and focuses her practice on structuring, negotiating, and executing complex commercial real estate finance transactions across all asset classes and is known for her work on acquisition financings, real estate development loans, hotels and resorts financings and mixed-use projects. Rebecca's experience also extends to advising (both borrower and lender side), in relation to Shari'a-compliant REIT's.

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