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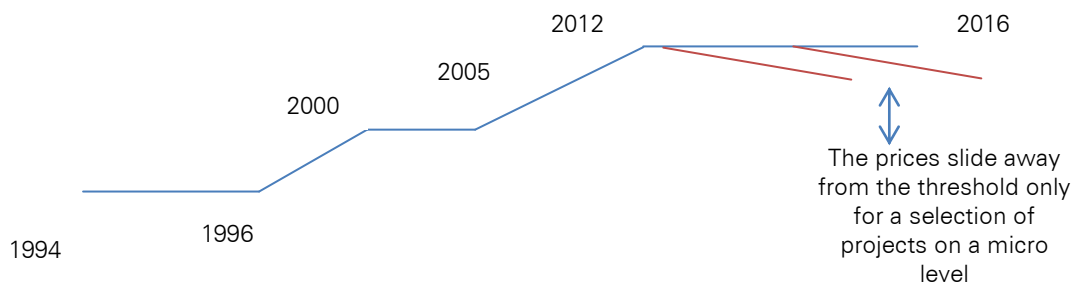
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The word on the street has it that times are tough on the Lebanese real estate market. However, opinions vary as to how bad things are: some ponder the idea of a crash while others simply acknowledge stagnation in the sector. The adepts to the latter point of view believe that speaking of a crash assumes there is a real estate bubble where prices are inflated and unreflective of the real value of real estate and that is not the case in Lebanon.

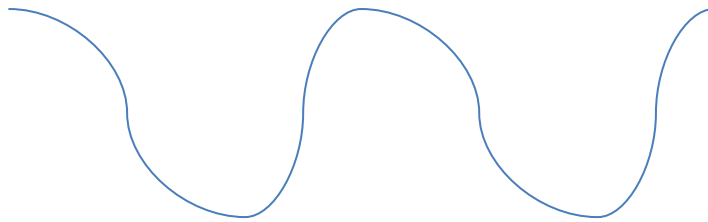
The aficionados in the sector that speak of stagnation rather than a crash note that, in terms of prices, the real estate trend in Lebanon evolves in thresholds or a staircase form rather than in a cyclical form. In other terms, in tough times, the prices in the sector don't plummet suddenly but rather stagnate at a certain threshold. Since the evolution is in a staircase form, the listed prices for real estate would have actually increased over the past five years on a macro level. However, the price only deviates from the threshold by 10% or 20% on a micro level, when only certain projects decide to enact discounts.

According to RAMCO¹ Real Estate Advisers, the sale prices of apartments under construction in Beirut have decreased by 1.2% in 2015, compared to a slower 0.7% drop in 2014. However, RAMCO also highlighted that only 29.8% of the projects under construction have adjusted their prices downward, 13.3% have increased their asking sales' prices while 56.9% maintained prices unchanged in 2015.

The Trend of Prices in the Real Estate Sector assumes a staircase form...



...Rather than a cyclical form



How the Stock of Inadequate Supply Took Shape in Lebanon

Let's first establish how the real estate market got to where it is now. In the booming period of 2010-2011, demand stemmed from oil-rich Arab countries, resident Lebanese and Lebanese expatriates. Therefore, real estate developers sold the entirety of their finished and under construction projects and 30% of the projects that were still at the permit stage.

¹ RAMCO's latest study covered 248 residential buildings under construction in 61 neighbourhoods across Municipal Beirut

The year 2012 was however a turning point that changed the face of the real estate sector and the Lebanese economy in general. The eruption of the Arab spring, especially in neighboring Syria and the ensuing spillovers slowed down the core sectors of real estate, construction and tourism. From that point on, the Lebanese scene was rattled with instabilities on the political and security fronts while in the region, conflicts kept on raging.

Given the new backdrop, demand for real estate suffered. Real estate investments made by GCC nationals in Lebanon were significantly reduced as instability in the country led to the issuing of travel bans and as the slump in oil prices starting June 2014 slowed down GCC economies. The demand for real estate from Lebanese expatriates living in the Gulf was also negatively impacted since the lower oil prices generated a wave of cost-cutting across companies in the GCC.

Therefore, the 70% of the projects that were still in the permit stage back in 2010-2011, which were large, pricey apartments, were left with no buyers. Currently, this stock of apartments that no longer meet the requirements of demand are left sitting there.

However, it's important to note that demand shifted faster than real estate developers had anticipated. A few avant-gardists foresaw that demand will tip over from large to small spaces at a time where they could still change the face of their project but this kind of change is costly and burdensome. Moreover, the real estate developer that set up parking spaces for 10 large apartments may not find additional spaces if and when he decides to turn these 10 large apartments into 20 or 30 smaller apartments.

Interestingly, some developers had hope that Syrians fleeing the war will boost demand for apartments but they were later proven wrong. The high income Syrians regarded Lebanon as a transit destination by renting spaces or staying in hotels only for a brief period until they get their paperwork ready. Therefore their impact on the residential real estate market was negligible due to the temporary nature of the stay. The Middle Income Syrians occupied apartments on a tighter budget outside Beirut in regions such as Louaizeh or Jounieh, etc... and therefore didn't boost demand for the high end apartments.

When the taste for smaller apartments was no longer questionable, all new projects adapted to the new demand. The construction area authorized by permits stands testimony to that as it regressed at a compounded annual growth rate (CAGR) of 6.44% over the period 2011-2016 as it dropped from 8.8 million square meters by June 2011 to 6.35 million square meters by June 2016.

With the new trend being firm and settled, some real estate developers remained in the market while others could not sustain to stay. Big real estate developers proved to be resilient despite the rough new operating conditions but it's the smaller developers who built a few projects here and there that were the most badly hit. By now, all the real estate developers that were unable to cope with the shift have been weeded out of the market.

When the profit margin of the small real estate developers is slowly eroded, they no longer have the means to invest in new projects and therefore exit the market. The sales price of a project is split between: construction costs, land cost and the profit margin of the real estate developer/promoter. With the construction costs being relatively stable, the scarcity of land in Lebanon drives the price of land upwards and that eats away at the promoter's profits. Usually, the developer utilizes this profit margin to invest in a new real estate project but if that profit margin is shrinking it will be utilized to cover any outlying debt rather than going into a new project and the promoter will eventually exit the market.

What's ahead in the Real Estate Market?

The stock of large real estate units that has no buyers will witness a smooth dilution. As time goes by, the stock of large-sized apartments will slowly be liquidated to the few interested buyers but of course this process will be lengthy as the frequency and volume of demand is subdued.

The stock of inadequate real estate supply that is currently idle on the market is not synonymous with a breakdown in the sector, since the scarcity of land offers it a certain form of support. In the country's hub where all the big universities, hospitals and centers are located land is scarce and that will keep prices from plummeting. The available space for building real estate units next to this hub is also very limited and does not exceed 500 meters above sea level.

Prices will also remain supported even if we utilize more land by pushing the construction perimeter away from Beirut. If we assume that the transportation system is modernized and real estate units in the periphery begin to proliferate, prices at the heart of Beirut will not plummet but rather prices in the periphery will start to increase. This is another argument in favor of real estate prices in Beirut not crashing. In addition, the Lebanese still regard real estate as their favorite fixed capital investment and that will continue to offer support for the market. According to the Lebanese Cadastre registry, transactions made by Lebanese nationals are what helped push real estate transactions upwards in the first half of 2016 (H1 2016) since the share of real estate transactions done by foreigners declined from 2.01% by June 2015 to 1.48% in the same period of 2016.

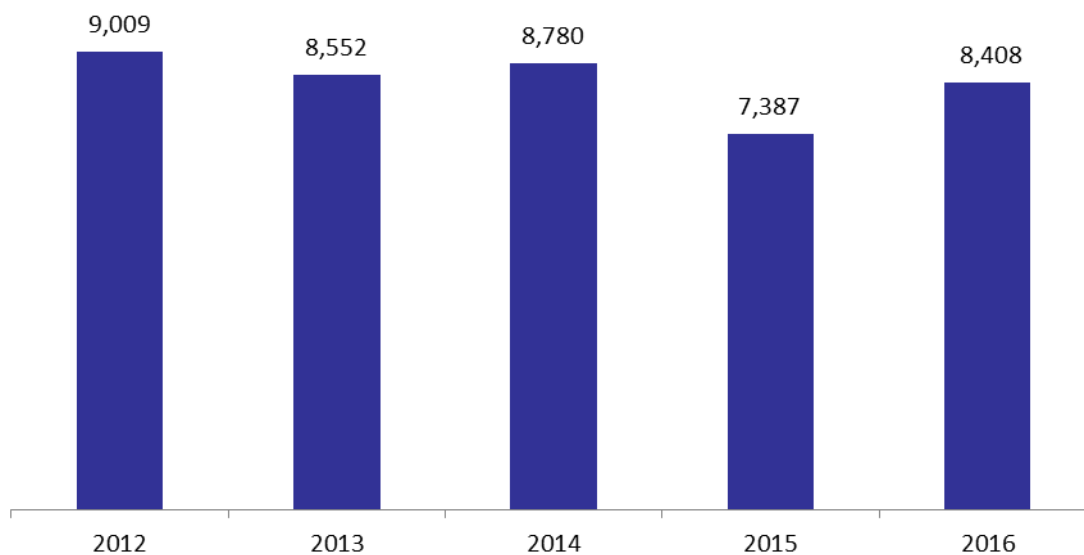
Given the tough operating conditions for the stakeholders in the real estate market, the Central Bank has already built a cushion for both banks and real estate developers. According to Banque du Liban's (BDL) Intermediate Circular #427, a real estate fund will be able to assist real estate developers facing low or stagnant demand and who are indebted to banks. At least 40% of the financing can be provided by the fund's own capital and no more than 60% can be offered to the real estate developers in the form of bonds that can be discounted at the Central Bank. For the real estate developers, the participation of the private sector will ease their debt burden substantially. The liquidation of some of their fixed assets will in turn allow them to meet the commitments of their existing contracts and perhaps access new lines of credit. The fund will also allow banks to deal with their non-operating loans that may turn into doubtful loans and therefore will spare them the need to take provisions and will allow them to boost their profitability.²

The Market Adjustment was Visible in H1 2016

The supply of real estate is finally adapting to demand and that is visible in the pick-up registered by the sector's main indicators. According to the Order of Engineers in Beirut and Tripoli, the construction industry grew within the first 6 months of the year, where the number of real estate permits increased from 7,387 by June 2015, compared to 8,408 in the same period of 2016. Data provided by the Lebanese Cadastre Registry also showed an improvement during the first half of the year with the number of real estate transactions adding 4.4% year-on-year (y-o-y) to 39,100. This increase mainly resulted from respective yearly increases of 5.0% and 4.2% in built units and land transactions. Similarly, the value of real estate transactions rose at a faster pace of 5.9% y-o-y to \$3.85B in H1 2016. This mainly resulted from the 11.2% annual growth in the value of land transactions, which was coupled with a 2.7% yearly rise in the value of built up transactions.

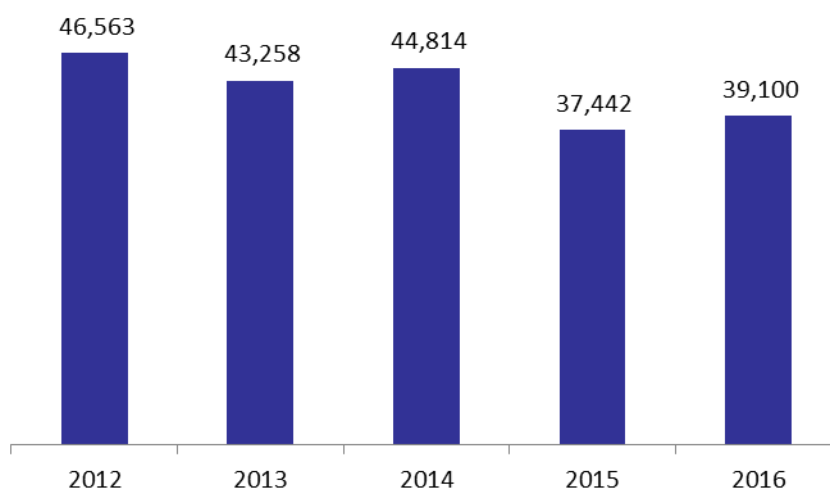
² It is worth noting that although this financial engineering initiative by the Central Bank aims at preventing any payment defaults on the loans extended to real estate developers, this does not mean that major defaults have been registered so far. The asset quality of all the Lebanese banks is solid with the ratio of net doubtful loans and substandard loans in total gross loans standing at a low 2.15% in 2014 down from 2.25% in 2013.

Number of Construction Permits by June



Source: Orders of Engineers in Beirut & Tripoli

Total Number of Real Estate Transactions by June



Source: Lebanese Cadastre Registry

We should always keep in mind that the real estate market does not only encompass the residential segment but also includes commercial spaces, offices, etc... Although the residential segment was shaken up in the past few years, we have recently witnessed developments of entertainment hubs such as Cascada Village, F&B clusters in Dbayeh, Hazmieh, Broumana, office spaces outside Beirut in regions such as Sin el Fil, Dora, Jal el Dib and “chalets” concepts outside the capital. Whether the market adjustment seen in the first half of the year will continue remains to be seen.

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