



Dubai: The Course of Asymmetry

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Executive Summary

- An income approach valuation reveals that Dubai property is systematically undervalued to its peers in other emerging markets. Using a basket of 5 cities (Moscow, Sao Paulo, Manila, Shanghai, and Hanoi), we can see that Dubai is the only city that has consistently provided yields above the 7% mark, whereas the average of other cities have trended downwards towards 4.5% level. Dubai has the highest risk premium (2.45%) above the US 10 year treasury, highlighting its relative discount. This reveals that markets rarely trade in a “fair value zone”; instead what transpires is a systemic period of “over and under shooting” around fair valuation levels; periods that persist over elongated periods of time.
- Using the price to book metric to measure the value of the Dubai real estate equity market (construction and development sector), we witness that there is a clear undervaluation of various stocks relative to their industry standard. A closer look into *construction and engineering* stocks reveals that the US industry standard is that the share price trades at a multiple of 1.5 times its book value. In Dubai there seems to be wide differential between Arabtec and Drake & Scull, where the latter trades at discount to its book value where as the former is at a premium. The valuation differentials have partly to do with the value of the orders that have been signed off on and not yet executed. A closer look into Drake and Scull’s stock price and fair value reveals that for the most time since ‘09 the stock price has been trading at a discount to its fair value value, implying a structural asymmetry.
- In the real estate development sector the industry standard for companies trading above their book value is 1.37 times. All three major listed companies in the DFM (Emaar, UPP, and Damac) currently are undervalued and trading below their fair value by this metric. A closer look into Emaar reveals that it is undervalued by 20% using the price to book as a metric. What is pertinent to highlight is the period of time the stock is trading below fair value levels, compared to the time that it is at or above fair value levels. In market valuation research this is the classics sign of “asymmetric equilibria:”, a phenomena that postulates systematic periods of over and/or undervaluation based on exogenous factors that ignore underlying asset fair values.



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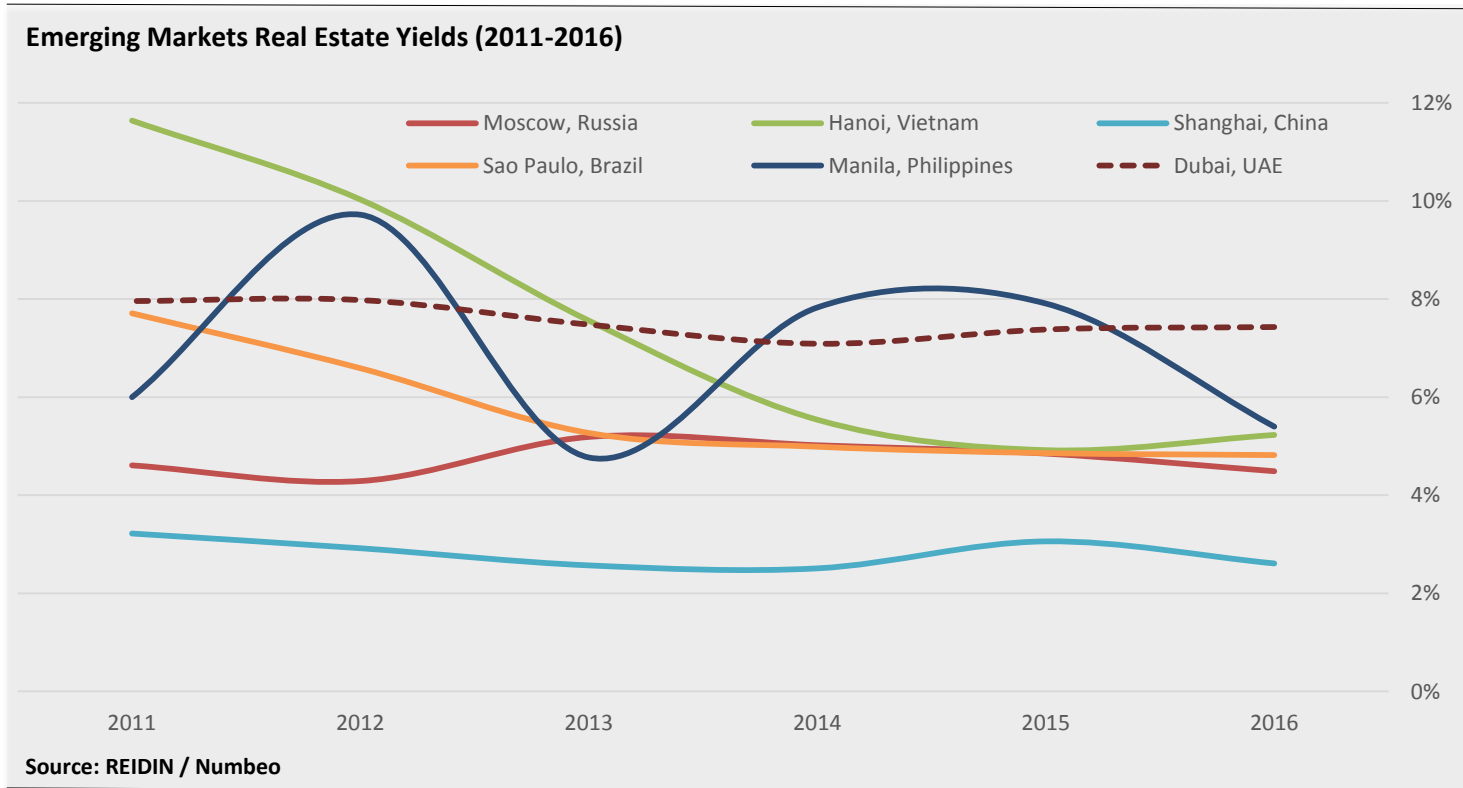
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Fair Value in Dubai Real Estate and Emerging Markets



"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets." – Peter Lynch

Emerging Markets Real Estate Yields



An income-approach valuation is a tool to assess the worth of real estate assets. It measures the potential income generated for rental income relative to the initial investment. In a basket of cities within the emerging markets, real estate yields are below 6% except for Dubai. Over the last 5 years, yields in most cities have trended downwards whereas Dubai has remained flat. Using this metric, relative to other emerging markets Dubai is undervalued.

A Snapshot of the Risk Premiums of Real Estate Assets in Emerging Markets

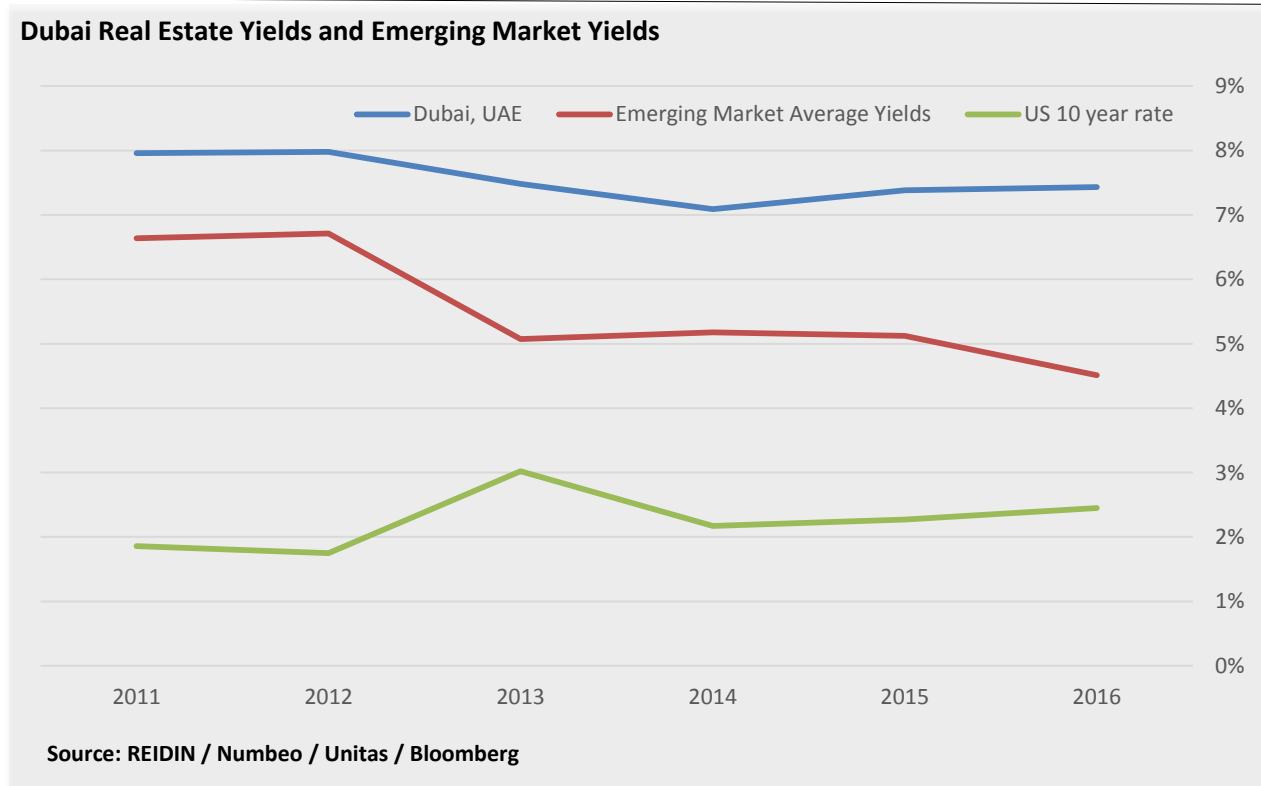
Real Estate Yields in Emerging Markets against the US 10 Year Treasury Rate

	Real Estate Gross Yield	US 10 Year Treasury Rate	Risk Premium
Moscow, Russia	4.5%	2.45%	2.05%
Hanoi, Vietnam	5.2%	2.45%	2.75%
Shanghai, China	2.6%	2.45%	0.15%
Sao Paulo, Brazil	4.8%	2.45%	2.35%
Manila, Philippines	5.4%	2.45%	2.95%
Dubai, UAE	7.4%	2.45%	4.95%

Source: REIDIN / Numbeo

The above table shows the yields for real estate assets in emerging market against the 10 year US treasury rate. The average yield from real estate assets is 5%, which has a premium of 2.45% above the risk free rate. Within this basket of cities Dubai has the highest return from rental income generation standpoint. From a risk premium perspective, Dubai appears to be trading at the highest levels relative to its peers, highlighting its relative undervaluation.

Real Estate Yields and the US 10 year Treasury Rate



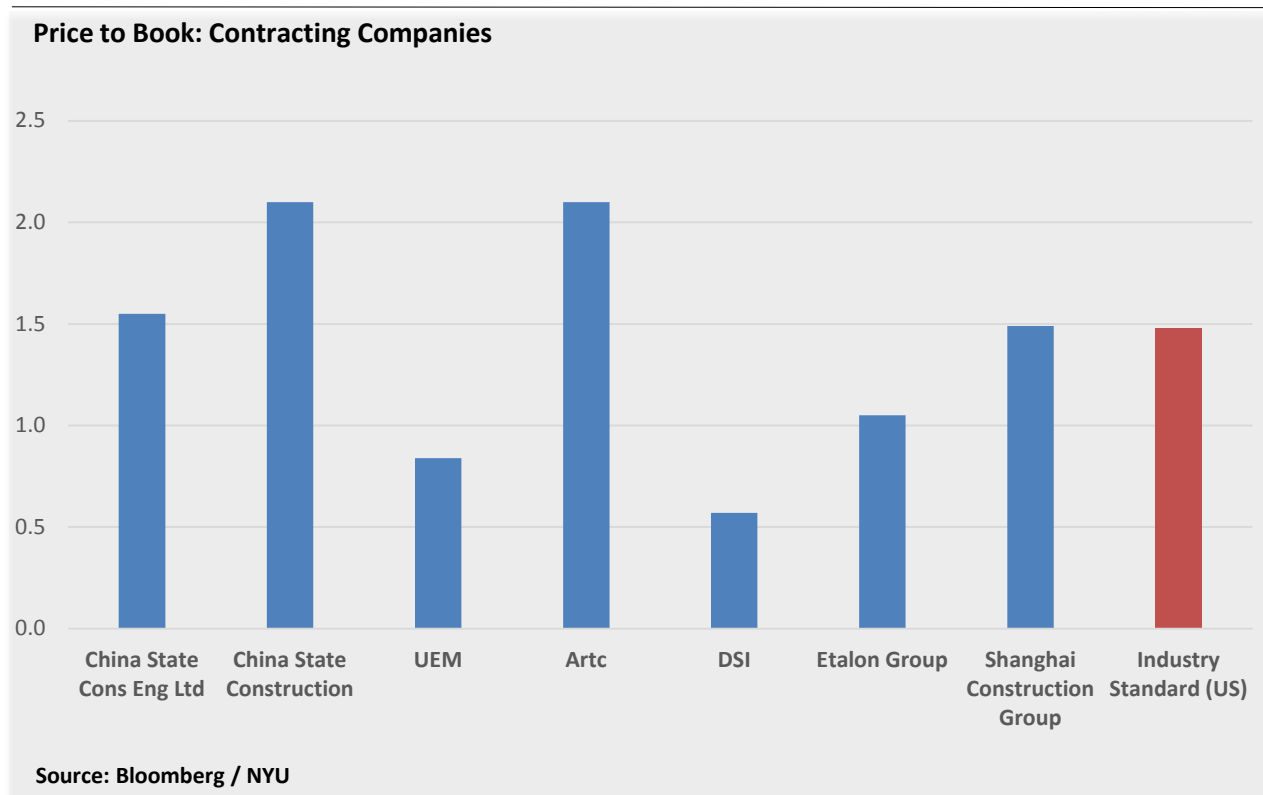
The above chart highlights that Dubai real estate appears to have been *systematically undervalued* over time relative to its industry benchmark, even as price volatility has seen peaks and troughs over the measured period. This highlights that markets rarely trade in a “fair value zone”; instead what transpires is a systemic period of “over and under shooting” around fair valuation levels; periods that persist over elongated periods of time.

Developers and Fair Value



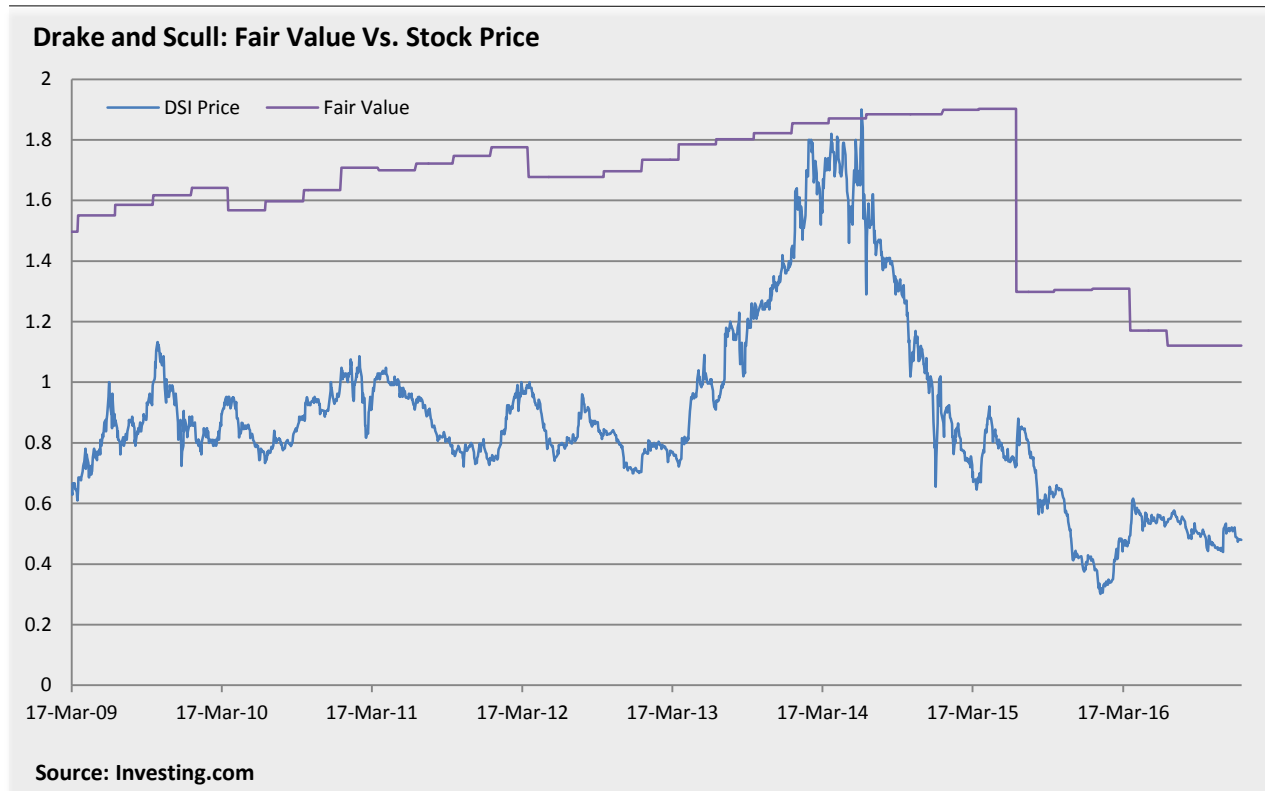
“Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can’t buy what is popular and do well.” – Warren Buffet

A look into Price to Book Ratios: Construction Companies in the Emerging Markets



Price to book is a ratio used by analysts to compare a stock's market price to its book value. The above graph reveals the price to book per share for publicly traded construction companies in emerging markets. The US industry standard for the *construction and engineering* sector is that the share price trades at a multiple of 1.5 times its book value. The valuation differentials have partly to do with the value of the orders that have been signed off on and not yet executed, but it appears that even after controlling for this variable that Drake and Scull is undervalued relative to the industry standards.

A closer look into Drake and Scull and its Fair Value



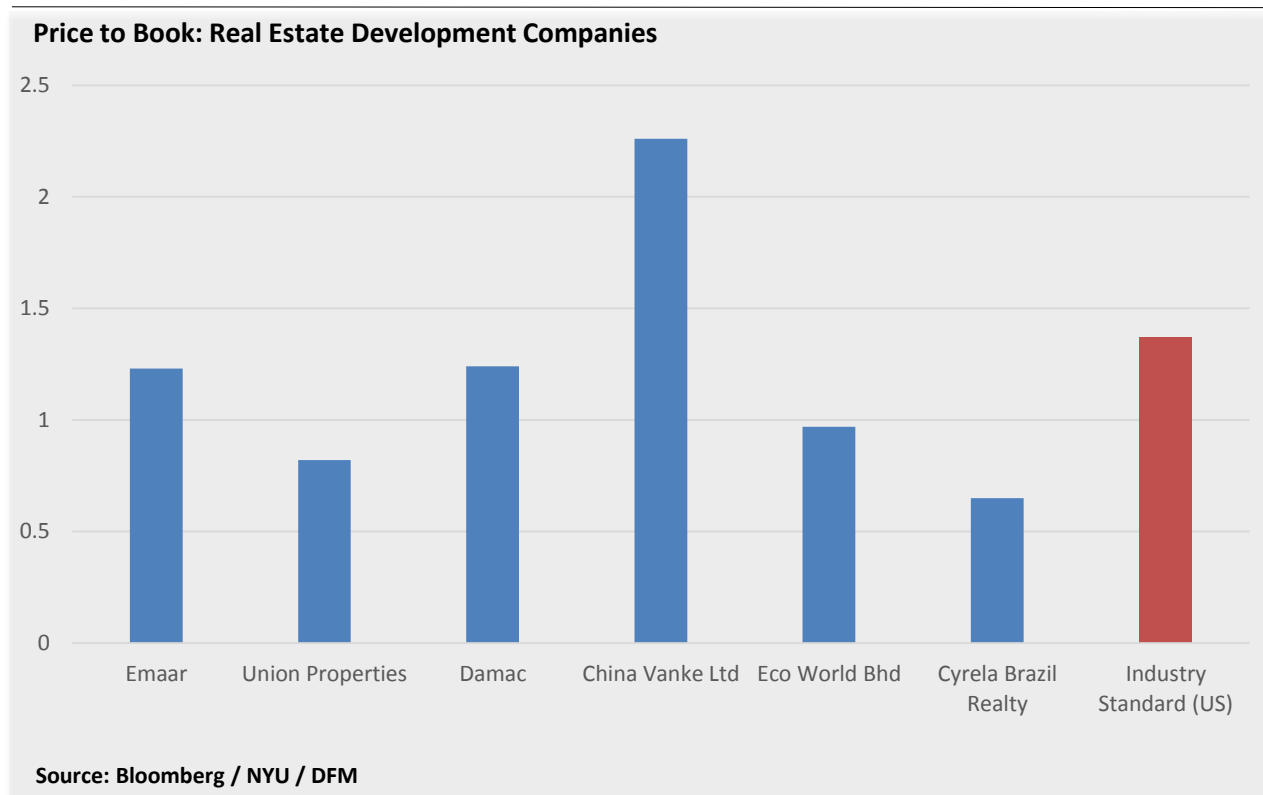
A closer look into Drake and Scull's stock price and fair value reveals that for the most time since '09 the stock price has been trading at a discount to its fair value value, implying a structural asymmetry. It is clear that liquidity concerns have dominated the sector both in the first boom bust cycle that originated in 2009 and in the second cycle that initiated in 2014; however it is of interest to note that these liquidity concerns (which have been global in both cycles) have not been reflected to this degree amongst peers. This asymmetry underlines the fact that markets go through extended periods of time where "fair value" is not reflected in underlying asset prices.

Construction Companies and Fair Value



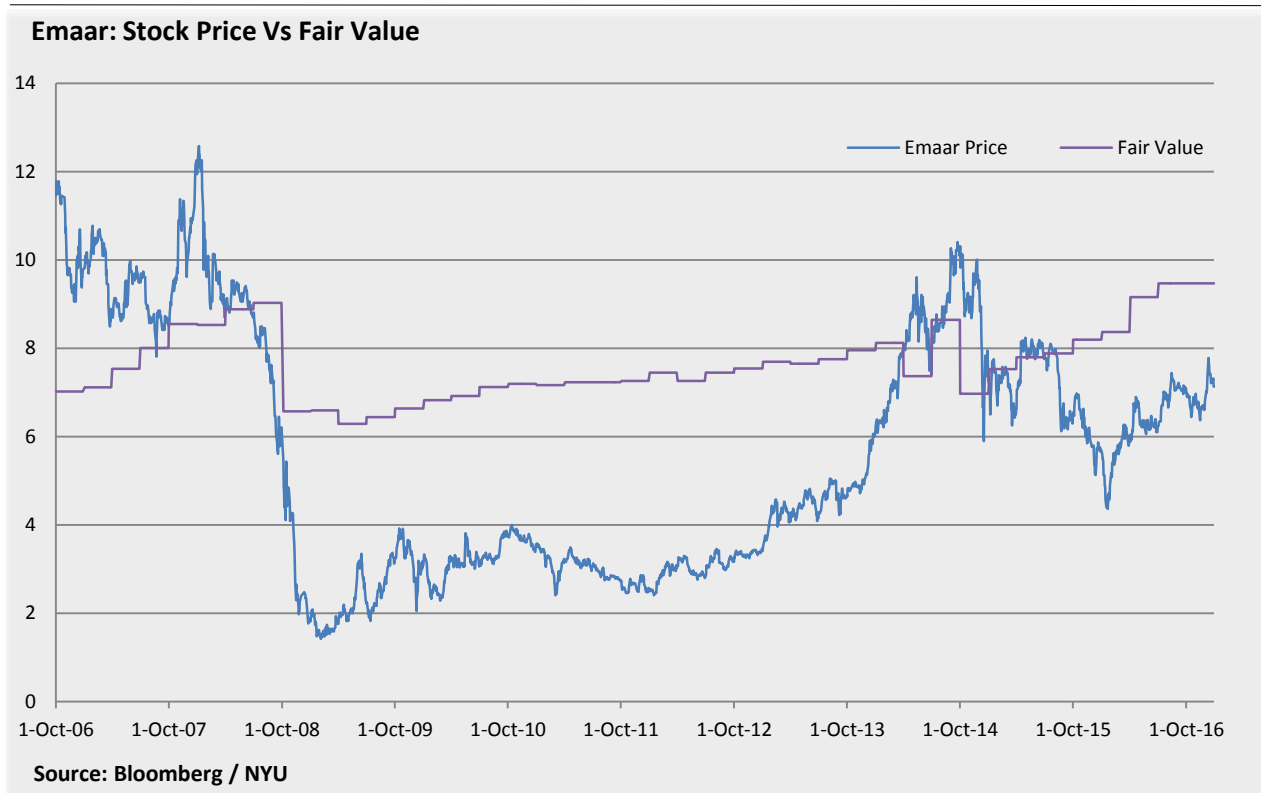
“It’s no use going back to yesterday, because I was a different person then.”
— Lewis Carroll

A look into Price to Book Ratios: Development Companies in the Emerging Markets



In the real estate development sector the industry standard for companies trading above their book value is 1.37 times. All three major listed companies in the DFM currently are undervalued and trading below their fair value by this metric.

A Closer look into Emaar and its Fair Value



A closer look into Emaar reveals that since the crash of 2008 the stock price has been trading significantly below its fair value. The current share price of Emaar is undervalued by more than 20% using the price to book as a metric. What is pertinent to highlight here is the period of time the stock is trading below fair value levels, compared to the time that it is at or above fair value levels. In market valuation research this is the classic sign of “asymmetric equilibria:”, a phenomena that postulates systematic periods of over and/or undervaluation based on exogenous factors that ignore underlying asset fair values.

Conclusions

An income approach valuation reveals that Dubai property is systematically undervalued to its peers in other emerging markets.

Using the price to book metric to measure the value of the Dubai real estate equity market (construction and development sector), we witness that there is a clear undervaluation of various stocks relative to their industry standard

Fair Value in Dubai Real Estate and Emerging Markets

An analysis of Dubai real estate market reveals that yields have remained within the 7% range over the last 5 years. Whereas for other emerging markets such as Manila, Hanoi and Shanghai yields have compressed towards the 4.5% level. Using this metric for valuation, we can infer that Dubai is relatively undervalued.

This highlights that markets rarely trade in a “fair value zone”; instead what transpires is a systemic period of “over and under shooting” around fair valuation levels; periods that persist over elongated periods of time.

Construction companies and Fair Value

The US industry standard for the *construction and engineering* sector is that the share price trades at a multiple of 1.5 times its book value. In Dubai, Arabtec trades above the industry standard, where as DSI trades below.

The valuation differentials have partly to do with the value of the orders that have been signed off on and not yet executed.

Developers and Fair Value

In the equity space, specifically developer stocks, we can see that UAE companies are undervalued when analyzed through the lens of the price to book ratio.

In the US industry standard is for development companies to trade at a multiple of 1.37 times their book value. All the major listed developers (Emaar, Damac, and UPP) trade at a discount at their current stock prices.

Summary

In analyzing the valuation of investment categories, we can conclude that Dubai relative to its peer in the emerging markets is undervalued.

In the real estate market it yield the highest rental income (premium of 2.45% above the risk free rate). Whereas in the equity market majority of stock in the construction and real estate sector trade below their fair value, in relation to industry standards.



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