Core Research
Dubai Property

In Focus:
Affordable Housing In Dubai

Overview

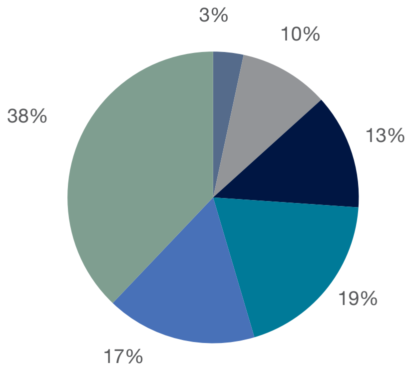
Affordable housing is a fundamental urban issue faced by most of the global cities and the quantity and quality of this residential strata greatly shapes a city's growth, scalability and sustainability. In the context of Dubai, where the luxury and ultra-luxury segment have been the key focus since the opening of the freehold real estate market in 2002, the Emirate is finally taking steps which could address this ever growing gap in affordable housing.

Despite this paradigm shift of public and private players in the last couple of years, the term 'affordable housing' is rather loosely used. The current new supply is catering largely to the middle income segment and affordable living is yet out of reach for the lower income members of society thus pushing occupiers to rent at penalizing high yields instead of transitioning to own.

Affordable housing typically indicates a market-quality accommodation that can be afforded by people of lower incomes, usually measured as a society's bottom income quartile with their housing expenses not exceeding 30-35% of the household income. Furthermore, to be sustainable in the long term, affordable housing must not make its inhabitants feel second class, or have any stigma attached to it. The Dubai Municipality defines affordable housing as living space for households whose income is between 3,000-10,000 AED per month.

GRAPH 1

Household by income group



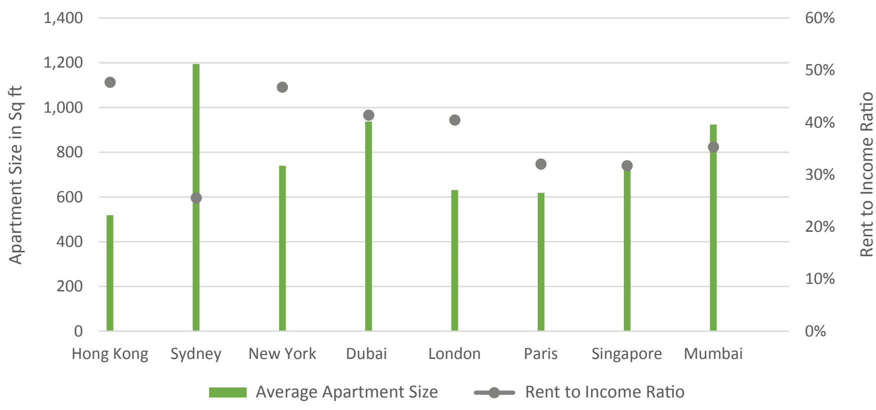
Source: Core, UAE associate of Savills, Dubai Statistics Center

Dubai's job sector traditionally has been attracting expats with lucrative salaries and comfortable housing allowances as many of the benefits, yet there is a vast majority of service class executives such as accountants, administrative staff, entry level architects and engineers with household income levels ranging between 9,000-20,000 AED, almost a quarter of the population, who struggle to find quality accommodation at feasible rental and sale prices. We intend to address this expat income segment through the article. Globally Dubai, when stacked against major metropolitan cities, trends at a high rent-to-income ratio of about 40% for affordable households, on par with London and lower only to New York and Hong Kong. Nonetheless, it offers larger unit sizes across the board coming second only to Sydney, where the residential market is predominantly villa based.

Locally, with the sharp rise in rents and capital values during 2012-2014 across the residential districts in Dubai, there has been a consistent geographical shift of the mid to lower income segment to the fringe locations or to northern emirates, which involves longer commute times, poorer quality of living and additional pressure on the transport infrastructure. The rush hour traffic, especially between Dubai and Sharjah, is compelling residents to make a trade-off between a stressful commute and smaller apartment sizes and relocate back to Dubai.

GRAPH 2

Affordability comparison across major metropolitans for SEU*



Source: Savills World Research

> "Many off-plan properties which are being marketed as affordable do not fit the economics of a lower income end user"

UNDERSTANDING THE ISSUE

To understand and address the pronounced shortage of affordable housing in Dubai in both ready stock and future supply, we need to take a closer look at the dynamics on both the supply and demand side of this equation.

SUPPLY SIDE DETERRENTS

Land acquisition

Acquiring land for construction at the right price and the right location is a challenge that developers in Dubai have largely faced, though conventionally they have recovered the acquisition cost through higher margins that prime and mid prime products offer. Investing energies in affordable housing thus may come across as a non-lucrative business option for the developers, although this issue could be dealt with through the combined efforts of the public and private sector. However, PPP (public private partnership) may need policy intervention by government and can lead to prolonged delivery timelines and lack of accountability. The overall efficiency of PPPs based on various countries experiences has also been largely debated across the globe.

Government can also redevelop existing areas or allocate land at subsidized rates for the sole intent of building affordable housing, however this may result in the occupiers feeling socially excluded from the urban fabric.

Regulatory incentives

The proposed law by Dubai Municipality for mandatory 15-20% affordable housing in future residential developments, when implemented, may provide further impetus to this segment of housing. In addition, FAR (floor area ratio) trade-off within the residential development may be looked into by the developers to lower the cost of construction for low rise affordable housing. These propositions nonetheless typically face resistance from developers due to loss in profit margins, perceived issues with project branding and difficulties to generate interest in these hybrid projects from the core target audience.

Construction cost:

Adopting cost conscious practice with design, specifications and standardization of units may also reduce costs for the developer but, due to the lower cost and quality of the construction material, the upkeep and maintenance charges coupled with higher utility costs may be counterproductive to the intent of affordable housing.

DEMAND SIDE DETERRENTS

Access to housing finance:

Lower LTV (loan to value) ratio and higher registration charges have strengthened the market but have warded off "affordable housing borrowers". Finance options to the lower income segment are limited as banks operate at an income threshold of 15,000-20,000 AED per month for granting mortgages (which again limits almost 20% of our target population). A few banks do provide mortgages for income levels as low as 10,000 AED per month for select properties but only with strict eligibility criteria

Although sale prices have softened since early 2015, a section of expats continues to struggle putting together sufficient capital for down payment to take the leap from renting to owning. It is imperative to note that for investors and end-users in the prime residential market, access to mortgages increases their purchasing power, although for the lower income bracket this access is an absolute prerequisite.

We are witnessing a surge of off-plan properties which are being marketed as "affordable" options. Some of these projects have tried to achieve the intent through innovative construction, marketing strategies and flexible payment plans, yet many don't fit the economics of a lower income end user. Buyers would be subject to higher down payment in the case of an off plan property in addition to their current rent. With delayed project deliveries, they cannot risk this scenario and hence continue to rent.

The developers could also propose a rent to own model where the occupier can contribute rent at a predetermined rate and tenure to pay for down payment. Though it may have its issues in execution and user behavior, this model is used in the UK to facilitate the required deposit.

The housing finance in first world economies is enabled with higher LTV ratios of 80% or above, however emerging economies may need to tread cautiously. With Saudi Arabia recently raising its LTV limit from 70% to 85% by introducing an "Affordable mortgage" by specialized mortgage companies to address its burgeoning demand for affordable housing, it would be stimulating for Dubai's residential market if UAE also devised something similar. However, this shift in LTV may be debated for Dubai as it has a higher demographic of expat buyers who are transient in nature.

RENTAL MARKET

Due to the ephemeral attribute of expats in Dubai, renting is preferred even when many of the tenants have the means to own. This is one of the reasons why Dubai's residential rental market has witnessed subdued decline despite the significant drop in sale prices. In particular, it is interesting to note that affordable districts such as IMPZ, International City, Sports City and Discovery Gardens have sustained their rental rates.

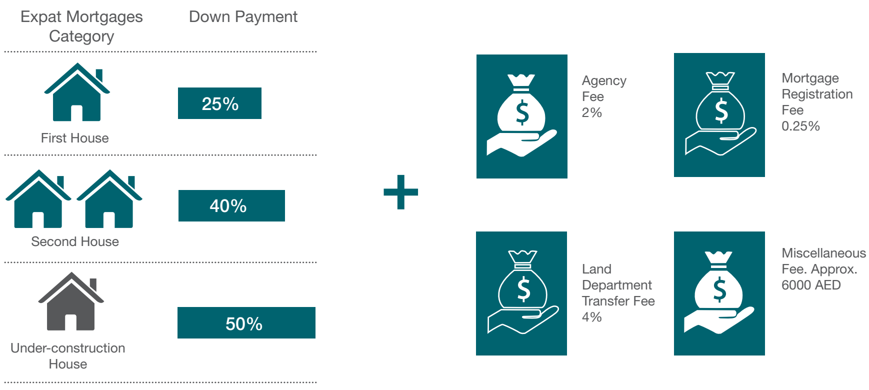
The proposed extension of the Dubai Metro would connect the Nakheel Harbour and Tower station to the Expo 2020 site, further enabling the lower income segment to explore affordable options by travelling further afield. This is likely to encourage occupiers to migrate to developments such as DIP and Dubailand where they would find newer apartments and yet remain accessible.

Rent control by the updated RERA rent calculator has already provided some relief to tenants. Nevertheless, the high rental yields in Dubai, especially in the lower and affordable segments of the market, are making the cost of renting vs the cost of owning disproportionally high in comparison to the rest of the global cities.

Rent control as a development instrument is widely debated across the world with few other cities such as Mumbai, Berlin, Paris and New York implementing it in various alterations, while London and Hong Kong have discarded it. Although Dubai's rent control has its limitations, it will be interesting to see how this mechanism plays out in the long term and effects the rental yield and investor sentiment.

FIGURE 1

Transaction cost for a ready property in Dubai

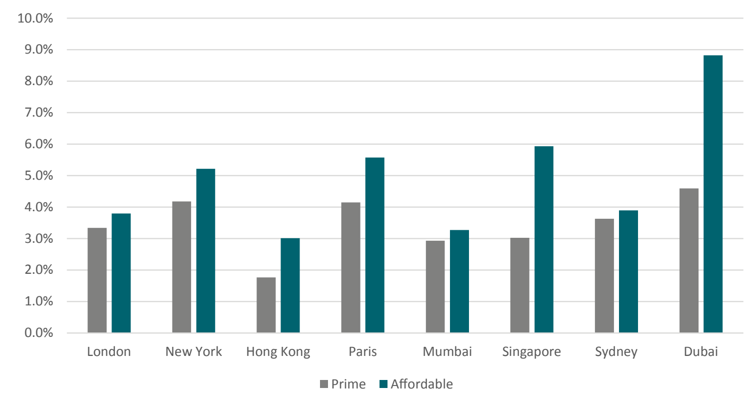


Source: Core, UAE associate of Savills

> "The high rental yields in Dubai, especially in the lower and affordable segments of the market, are making the cost of renting vs the cost of owning disproportionally high in comparison to the rest of the global cities."

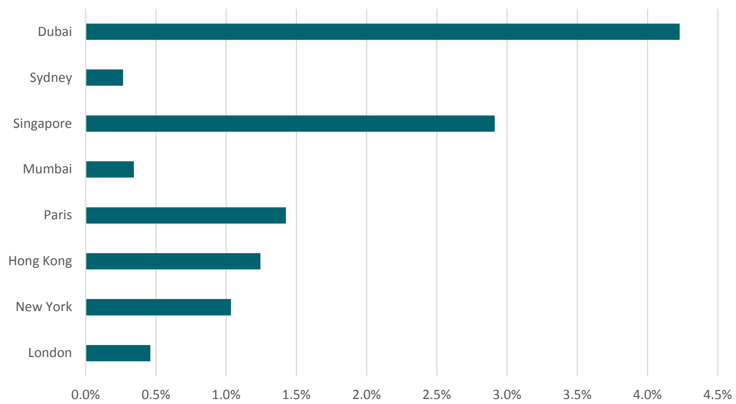
GRAPH 3

Prime yields vs Affordable yields across major metropolitans



GRAPH 4

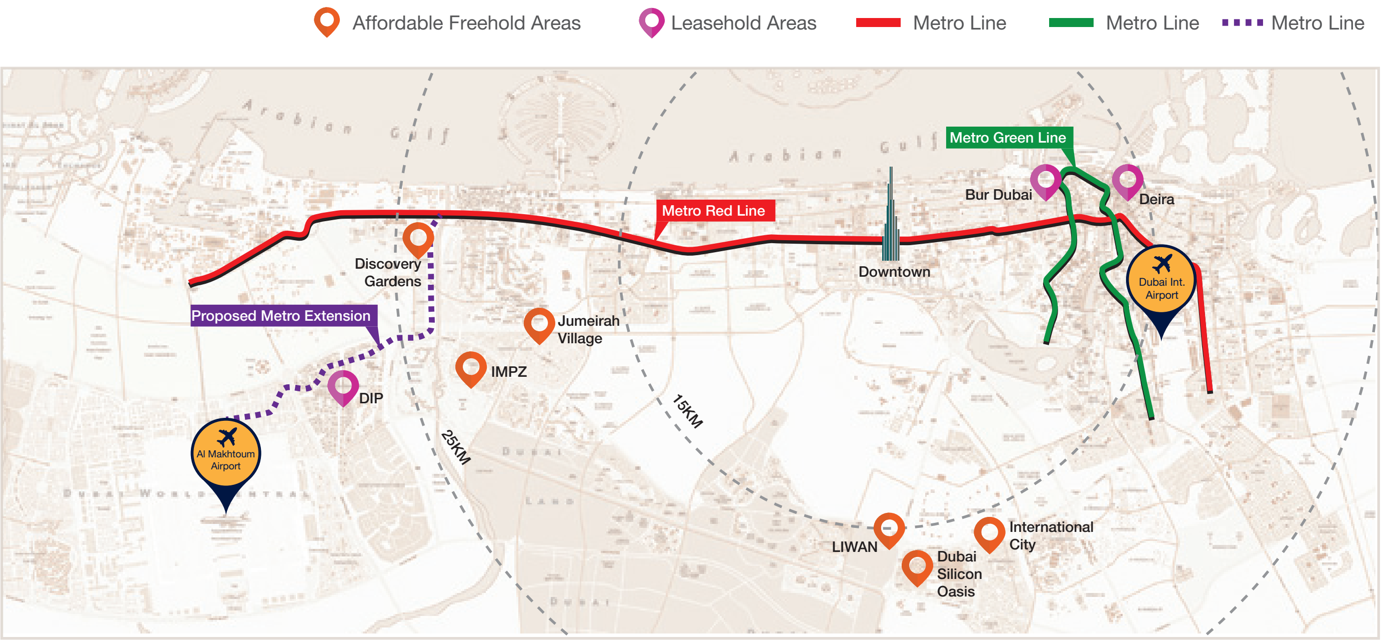
Difference in prime and mainstream yields across major metropolitans



Source: Core, UAE associate of Savills

DUBAI MAP

Affordable Areas in Dubai



INVESTING IN AFFORDABLE HOUSING

In the past few quarters, there has been a wide marketing of the term "affordable housing" by various stakeholders in the Dubai residential real estate market. Although debated, a variety of media and research publications have touched upon this issue. By reading and listening to a lot of what has been said, it would seem that affordable housing is a new, promising and rewarding opportunity for Dubai investors. However, does this general feeling in the market place hold up against a deeper analysis of the underlying dynamics of this investment segment?

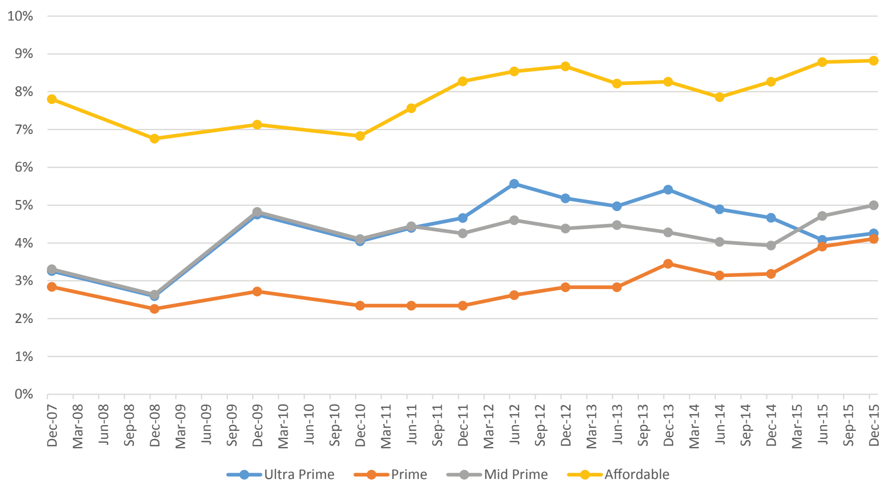
Whilst gross rental yields may reflect higher short term returns in affordable housing in comparison to prime residential in most metropolitan areas across the world, this effect is particularly strong in Dubai. Nevertheless, historic trends in major global cities tend to show that the short term high level of yields offered by the affordable segment do not compensate the lower overall total return achieved by this investment segment in comparison to the prime market in the long term.

Lower level of total returns in affordable housing over time are typically due to higher recurring costs in the life cycle of this type of development in contrast to prime residential. Across the world, to build affordable housing, builders largely resort to cheaper materials and specifications to reduce their construction costs leading to lower quality of construction.

This, in due course, translates to faster depreciation of the building and higher maintenance costs. Investors and occupiers (by mechanism of higher rents) are generally not favourable to spend more on maintenance for affordable property than they would on a more expensive asset due to the very nature of this low cost investment. This results in even faster depreciation of the property – or a very strong negative impact on mid to long term yields when high refurbishments or maintenance cost become unavoidable to keep the unit competitive to the market.

GRAPH 5

Affordability comparison across Dubai for SEU*



Source: Core, UAE associate of Savills

It seems this well verified scenario around the world can only be amplified in Dubai's case as the Emirate sees additional aspects affecting its building lifecycle. Firstly, the extreme heat conditions induce stress in the building structural system if they are not built to high standards. Secondly the salt and sand content in the soil and air further act as a weathering agent increasing both the depreciation speed and cost of maintenance even in prime buildings. Lastly, we have seen that sometimes unpredictable rains can induce damages even to properties considered to be Grade A in Dubai. One can only imagine what it might do to lower rung developments in the future! All these aspects play jointly to fasten the asset depreciation.

A different aspect is also in play here, around the world, as lower construction quality tends to also relatively reduce building's energy efficiency leading to higher utility costs. While this effect is relatively mitigated in temperate climate, it is amplified in Dubai due to the arid subtropical climate leading to substantially higher cooling costs for the affordable units in the long term.

The lower depth of this segment in terms of offerings coupled with relatively higher maintenance, service and utility charges will potentially lower the total yield and capital appreciation of affordable housing in the long term when compared to prime residential developments.

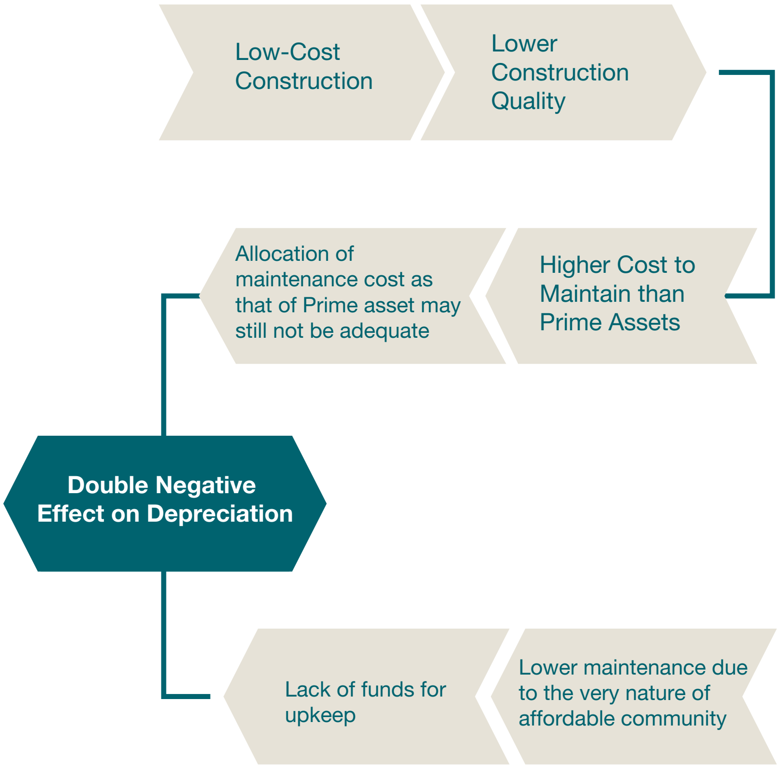
In our opinion, affordable housing could be a good investment option for end users who cannot afford any higher asset and yet are looking to relieve themselves of the punitive rental yields provided they are able to fulfill all the other mortgage eligibility criteria which unfortunately is still more of an exception today rather than a general scenario

Investors and real estate funds looking to diversify their portfolio in affordable housing may approach this segment, albeit with caution and could resort to economies of scale, diversification and renewal/flipping of stock to keep the overall value of the portfolio. However, the disposition/acquisition cost would prohibitively penalise the return.

Affordable housing may also be a profitable venture as a multifamily investment, a model that is almost nonexistent in Dubai. A single or few end-users do not have the scale nor the vision to take the same long term asset management views and required maintenance measures to minimize property depreciation that a multifamily investor/entity can. This avenue is commercially viable because the investor/entity can exercise higher control over the service costs of the asset and moderate rents relatively uniformly to fund the upkeep.

FIGURE 2

Life Cycle of Affordable Housing



OUTLOOK

Over the past 14 years, Dubai has seen the emergence of a world class prime segment that has, and continues, to attract global and regional buyers. We do not believe that the affordable segment will ever compete seriously with the prime market in Dubai in terms of long-term investor interest. That is not to say that the affordable segment should not be considered as a critical part of the future of Dubai's residential market. In fact, to perform well over time, and because it requires social stability and mature domestic demand, the Dubai market will indirectly need the affordable segment to be successful in addressing properly the emerging demand of the lower income classes, both in terms of non-prohibitive rental levels and reasonable acquisition prices, coupled with realistic lending regulations.

It is only natural as a relatively new concept that the definition of affordable has not yet met its target market as regulations are still to define more precisely the rules of the game. But we are fairly confident that the Dubai Government will be able to find/follow the right solutions to develop this market to a mature level.

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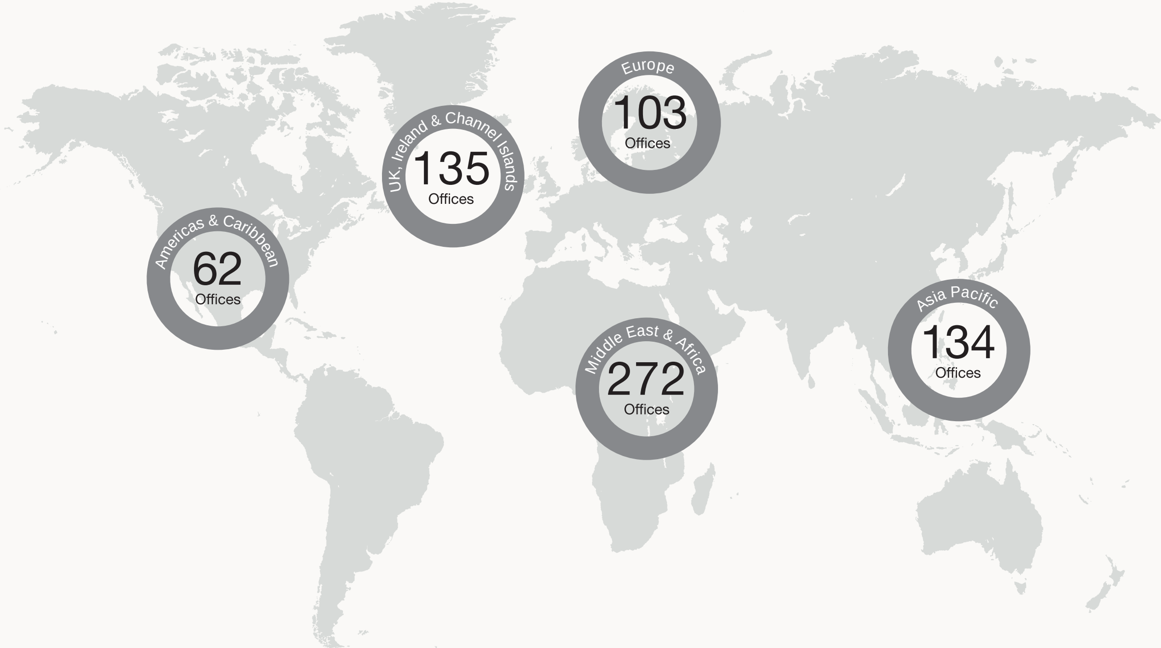

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*Savills World Research methodology: In order truly to compare the cost of residential and commercial real estate across different global cities, we use the Savills Executive Unit (SEU), which measures the cost of housing an identical group of people living and working in different countries. The people who make up our SEU include one middle-aged expat CEO, one senior expat director, a locally employed director and four locally employed administrative staff (assumed as mid to lower income segment. The Dubai equivalent of household income is between the range of 12000-20000 AED). They each live in different types of household and each member of the group chooses different types of locations and different types of property in world.