

Plain vanilla... with some sprinkles please

YAHYA ABDULLA discusses the investment habits of Islamic financial institutions, and examines the need to consider new markets and asset classes in order to produce better returns.

Real estate as an investment class has historically been one of the most accessible and diverse offerings available to corporate and individual investors across the globe. From sky scrapers to bungalows and shopping centers to logistics parks, the global real estate market has often generated substantial returns for investors whilst allowing for sector and geographic portfolio diversification.

The total size of the real estate market would easily fall into the many trillions of dollars and there are an abundance of opportunities to suit a wide range of demanding investor criteria; ranging from lower risk income-generating assets in developed economies to more risky development projects and more exotic locations.

In spite of this diversity of asset classes, Islamic financial institutions (IFIs) tend to gravitate towards a 'plain vanilla' type of product, generally preferring to be followers rather than leaders.

There are of course exceptions, but the fact remains that outside of their local

markets, IFIs would prefer to invest in traditional real estate initiatives: frequently at the expense of other, less traditional but perhaps more profitable, opportunities.

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Unleashing growth potential
The past few years have been challenging for all financial institutions (conventional and Islamic), but while

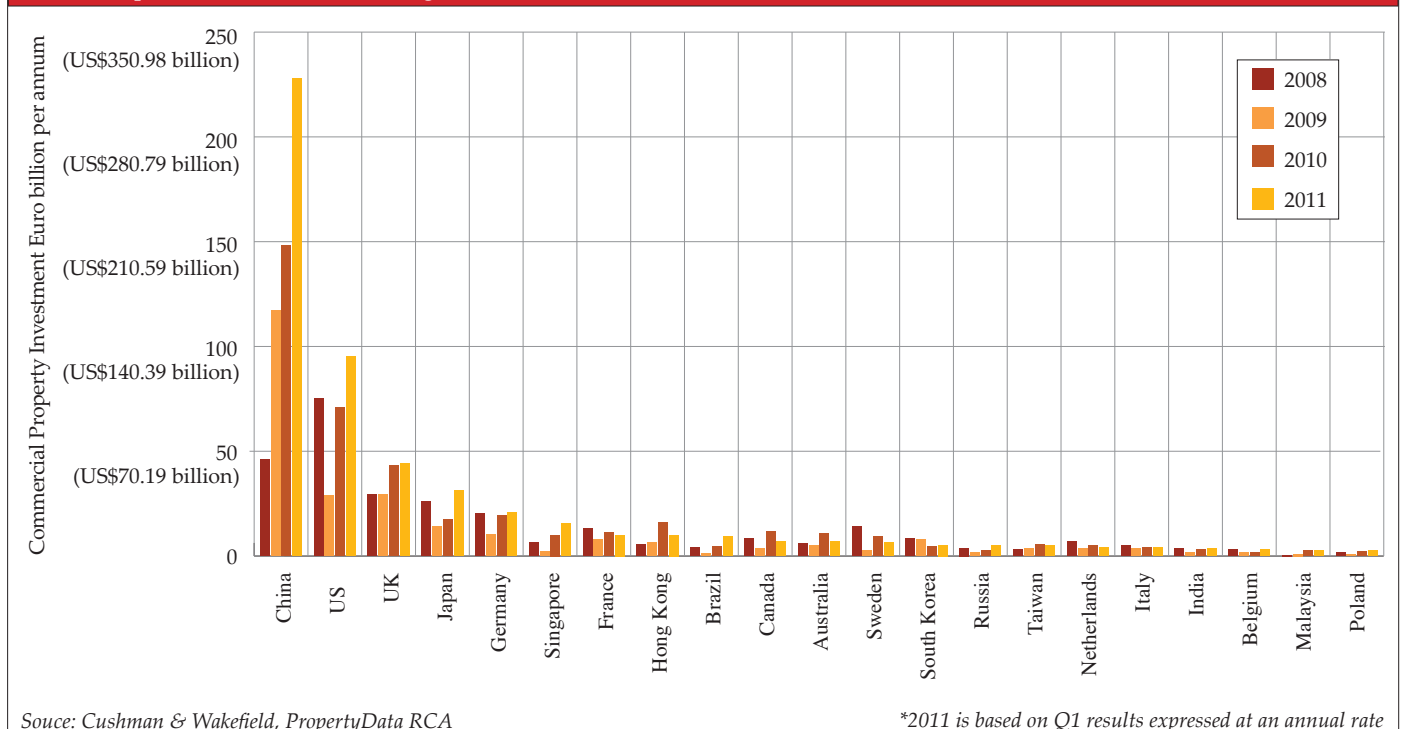
consolidation is inevitable, IFIs have generally emerged from the crisis with fewer scratches than their conventional counterparts.

Nevertheless, the industry should not sit on its laurels; it is worth noting that though the total size of global Islamic banking assets is approximately US\$1 trillion at the moment, while on an absolute basis this number may sound impressive, it is around one third the size of the assets of one large German bank: i.e. on a relative basis, the Islamic banking industry is actually very small.

This comparison highlights the substantial potential for growth. Given the current state of the conventional banking sector as well as global macro economic trends, the business environment is now ideal for IFIs to take advantage of their strong liquidity positions and aggressively highlight the benefits of a Shariah model to the rest of the world. This value-addition can especially be demonstrated in real estate, a sector which due to the nature of the asset, lends itself to many different

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Table 1: Top 20 real estate investment targets



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Islamic structures and subsequently investment products.

Time to take the lead

In a relatively new industry, there will inevitably be 'trail-blazers' pioneering innovative structures, entering new geographies and leading the way for others to replicate similar Shariah compliant products and strategies (a lack of open architecture and insistence on exclusive mandates is stunting this growth, but that is another discussion).

However, taking a step back in order to view the real estate market holistically (conventional and Islamic), it is clear that the IFIs have generally been followers, entering markets which have had a long track record of conventional investments.

“ The reasons for considering new markets and asset classes go beyond the search for better returns, and include providing a real estate portfolio diversification which is currently missing from many Islamic banks’ product offering ”

Indeed, outside of their geographic comfort zones of the Middle East and Asia, there has been relatively limited real estate investment activity.

The traditional first step has been into long established markets where there is a substantial track record, significant competition from global investors and hence considerable upward pressure on pricing.

Whilst this is a sound strategy for the newer entrants into the market, more experienced IFIs who have developed some international track record, should start exploring new asset classes and geographies.

The graph in Table 1 presents the top 20 global commercial real estate targets over the past few years. It is clear to see that China has very much started to dominate global capital flows, driving world economic growth and undergoing comprehensive development on a large scale.

It is a country which some commentators are suggesting may be over-heating, but as the final numbers for 2011 will surely illustrate, continues to attract international capital for real estate investments on a remarkable scale (almost twice that of the US) — suggesting that the market is simply too large to ignore.

While conventional firms have actively invested in laying down the infrastructure (building teams and track record) to tap into the Chinese market, there have been very limited forays by IFIs into China.

Yes, part of this is due to the opacity of the market and perhaps lack of regulatory clarity with regards to Islamic investments, but given the scale of opportunities and associated returns, surely the Islamic segment should be more proactively placing itself to take advantage of China in the future.

This includes increased lobbying with the Chinese regulatory authorities in order to create and/or clarify the treatment of Islamic investments, as well as the development of partnerships with institutions that have a strong understanding of the market. Based on recent discussions with various IFIs in the Middle East, China and indeed Asia has only recently been mandated in their real estate investment portfolios.

Looking further through the list in the graph, I would say there are a limited number of IFIs which are actively focusing or at least strategically considering targeting the majority of these countries.

Also interesting to note is that aside from Malaysia, none of the Islamic

countries marketing themselves as hubs for Islamic banking are on the list, in spite of the circa US\$1 trillion size of the industry.

The fact that GCC states are smaller on a land mass / demographic scale cannot be used as an excuse, since Singapore (a small island country with a population of around five million) is currently the sixth largest real estate investor destination in 2011.

The reasons for this may be due to a lack of sufficient investment grade real estate assets in these countries; however, with the development pipeline of Saudi Arabia and the internationalization of other GCC states, perhaps we are not far from seeing more Islamic countries on this list.

Embracing diversification

The reasons for considering new markets and asset classes go beyond the search for better returns, and include providing a real estate portfolio diversification which is currently missing from many Islamic banks’ product offering.

Completing transactions in the same geography, within the same asset class, taking the same political, economic and currency risk is not advocated by any investment advisor.

This does not mean stop acquiring single-tenant long-lease assets in central London, rather, complement those assets with a logistics park outside Berlin and consider opportunities which require some form of asset management which is a clear way to add value to a real estate acquisition (as examples).

Islamic institutions with a longer track record and larger capital base have recently sought to diversify exposure globally with Shariah compliant real estate acquisitions being made across Europe, Asia and North America.

This trend will hopefully continue and extend into newer geographies and asset classes where conventional firms have already started to take advantage of higher yields and limited market participants.⁽²⁾

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