LEBANON REAL ESTATE SECTOR

SHORT-TERM PAIN, LONG-TERM GAIN

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- Weakening demand for lodging in a sluggish realty market

Lebanon's real estate market has witnessed a further slump this year in all its components, with overall demand decelerating in recent months in the currently prevailing regional and domestic environment. Property sales declined by a yearly 20.6% in the first eight months of 2018 after having relatively bounced back last year within the context of an improved domestic climate and functioning government after the domestic political settlement in late 2016. The number of property sales transactions similarly declined by 20.2% after a rise last year from low levels in 2016. Even sales of small and medium-sized apartments that are usually less expensive and often secured through subsidized banking loans were hit after the BDL support envelopes ran out. It is worth noting that sales to foreigners also dropped by a yearly 12.0% so far in 2018, confirming their declined interest in purchasing Lebanese property in today's tough regional/domestic environment.

- Supply pressured by waning demand with increasingly smaller housing units

With demand patterns shifting to more affordable housing especially in the form of smaller surfaces whether in the capital city or nearby suburbs, the supply side of the real estate industry adapted and starting offering smaller units below 180-200 sqm. Due to the prolonged downturn in the market, some developers have been forced to slow down or even halt their construction works awaiting sales or better days, and some others have postponed plans to start new realty ventures given prevailing uncertainties. This reflected on the total area of new construction permits, an indicator of forthcoming activity in the sector, which retreated by 23.8% in 8M2018, following a 4.1% dip in full-year 2017.

- Price resilience tested anew in an increasingly tough market

The difficult conditions the Lebanese real estate market has witnessed over the past few years took a relative toll on price levels in the country. The latter have been largely resilient in the sense that they are by nature sticky on the downside, and this has avoided a collapse in market prices in recent years, but sluggishness in sales has prompted some developers to grant discounts to interested enquirers/buyers. The latter averaged 15% post-negotiations in Beirut relative to levels prevailing five or six years ago as per Ramco Real Estate Advisers. Similar views were echoed by the InfoPro - Lebanon Opportunities 1H2018 price index which indicates a reduction in new apartments' asking prices in Beirut, Metn, Baabda, Aley and Kesrouan across more than half the 117 real estate districts surveyed.

- Short-term woes likely to persist…

The most likely scenario in the near term is the continuation of the current market status quo. The formation of a government might ameliorate sentiment but not trigger a massive unwinding of the sluggishness in the market. For that to occur, the investment climate would have to ameliorate tangibly in a way that encourages non-residents (especially Lebanese expatriates) to make a comeback on the local scene and residents to resume their buys (notably by providing them with more affordable financing options). Otherwise, price discounts are likely to continue being obtained, but not necessarily increase. If the sluggishness persists, more and more developers might agree to grant discounts and the rebate range might become more of a norm or might be gradually generalized. But for developers to increase the discounts obtained today might be difficult, except perhaps in some isolated cases, as those rebates are eating up their profit margins mostly.

- …but Lebanese realty remains an enticing long-term bet

The structural factors behind price resilience on the overall rest on an ongoing demand, with continuous population growth in need of lodging and the narrow size of a country with limited land plots for sale. Thus, apartment prices naturally see upward price pressures and realty remains in demand, even if this demand is curbed in difficult times. Real estate investment is a safe long-term bet, even if nowadays the market does not provide short-term upside price potential. Buy-and-hold investors will undoubtedly benefit from a likely upside, even if the resumption of an upside is being delayed by the currently prevailing conditions, and can take advantage of a market very much in their favor to buy today on dips and hold on to their investment until the tide turns in their favor in the long run.

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MARKET DEMAND

Weakening demand for lodging in a sluggish realty market

Lebanon's real estate market has witnessed a further slump this year, with overall demand decelerating in recent months in a sluggish environment. All components of the market, namely the residential (largest segment in the sector by far), retail and office segments, have been affected by the currently prevailing regional and domestic environment. Realty was already in a difficult spot after the start of the Syrian crisis seven years ago and the practical exit of wealthy Gulf nationals and well-off Lebanese expatriates (also notably after the decline in oil prices a few years ago) from the Lebanese realty market. Demand waned and locals took the driving seat, which dealt a blow to the market for larger and more expensive housing units.

Within this context, the Central Bank helped locals access property as prices had by the start of this decade attained highs (even after discounts granted by developers) unmatchable by their purchasing power. Yearly stimulus measures targeting productive sectors (of which real estate) allowed the banking sector to extend subsidized loans to property seekers, noting that the total housing loans portfolio reached US$ 13 billion at end-2017.

But this year, things took a slightly different turn with the subsidized housing loan program running out. As a matter of fact, demand for housing loans surged especially after the recent salary scale approval rendered many public sector employees eligible for housing loans as their income rose. This occurred along with a relative improvement in overall domestic conditions after a President had been elected and a new government formed, thus to a certain extent encouraging locals who had been refraining from seeking a loan to do so. This largely contributed to the draining of BDL envelopes earmarked for banks to on-lend to homeowners-to-be at subsidized rates.

As a result, supply of loans could not keep up with demand and home sales weakened noticeably, visibly not propped up by the successful outcome of parliamentary elections or the CEDRE conference. As such, the BDL did not extend a further envelope ahead of its scheduled scheme for 2019, which affected market demand especially for units below US$ 500,000 that usually get financed through the subsidized programs. It is worth noting that the Parliament recently authorized the Ministry of Finance to allocate LP 100 billion (around US$ 66 million) out of the approved 2018 budget to help limited income families buy housing units through borrowing at low interest rates, adding this should be a temporary measure until the next government draws a broader policy in this respect. The amount is earmarked for the subsidy of interest rates on housing loans to be granted by the State-owned Public Corporation for Housing.

At the same time, interest rates rose in the country in the aftermath of the Hariri resignation episode. The temporary uncertainties actually pushed banks to raise interest rates to entice depositors especially in Lebanese Pounds while US dollar rates also rose in line with the US Federal Reserve increasing their benchmark rates as the US economy showed persistent signs of strength. Consequently, non-subsidized loans saw their rates increase and became even less appealing to potential homebuyers.

To put some figures around the findings, we note that property sales declined by a yearly 20.6% in the first eight months of 2018 after having relatively bounced back last year within the context of a relatively improved domestic climate and functioning government after the domestic political settlement in late 2016.

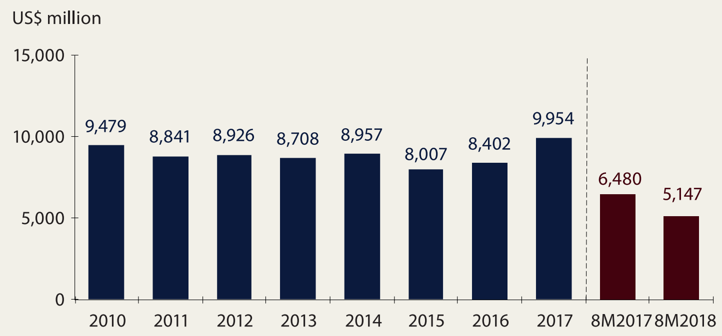
The decline in property sales value was broad-based as practically all regions in Lebanon reported a decrease on a yearly basis according to official data. Baabda, North Lebanon and the Metn areas saw the sharpest declines over the covered period. But Beirut and nearby areas (i.e. Baabda and Metn in respective order) accounted for the largest share of total market activity so far in 2018 with a combined 65% of total property sales value in Lebanon.

The number of property sales transactions similarly declined by 20.2% in this year's first eight months after a rise last year from low levels in 2016, a year that was marked by tense domestic conditions amid a deadlock in presidential elections until October. This time, even sales of small and medium-sized apartments that are usually less expensive and often secured through banking loans were hit. It is worth noting that sales to foreigners also dropped by a yearly 12.0% so far in 2018, confirming their declined interest in purchasing Lebanese property in today's tough regional/domestic environment.

Similar developments have been echoed at the level of commercial property activity, i.e. the retail and office markets. Lebanon's retail market was tilted to the downside over the past year, comparable largely to its performance in the previous year. This comes within a context of weak economic activity and tough political situation. The currently prevailing politico-economic conditions left their imprints on the entire retail segment, including malls and shopping streets. Given the wait-and-see mood the country is witnessing, demand is not rising at a rate that could meet with the increase in supply in various areas of the capital.

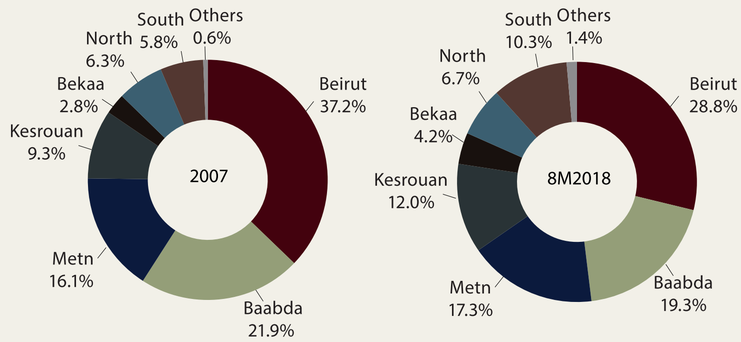
Lebanon's office market continued coming under pressure in 2018, with slower activity and a more feeble performance witnessed over the past year. Political bickering and economic sluggishness in the country were the main drivers for a further drop in activity. The market witnessed an increase in the number of unsold offices in the past few years. The BCD remains the largest office destination in the capital city in the sense that it has the highest number of office buildings in Beirut. Achrafieh is now almost saturated,

PROPERTY SALES TRANSACTIONS VALUE



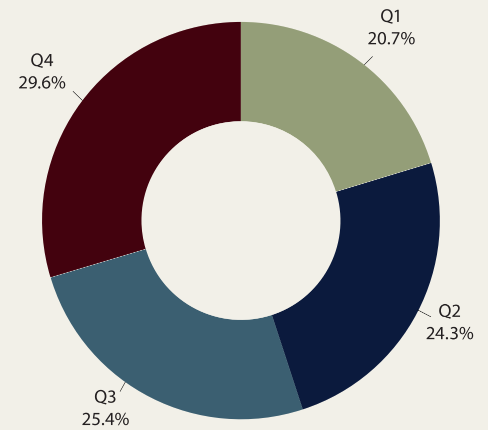
Sources: Real Estate Registry, Bank Audi's Group Research Department

PROPERTY SALES TRANSACTIONS VALUE BY REGION



Sources: Real Estate Registry, Bank Audi's Group Research Department still seeing new projects and supply that is outpacing demand and resulting in vacant offices. Moreover, new office buildings are being developed outside of Beirut. On the overall and barring a few underserved areas (such as Jnah), it is not easy for developers to find tenants and buyers given the weaker demand and higher supply, and this is having an impact on the segment's performance.

SEASONALITY ANALYSIS OF PROPERTY SALES: 2008-2017



Sources: Real Estate Registry, Bank Audi's Group Research Department

PROPERTY SECTOR FINANCING

US$ million	2010	2011	2012	2013	2014	2015	2016	2017
Property sales transactions	9,479	8,841	8,926	8,708	8,957	8,007	8,402	9,954
o.w. Built property estimate*	4,542	4,089	4,219	4,191	4,353	3,987	4,243	5,166
Housing loans portfolio	4,511	5,982	7,269	8,535	9,879	10,917	11,927	13,026
New housing loans	1,706	1,471	1,287	1,266	1,344	1,038	1,010	1,099
Avg lending ratio	37.6%	36.0%	30.5%	30.2%	30.9%	26.0%	23.8%	21.3%
Avg self financing ratio	62.4%	64.0%	69.5%	69.8%	69.1%	74.0%	76.2%	78.7%

* estimate derived from the share of the number of built transactions out of the total number of sales transactions

Sources: Real Estate Registry, BDL, Bank Audi's Group Research Department

MARKET SUPPLY

Pressured by waning demand with increasingly smaller housing units

With demand patterns shifting to more affordable housing especially in the form of smaller surfaces whether in the capital city or nearby neighborhoods and suburbs, the supply side of the real estate industry adapted, starting to offer smaller units. The trend has been accentuating year after year and the new trend now are flats below 180-200 sqm or even studios. One-bedroom housing units are mostly demanded by a diversified client profile, such as bachelors, divorcés, young couples without children and investors seeking to rent their property.

Developers are carefully crafting their master plans and taking advantage of every square meter to fit all requirements of buyers into the smaller surfaces being built. The difference lately with the post-Syrian crisis start trend of the past few years is that due to the prolonged downturn in the market, some developers have been forced to slow down or even halt their construction works awaiting sales or better days.

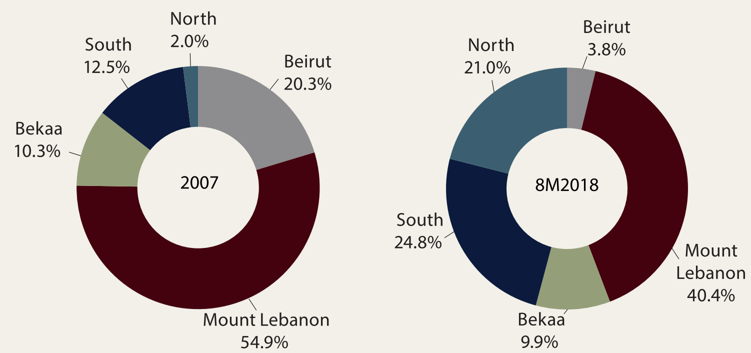
Some developers have postponed plans to start new realty ventures given prevailing uncertainties and this has reflected on the total area of new construction permits, an indicator of forthcoming activity in the real estate sector. Indeed, figures released by the Order of Engineers of Beirut and Tripoli shows that the total area of newly issued construction permits plunged further in 2018 with a 23.8% retreat in the first eight months on a yearly basis, following a 4.1% dip in full-year 2017.

Cement deliveries, another coincident indicator of construction activity, declined by 2.7% in this year's first seven months according to the most recent BDL statistics, after a drop of 1.9% in full-year 2017. In short, the supply side is simply responding to waning demand and prefers to scale back awaiting a bounce back in activity and sentiment. Some developers are opting for the lease-to-own model, whereby they rent the flat for a few years (and transfer charges to tenants) and subsequently propose a balance settlement against full ownership.

A recent survey by InfoPro and Lebanon Opportunities shows that the stock of apartments for sale is still on the rise. As a matter of fact, a survey covering buildings that may be complete or under construction finds that there were more than 2,400 buildings with apartments for sale at the end of May 2018 in Beirut and the four surrounding cazas (Baabda, Aley, Metn and Kesrouan), representing a 6% increase relative to the same date of last year.

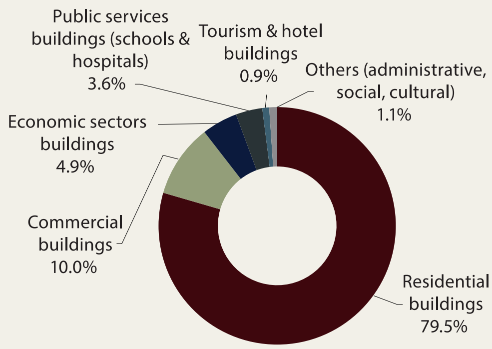
The same view is shared by the latest Ramco Real Estate Advisers survey covering a panel of 269 buildings under construction in Municipal Beirut and which highlights an 8% decline in the average size of an apartment under construction to 182 sqm in 2017. As such, between 2009 and 2017, the average size of a

BREAKDOWN OF CONSTRUCTION PERMITS BY REGION



Sources: Order of Engineers of Beirut and Tripoli, Bank Audi's Group Research Department

CONSTRUCTION PERMITS (AREA) BY USAGE PURPOSE (2017)



Sources: Order of Engineers of Beirut, Bank Audi's Group Research Department new flat shrank by 128 sqm, which according to the same source is equivalent to the size of an apartment in Beirut today.

At the retail realty segment level, and while some street spots are now vacant even in major shopping areas, more malls have opened and competition between them has intensified especially within Beirut and nearby suburbs. Malls are keen on introducing diversified services and adopting innovative marketing strategies to capture clientele. Some developers are opting to go where demand is high relative to the offerings available and are opening malls in the southern part of Beirut or the southern part of Lebanon. As such, The Spot Shoueifat opened recently after similar centers in the South, and Cascada mall opened in the Bekaa. Further malls are in the development stage in Metn, Kaslik, Jbeil, Batroun, Baabda, and other areas in the South or East of Lebanon.

In parallel, the recent decentralization of F&B clusters away from the capital to the benefit of Dbayeh, Naas, Hazmieh, Broumana and other areas in the North and South is allowing the clientele that lives away from Beirut to benefit from F&B venues closer to their homes instead of having to go to the capital city for that purpose. This actually appeals to developers who are seeking opportunities in farther areas north or south of the country, and can also help explain the relative slack in Beirut's performance. A recently conducted Le Commerce du Levant magazine/Hodema Consulting Services survey of 942 establishments scattered across 11 F&B zones in Beirut, namely Bliss, Hamra, Verdun, Zaytunay, Park avenue zone, down town, Gemmayze, Mar Mikhael, Monnot-Sodeco, Sassine and Badaro, shows a 1.8% decline in the number of establishments relative to last year.

At the office realty segment level, the overall market slowdown was reflected on office projects under construction in Municipal Beirut. The latter had 28 projects under construction towards the start of the year, down by 12.5% in one year and representing 164,754 square meters of total office space (also down by 14%), as per Ramco Real Estate Advisers' latest survey released earlier this year. The latter focuses solely on office projects listed on the sales or rental market (and not taking into account projects to be used as headquarter offices by private companies).

Upcoming office space in the capital city is dominated by Achrafieh which accounts for 58% of projects under construction. More than 41,000 sqm of office space was under construction in the area of Corniche el Nahr alone. There have been no new projects launched in the BCD over the past four years, and no current projects in Hamra, Clémenceau, or Verdun, as per the survey. On the other hand, several office projects are underway in Jnah, Mar Elias, and Bachoura.

MALLS IN BEIRUT AND SUBURBS

Mall	Gross Leasable Area (sqm)*	Visitors/year	Shops	Restaurants & Cafes
Le Mall Dbayeh	23,000	3,500,000	110	14**
ABC Dbayeh	24,095	5,500,000	205	12
City Mall	80,000	8,000,000	192	28
ABC Achrafieh	42,000	5,500,000	170	20
Le Mall Sin El Fil	12,000	1,700,000	80	5**
City Centre	62,000	9,000,000	152	21
ABC Verdun	50,000	n/a	200	29
Beirut Mall	16,330	380,000	60	3
The Spot Shoueifat	42,000	6,000,000	119	29

*Gross Leasable Area is the total floor area designed for tenant occupancy and exclusive use, including any basements, mezzanines or upper floors, but excluding the walkways and common areas. It refers to the amount of square meters that could be leased
**Only considering dining outlets, not stands or cafes

Source: Infopro - Lebanon Opportunities

MARKET PRICES

Price resilience tested anew in an increasingly tough and competitive market

The difficult conditions the Lebanese real estate market has witnessed over the past few years took a toll on price levels in the country. The latter are largely resilient in the sense that they are by nature sticky on the downside, and this has avoided a collapse in market prices in recent years, but sluggishness in sales has prompted some developers to grant discounts to interested enquirers/buyers.

Residential realty prices are sticky for three main reasons. First, land prices continue to hold up rather well in a small country with limited available land plots for sale. Second, many developers are self-reliant or rely on pre-sales rather than bank debt and are thus not in a hurry to sell. And third, lodging is mostly sought-after by locals who actually live in purchased properties, which avoids quick and massive exits once conditions are less rosy.

Having said that, it is difficult to imagine developers not tempted to grant discounts to serious enquirers or at least to close a deal, given that the market lacks serious impetus these days. Some developers started to accept the idea of some rebates here and there, though asking prices barely nudged down in recent years and until today.

The latest Ramco Real Estate Advisers on-the-ground survey of Municipal Beirut this year reveals that prices in the capital city are estimated to have declined by 15% on average in real terms (i.e. post-rebates and negotiations) relative to levels prevailing five or six years ago, with the range extending from 10% to 30% in some isolated cases. It is yet worth noting that some developers continue to show rigidity with regards to realty prices and opt to stick to their asking prices, even if it costs them a sales deal. One must bear in mind that this downward price correction is occurring following a circa 35% average increase per annum over the 2006-2010 period.

Similar views were echoed by the latest InfoPro - Lebanon Opportunities semi-annual price index published in June 2018 and which indicates a reduction in new apartment prices across Beirut, Metn, Baabda, Aley and Kesrouan. The index tracks changes in the asking prices of apartments offered for sale, bearing in mind that more than half the 117 real estate districts surveyed saw a contraction in asking prices.

But this does not mean that granting discounts ensures a house is sold. Some units do not find a buyer even after a noticeable rebate. Buyers are very much aware that the tide has turned in their favor and that there is a large stock of housing units available on the market. They can afford these days to choose from a large array of diversified options and more or less impose their conditions and get perks they would have never gotten a few years ago.

The residential rental segment has also felt the impact of the increasing gap between supply and demand on the market. While studios fared better, larger flats saw low double-digit declines in rents relative to a couple of years ago noting that the rental market is characterized by some sort of mismatch in the sense that many higher end flats are available in a proportion that exceeds smaller or more affordable ones. What widens the supply/demand gap is the fact that units that were originally earmarked for the sales market are not being sold and some developers are opting to rent them at least temporarily, which increases further available supply and exerts more pressure on rents.

At the commercial realty market level, the supply/demand gap took its toll on rental values in the retail market which sees nowadays many vacant units in several areas such as BCD, Hamra, Verdun, Mar Elias, Sassine etc. Verdun is reported to have seen the largest yearly drop, bearing in mind that the opening of ABC Verdun pushed rental prices outside the mall downwards. Mar Mikhael, now crowded and saturated, and Badaro, known for their food and beverages outlets, are reporting stagnant rents on the overall. On the other hand, Gemmayze benefited to a certain extent from the saturation of neighboring Mar Mikhael and is bucking the trend after becoming cheaper in the last couple of years with tenants, mainly F&B destinations, taking advantage of lower price levels in the past couple of years and pushing rental values upwards lately.

Last but not least, the same market demand/supply mismatch and the repercussions of the sluggish economic momentum and its impact on corporate activities are causing a more or less generalized decline of 10%-20% in rents and selling prices relative to a couple of years ago in the Beirut office market according to Ramco Real Estate Advisers, which suggested that official listing market prices have not declined but negotiation margins keep widening.

MARKET OUTLOOK

Long-term outlook still favorable despite accentuation of short-term woes

The domestic realty market has been suffering from weakening investor sentiment amid currently prevailing regional uncertainties, domestic political bickering and most recently the lack of ongoing subsidized housing loans until the awaited 2019 BDL housing loan envelope (in addition to the promised Ministry of Finance interest rate subsidy envelope). Buyers who decided not to postpone their buys are thus even more in a position of strength and their bargaining power has increased. Consequently, some developers are being encouraged to grant price discounts.

But those price discounts (as mentioned an average of 15% relative to a few years ago in Beirut) are a mere respite from a few years of higher double-digit growth per annum (and not over the entire period as is the case for current discounts). This means that realty prices remain elevated and have only slightly nudged down from their record highs attained at the start of the current decade.

What does this say about the outlook for real estate prices in the country? Are discounts likely to increase due to the current conditions? If so, to what extent? Are future price increases, even in the longer term, inevitable? And if so, when could they occur? We will attempt in what follows to address those pressing questions on real estate investors' and observers' minds.

The most likely scenario in the near term is the continuation of the current status quo in the market. The formation of a government might ameliorate sentiment but not trigger a massive unwinding of the sluggishness in the market. For that to occur, the investment climate would have to ameliorate tangibly in a way that encourages non-residents (most particularly Lebanese expatriates) to make a comeback on the local scene and residents to resume their buys (notably by providing them with more affordable financing options).

Otherwise, so in a lingering status quo scenario, price discounts are likely to continue being obtained, but not necessarily increase. One must not forget that not every developer grants a discount, and when one does, it is not necessarily at the upper end of the already mentioned range. What could happen is that, if the sluggishness persists for a reason or the other, more and more developers might agree to grant discounts and the rebate range might become more of a norm or might be gradually generalized. But for developers to increase the discounts obtained today might be difficult, except perhaps in some isolated cases. Those rebates are eating up their profit margins mostly and there will be some point (depending on each case) where they feel they'd better refuse a sale rather than agree to a large cut and not make a satisfactory profit margin from the property.

On a different note, and in a scenario of tangible improvement in the investment climate, which we mentioned here above, the sales momentum will undoubtedly improve, and the large stock of properties available for sale or rent on the market will start to decline. At a certain point, developers might become less inclined to grant rebates, and buyers will lose some bargaining power.

However, years of widening supply/demand gap cannot be erased that quickly. In other words, it will take some time for the market momentum to swing back in favor of sellers. The pace at which such a scenario would unroll depends firstly on the intensity of its triggering factors and secondly and subsequently on the sales momentum thereafter.

Eventually, that would happen and the stock of realty will be gradually depleted within the context of limited new construction projects. It is only then that upward price pressures might start to reappear, especially in the event of reforms undertaken by the government and that would unlock economic growth and raise the purchasing power of locals. The structural factors behind price resilience on the overall rest on an ongoing demand, with continuous population growth in need of lodging and the narrow size of a country with limited land plots for sale. In other words, apartment prices naturally see upward price pressures and realty remains in demand, even if this demand is to a certain extent curbed in difficult times.

In short, in a long-term timeframe, prices could go up again and would have reasons to do so. This is why real estate investment is an enticing long-term bet, even if nowadays the market does not boast a high turnover and does not provide short-term upside price potential. Buy-and-hold investors will undoubtedly benefit from a likely upside, even if the resumption of an upside is being delayed by the currently prevailing conditions, and can take advantage of a market very much in their favor to buy today on dips and hold on to their investment until the tide turns in their favor in the long run.

DISCLAIMER

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