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Government Initiatives Towards Tackling the Housing Challenges

Saudi Housing Sector Review

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Executive Summary

- Key determinants, which include a growing population entering the marriageable age, an expanding labor force and a rising income per capita, have created a significant demand for housing.
- A change in cultural norms caused a drop in the average household size. Thus, the average Saudi household size will decrease to 5.28 persons per occupied housing unit by 2020.
- Total housing stock is expected to expand from 4.6 million units in 2010 by 2.4 million units during the next 10 years, with annual demand rising from 195,000 in 2011 to 264,000 units by 2020.
- Key regulatory initiatives such as the King's injection of SAR250 billion into the construction of new homes, REDF allowing banks to offer bridge financing and the newly passed mortgage law will stimulate the demand for housing in the medium to long-term.
- The lack of affordable housing continues to be a challenging issue, which has limited home ownership for Saudis, as renters account for the largest share of the population at nearly 60%.
- Assuming historical growth rates, the Gross Fixed Capital Formation in residential construction will amount to SAR650 billion through 2020.
- After factoring in the allocation of SAR250 billion, total expenditures will reach SAR900 billion, still short by SAR400 billion needed to meet the SAR1.3 trillion in housing expenditures.
- We estimate residential bank lending will reach SAR60 billion in 2012.
- The King's SAR250 billion in financing aid to the housing market will mainly benefit the low income segment.
- SR40 billion injection into the REDF and the increase in loan size from SAR300,000 to SAR500,000 along with supplementary bank lending will primarily cater to the middle income segment.
- While all income segments will stand to benefit from the enactment of the mortgage law, those within the affluent segment will benefit the most as loan tenors and product ranges will increase.

Overview

The Saudi housing market continues to expand on the back of high population growth and increasing availability of financing alternatives. Other key determinants include the increasing kingdom's GDP, growing Saudi labor force and rising personal income, which all have a direct impact on the housing market. This trend will continue as the Saudi economy is expected to grow by 3.9% through 2012. Key regulatory initiatives such as the newly passed mortgage law, once implemented, will certainly stimulate the demand for housing in the medium to long-term.

The Saudi housing market is already experiencing a supply/demand imbalance and this trend is expected to continue as the supply of houses will lag behind demand. Meanwhile, the lack of affordable housing continues to be a challenging issue, especially the limited ownership of modern homes (villa) by Saudis. In addition, the artificially high prices of land plots, which are increasingly sought after in the Kingdom as a long-term investment option by high net worth Saudis, are accessibly limited to Saudi citizens and home developers.

Market Determinants

The kingdom's growing economy, on the back of high oil prices, has led to heavy investment in infrastructure including housing over the period 2005–2010. The Ninth Development plan for the Kingdom calls for investing SAR1.4 trillion on physical and social infrastructure between 2010 and 2014. The municipal and housing services' share of the plan's budget is 7% of total spending or SAR101 billion. According to the plan, both the public and private sectors are expected to build an additional 1 million housing units during this period. The budgeted allocation for municipal and housing represents a 53% increase over the eighth development plan.

Table 1: Ninth Five-Year Plan Allocations 2010-2014

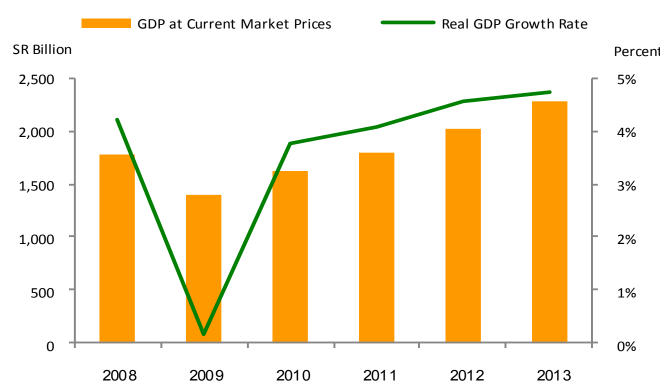
Development Sector	Allocation (SR billions)	Share (%)
Human Resources	731	50.6%
Social and Health	274	19%
Economic Resources	228	15.7%
Transportation and Communication	111	7.7%
Municipal and Housing Services	101	7.0%
Total Expenditure	**1,444**	**100.0%**

Source: Ministry of Economy and Planning

In 2011, a royal decree was announced to allocate SR250 billion to build 500,000 housing units under the newly established Ministry of Housing. This will accelerate the supply of housing units, especially, to the low to middle income groups.

While the global economy is still grappling with the effects of the financial crises, the kingdom's GDP growth rebounded in 2010 and is estimated to further grow by over 4% in real terms until 2014. Despite strong economic growth, the Saudi labor force market has been suffering from structural imbalances, which resulted in the unemployment rate of Saudi nationals to climb to 11%. Between 2000-2009, the kingdom's total labor force grew by a CAGR of 4% and is forecasted to grow to 9.5 million workers by 2013. The continued support by the government along with policy reforms to expand the non-oil GDP, which aim to create employment opportunities, will ultimately fuel the demand for housing. Another key factor affecting the housing demand market is the rising purchasing power of consumers, which is largely driven by emerging employment opportunities, particularly in the public sector.

Chart 1: GDP in Market Prices & Real Growth Rates



Source: SAMA and NCB Estimates

Furthermore, the young to adult age group, currently accounting for the largest portion of the population at nearly 15.2 million of the 27 million residents, will constitute the target demographic segment that seek home purchasing. Moreover, we estimate the population growth rate to remain constant at 2.6% CAGR through the forecast period as a larger segment of the Saudi population enters the marriageable age. Thus, the total population will reach 29 million by 2013 with the majority of the population to remain in the Western, Central and Eastern regions.

Table 2: Saudi Population Growth & Occupied Housing

Population	2004	2007	2010	2013F
Makkah	5,797,971	6,097,077	6,915,006	7,551,806
Riyadh	5,455,363	5,835,613	6,777,146	7,553,677
Eastern	3,360,157	3,545,644	4,105,780	4,538,515
Others	8,060,047	8,502,500	9,339,045	9,408,827
Total Population	**22,673,538**	**23,980,834**	**27,136,977**	**29,052,825**
Number of Occupied Units	**3,990,559**	**4,208,121**	**4,643,151**	**5,121,132**

Source: Ministry of Economy and Planning, 2010 Population census, NCB Estimates

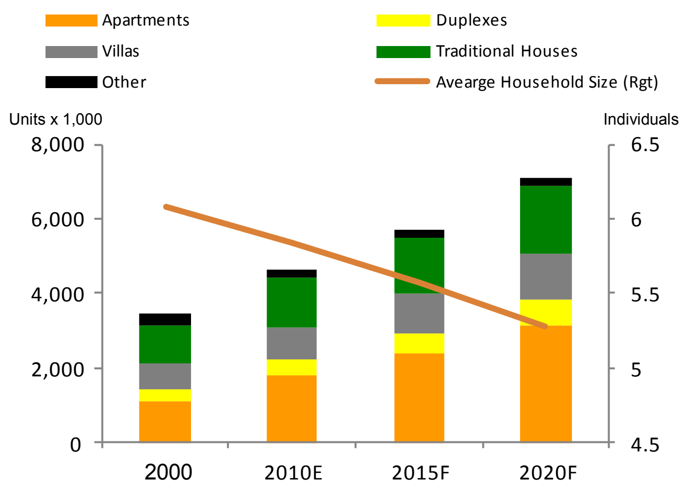
Demand for housing across the kingdom has centered around the three major regions, which include Makkah, Riyadh and the Eastern province. The housing concentration in these three regions are largely based on population count, housing development and available financing. Approximately 66% of the 27.1 residents are clustered in those three regions. Furthermore, the number of occupied homes in those same regions represent 67% of the total in the kingdom.

Historically, Saudi household sizes have been commonly large, thereby accommodating extended families. Although this practice is somewhat still in use today, cultural changes coupled with rising per capita income has caused a desire to shift towards breaking away from the extended family system. Meanwhile, the average household size in Saudi Arabia has been noticeably shrinking over the years. Between 2000-2010, the average Saudi household size declined from 6.08 persons per occupied unit to 5.84 persons per occupied unit in 2010, reflecting the shift from the extended family system to a smaller single family system. This phenomena has been a driving force in the rising demand for additional housing units.

Housing Units Characteristics

The change in distribution of the housing stock by type of property is another indicator of the changing household breakup that favors a single family system. This is evident in the share of occupied apartment units compared to other property types, which grew from 32.7% in 2000 to 38.8% in 2010. Furthermore, apartment units represented the only property type that grew at an accelerated rate compared to other property types. Given the growing popularity of apartment units and the decrease in average family size, we anticipate that apartment units will comprise 44.5% of the total number of housing units by 2020.

Chart 3: Occupied Housing Units by Type



Source: CDS, NCB Estimates

Housing Demand/ Supply Balance

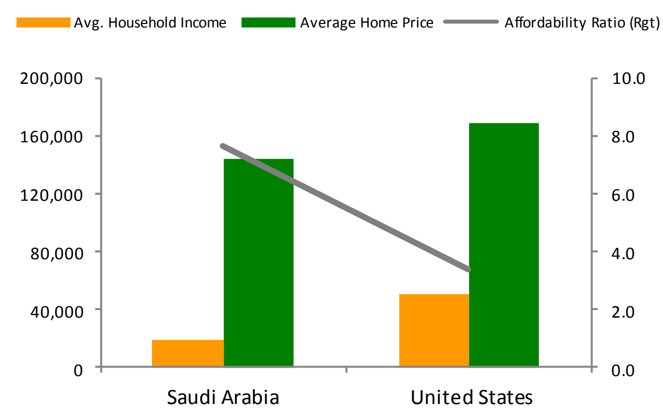
Demand for housing is driven by overall population growth. In addition, as previously mentioned, the average household size is on the decline, which also results in increased demand for housing units. Meanwhile, the supply of housing units has not been able to keep up with demand causing the current imbalance. On a full occupancy basis, the stock of housing units in the Kingdom increased by 1.2 million units between 2000-2010, bringing the total stock of occupied housing units to 4.6 million in 2010. This reflects the construction of 121,000 new units per annum, on average, during the same period.

The major factor contributing to the supply and demand imbalance is affordability. The commonly accepted guideline that defines affordable housing is that housing related expenditures do not exceed 30% of a household's income. As in the case of Saudi Arabia, most of what is considered to be affordable (below the SAR600,000 range) are in areas where there is less demand for housing. Another major issue facing housing developers is the rising price of land, which is generally manipulated by real estate speculators. In theory, land prices should not exceed more than 30% of the total cost of a villa type in order to keep housing development projects feasible. However, a number of developers are unable to meet the demand for affordable housing since land prices in the main three regions of Makkah, Riyadh and the Eastern province are overvalued. According to market sources land prices represent 40-50% of total housing development costs in the Kingdom's three main regions. Hence, housing developers tend to cater to the affluent segment of the population to make up for high land costs.

Further exacerbating the affordability issue is the lack of a regulatory framework by the government for land trading. A common practice in other countries is to impose a punitive tax on vacant land in order to curb land hoarding. The tax rate varies among countries, and even within a country's own jurisdictions. The Office of State Revenue in New South Wales, Australia, introduced a vacant land tax of 1.6% of the land value between AUS$396,000 to 2,421,000, and 2% thereafter. Also, the Taiwanese government reinstated a punitive tax on vacant land to restrain property speculation. Implementing taxes, services fees, or Zakat on large pieces of vacant land not intended as a principal place of residence would help release some of the vacant lands and curb escalating prices. The current practices are attributed to land owners who believe it is a safe and tangible investment, and are willing to wait substantial periods of time to achieve higher margins. The spillover effect from the lack of adequate affordable housing has led to an increase in rental unit occupancy.

To illustrate the housing affordability issue in the Kingdom, a comparison with an advanced economy like the U.S.A. highlights the growing gap between income and house prices. For instance, the median household income in the U.S. is USD50,221, while the average price of a house is close to USD168,800. In absolute terms, the average American's affordability ratio of housing to income is 3.4 times. This indicates that the average home price is 3.4 times the American citizen's average annual income. Conversely, the average income of a Saudi is USD18,851 according to the General Organization for Social Insurance (GOSI), while the average price of a house is approximately USD144,000. This puts Saudi's housing affordability ratio at 7.6 times.

Chart 4: Home Affordability of Saudi vs. U.S.A.

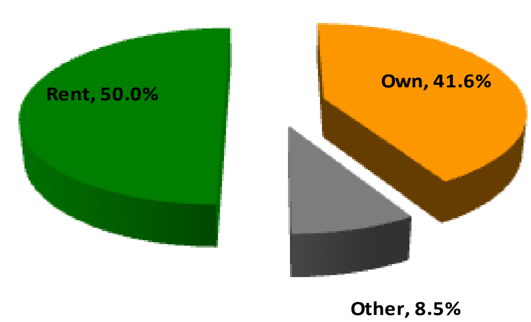


Source: CDS, CIA Factbook, U.S. Census, NCB Estimates

Saudi Home Ownership Breakdown

An estimated 50% of the total stock of housing units in the Kingdom is occupied by renters, while 41.6% is occupied by property owners. This is due to an increasing number of the population electing to live in apartment units since the availability of adequate affordable housing is not available to meet demand. Additionally, the increase in expatriates, which account for 31% of the total population, create additional demand for rentable units as their ownership is restricted through the period of securing a valid working visa permit (Iqama). The “others” category reflects housing that is provided by employers. It currently accounts for 8.5% of the total housing stock. The increase in the demand for rentable housing has caused a natural increase in rental prices.

Chart 5: Occupied Housing Units by Type (2012)



Source: CDS, NCB Estimates

According to the latest official government data released in 2007, Saudis owned 62% of their homes. However, by excluding traditional houses, which account for a sizable share of housing units, Saudi homeownership significantly drops to 36%. Traditional houses, which include mud houses and shacks, are considered to be of lesser quality in terms of building standards compared to other housing types and are not viable as livable units. This reflects the disparity of homeownership in the Kingdom. It is unlikely for these ratios to have changed much over the past three years. Thus we believe homeownership stands near the 40% mark.

Given the higher number of rented units compared to owned units, this demand has caused the rental cost of living to grow by 7% from 2010 to 2011. The rental cost of living has increased every year, albeit at a decelerated rate since 2008. According to market sources, the average residential yields in Riyadh and Jeddah are a healthy 8% and 10%, respectively. This indicates that property owners and developers are not prepared to abandon the rental market as long as there is an imbalance between what the population can afford and what is available to them for purchase.

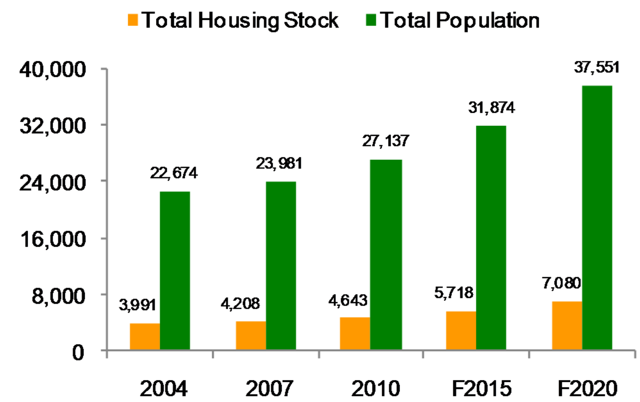
Chart 6: Yearly Change in Rental Cost of Living

Source: SAMA. CDS, and NCB Estimates

Demand Outlook

Total population in the Kingdom is projected to reach 37 million by 2020. Assuming the average Saudi household size maintains its declining trend thereby reaching 5.28 persons per housing unit, housing stock is expected to amount to 7,080 million units by 2020. Accordingly, total housing stock in the Saudi housing market is expected to expand by 2.4 million units during the next 10 years, with annual demand rising from 195,000 units in 2011 to 264,000 units by 2020.

Chart 7: Housing Market Size vs. Total Population



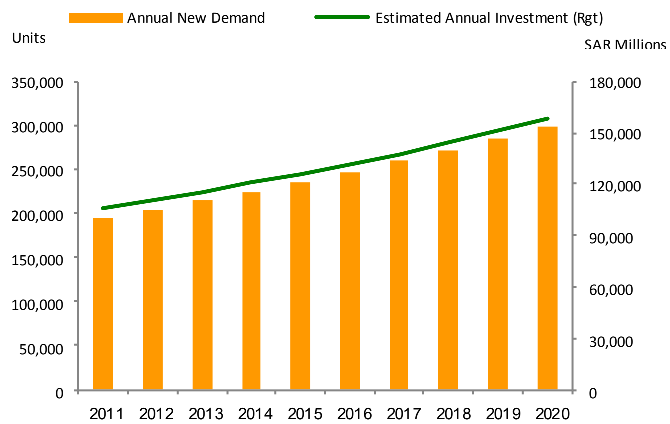
Source: CDS, NCB Estimates

The public and private sectors are expected to contribute to the growth in investments within the housing sector. Based on market sources for the average housing unit cost of around SR540,000, total investment required will amount to SR1.3 trillion, in order develop 2.4 million new housing units between 2011-2020. This represents an average outlay of SAR130 billion per annum.

One way to measure the current level of investments in the housing sector on a macro level is through gauging the value of Gross Fixed Capital Formation (GFCF) expenditures in residential construction. The level of residential expenditures reached nearly SAR43 billion in 2011. Accordingly, total GFCF in residential for the period 2011 to 2020 is projected to amount to SR650 billion. This number, however, falls short of the total investment needed estimated at SR1.3 trillion, even after accounting for the recent allocation by the government of SAR250 billion for the housing sector.

Evidently, further investment will be required by the private and public sectors in order to close this investment gap of nearly SR400 billion to meet anticipated housing demand. This gap will surely be reduced once the recently approved mortgage law is fully enacted and more real estate financing companies besides Saudi banks along with licensed foreign banks expand their financing options. In addition, this will contribute to partially restore the demand supply imbalance of the housing market and ultimately moderate the land and property prices from their artificially high levels.

Chart 8: Incremental Housing Demand vs. Investment Required



Source: CDS, NCB Estimates

Private Sector Role in the Housing Market

The housing market has witnessed an increased commitment by private entities in the development of recent residential real estate projects. These projects, not only were sizable, but also have focused on providing home ownership opportunities in addition to improved building quality and standards. In the first half of 2011 alone, approximately SAR10 billion in contracts were awarded for housing developments.

The construction of the SAR6 billion 'Nasamat Al Riyadh' residential project by Thabat (joint partnership between Al Oula Real Estate Development Company and Talaat Moustafa Group Holding), illustrates the amount of investment being poured into the housing market by the private sector. Situated on four million square meters of land, the development will include villas, apartments, commercial areas and a mall.

Another significant contract in the housing market during 2011 was the joint partnership between Ewaan Global Residential Company and Islamic Development Bank (IDB) awarding a contract to Arjab Development Establishment in the amount of SAR1.4 billion. The details include the development and management of "Ewaan Al Farida Project" on the north side of Jeddah. The project will cover an area of 2 million square meters with a construction of 2,500 housing units catered to middle income families. The development will also include mosques, a shopping mall, healthcare and educational facilities, sport clubs and other diverse facilities.

Regulatory Developments

The growth and diversification of the housing sector generally depends on a robust regulatory framework where legal policies are enforced and executed. The lack of a mortgage law in the Kingdom has hindered the potential growth of the housing sector, thus causing many financial institutions and developers to maintain low-risk portfolios. The recently passed mortgage law, including other related laws, aims to rectify currently existing obscurities and to protect the interests of all direct and indirect participants. Specifically, it is important to note that the set of laws also include articles on property repossession, enforced eviction and asset liquidation in the case of delinquencies.

Although the long awaited mortgage law was finally approved, it will not have an immediate impact on the housing market. However, after its ratification, it will help convince individuals and entities to enter the housing market, whom would otherwise hold off in the absence of the law. While the articles of the law seem to address housing demand through easing access to finance, it does not address supply shortages. Additionally, until precedence has been set, the enforcement and applicability of the law will be unknown.

The mortgage law will, ultimately, help develop an active secondary market whereby mortgage lenders, among which banks, will be able to clear the assets on their balance sheets and utilize their capital more efficiently. Additionally, mortgage securitization will allow originators of the loans to diversify their risk and enable them to secure immediate liquidity for assets, which would otherwise have faced some difficulty in trading. An increase in loan tenors, with the expectations of higher returns, would make the assets more attractive to the secondary market, especially for institutional investors such as GOSI and investment banks. The development of mortgage securitization would give birth to government sponsored institutions, equivalent to Fannie Mae and Freddie Mac in the United States, resulting in the formation of a deep housing bond market.

The establishment of a Ministry of Housing will further bring regulatory enhancements to the housing sector. As part of the King's Royal Decree that was announced during the first quarter of 2011, the Ministry of Housing assumes all the responsibilities that were under the former General Housing Authority, in addition to the construction of 500,000 housing units worth SAR250 billion. Additionally, a board of directors for the Real Estate Development Fund was formed, with the minister of Housing instead of the minster of Finance being appointed as chairman of the board.

Housing Finance Market– REDF/ Banks

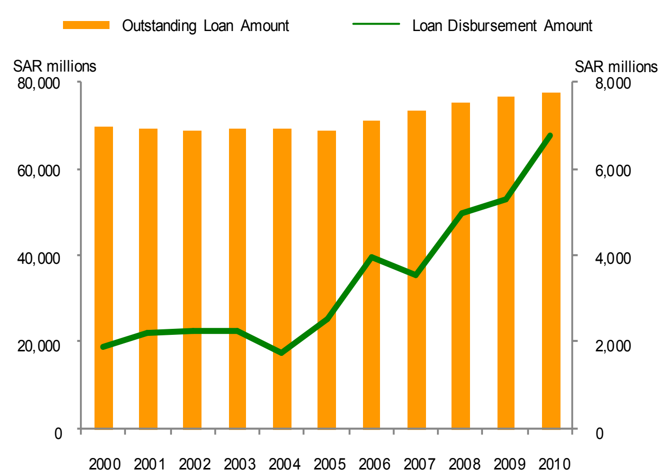
Government programs, specifically, the Real Estate Development Fund (REDF), provide housing assistance to Saudi citizens in the form of interest free loans. According to 2010 data, the REDF provided loans in the amount of SAR6.7 billion. The loans were disbursed for financing the construction of owner occupied units. Loan repayments in 2010 stood at SAR5.9 billion. The REDF has disbursed SAR172 billion loans for the construction of nearly 700,000 homes since its inception to 2010.

A major obstacle that Saudis used to face with the REDF was the requirement to own land upon submitting a loan application request. However, the land requirement was recently revoked. This policy change has increased the number of applications, allowing loan disbursements to respond to the current pent-up demand for loans. The government also initiated an online application option, however this caused an additional 1.7 million citizens to the waiting list. Furthermore, the King's last year decree related to residential finance stipulated an increase in the loan from SAR300,000 to SAR500,000 besides raising the REDF's capital by SAR40 billion. According to the Finance Minister, the injection of SAR40 billion will translate into 133,000 soft housing loans. More recently, the REDF has approved 11,666 loans amounting to SAR5.83 billion for building 14,000 housing units as the third installment of loans that have been approved for 2012's budget.

Additionally, the recent establishment of the Dhamen program, which provides buyers with added financing above and beyond the SAR500,000 in the form of bridge loans provided by local banks, will provide buyers the ability to buy a home without having to acquire land. The Dhamen program stipulates that the desired housing unit must already be built and does not offer bridge loans to finance the construction of a home.

Despite the lack of a mortgage law in the Kingdom, local banks have been offering residential finance to their customers. However, its growth has been rather modest compared to other types of consumer finance like auto-lease. To minimize risks in the absence of robust regulatory framework governing this type of financing, banks with varying degrees opted to enforce strict loan criteria. Some of these borrowing criteria include: limiting residential loans to payroll-only customers, providing loans in cities where bank branch operates and in some cases in predetermined regions where risk is perceived to be lower, restricting the type of property that can be purchased and in most cases the prohibition of off-plan financing. In anticipation of the approval of the mortgage law, the Saudi market witnessed the entrance of new non-bank players, signaling a growing attraction to the Saudi housing market. Although their impact has been minimal, these non-bank residential finance providers, such as Deutsche Gulf Finance and Amlak International expanded their loan offerings to include non-payroll customers, and off-plan financing. These credit institutions will play a critical role in the development and evolution of the mortgage lending landscape in the future.

Chart 9: REDF Total Outstanding Loan Amounts

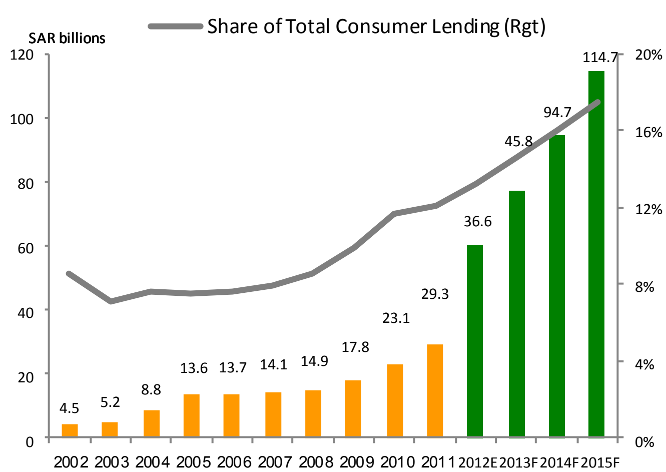


Source: SAMA, NCB Estimates

According to SAMA, the total real estate financing by local banks reached SAR29.3billion in 2011. During the second quarter of 2012 alone, total real estate lending grew by SAR17 billion. This significant growth in real estate bank lending highlights a historical shift away from the conservative lending that has been practiced in previous years. Thus, we estimate the total real estate market financing to reach SAR60 billion in 2012. The residential lending market in the kingdom overwhelmingly consists of loans by commercial banks, however, the mortgage market, upon the implementation of the mortgage law, has the potential to attract non-bank lenders to this market. The Kingdom's current banks' residential finance amounts to a meager 2% to GDP. This reflects the potential that residential financing has in comparison to other developed economies like Germany, UK and France where the mortgages to GDP ratio stands at 50%, 55% and 32%, respectively.

Meanwhile, we do not expect the supply demand imbalance of the housing market to significantly change in the short-term even after the passing of the mortgage law. The impact of the mortgage law will take some time. Banks and non-bank players will need sometime to test the robustness of the law. In addition to limited availability of financing, another real constraint has been affordability. As previously mentioned, as long as there is no incentive for land owners to sell (i.e. land prices sky rocketing, no land tax, no capital gains tax), this will continue to restrict availability of affordable land.

Chart 10: Residential Bank Lending Market Size



Source: SAMA, NCB Estimates

Conclusion

The housing market is crucial to the development and advancement of the Saudi Arabian economy. While several constraints exist, the potential for growth is plentiful. The demand for housing, especially affordable units, continues to grow at a rapid pace. The continued migration to the Kingdom's three main regions of Makkah, Riyadh and Eastern Province has been exerting pressure on property developers and banks to provide the necessary facilities to accommodate such shifts. In addition, the younger age demographic, which represents the largest segment of the population, besides generating additional demand as they enter the marrying age, are gradually breaking from the extended family life style.

The current policy initiatives are aimed at targeting pent-up demand for housing across the low, middle and affluent income categories. Firstly, the allocation of SAR250 billion announced last year for the construction of 500,000 homes will largely benefit the low income segment. With the average value of a housing unit approximately falling in the SAR500,000 price point, such a level is within an affordable range to the lower income demographic. Meanwhile, the speed at which these homes are expected to be erected underscore the lack of input the buyer will have to customize or tailor these homes as they will largely be constructed on a pre-fabricated basis.

Secondly, the SR40 billion capital injection in the REDF and the increase in loan size from SAR300,000 to SAR500,000 along with the supplementary bank lending program known as Dhamen, will primarily cater to the middle income segment. This will allow for the purchase of an existing dwelling unit such as a villa at a cost that exceeds SAR500,000 without a prerequisite to own land. As the mortgage industry matures and competition heightens, the middle income segment will stand to benefit the most from aggressive mortgage rates and lower risk criteria set forth by lending institutions.

Although the benefits of such changes may not be felt until the medium to long-term, it will go a long way towards providing economic stability in the market. Lastly, the ratification and enforcement of the mortgage law will provide much needed clarity to the housing market and will allow for the proliferation of new mortgage products.

While all income segments will stand to benefit from the enactment of the mortgage law, those within the affluent segment will benefit the most. Current residential lending by banks use various forms of financing but prefer Ijara scheme due to the lack of legal regulation necessary to implement mortgages. The mortgage law would allow for greater use of Islamic financing schemes within mortgage lending such as Murabaha (transferred ownership of asset) and Istisna'a (project finance) between developers and potential buyers. Motivated also by implementation of the law, banks would be inclined to issue mortgages with higher loan amounts and longer amortization periods than is currently being offered.

The estimated SAR1.3 trillion investment needed to construct the 2.4 million housing units between 2011-2020 illustrates the magnitude of expenditures needed by both government and private entities in order to close the supply and demand gap. The growing demand in the housing market will create many opportunities for both commercial banks and real estate developers alike to take on more active roles.

In the medium to long-term, the mortgage law will have a positive impact on increasing home ownership, as lenders gain more confidence that the law will provide needed protection. These new initiatives, which are aimed at addressing the housing market across different income groups, will gradually remedy the supply-demand imbalances towards equilibrium.

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