Residential Research

International Residential Review

2008

Contents

Castelfalfi, Tuscany, Italy

- In the 2008 edition of the Knight Frank International Residential Review we examine the fortunes of the main prime property markets around the world and consider the prospects for growth over the coming year.
- We provide a brief commentary on the impact of the global credit crunch on prime residential property. We assess the dependence of internationally oriented property markets on the financial and business services sector as a source of purchasers.
- As with previous editions of this review, we have provided a table of comparative residential values. This table has been compiled with the assistance of agents working on the ground. As such, the data is generated directly from those markets, rather than from remote secondary sources.
- 2008 should be an interesting year for the prime residential markets; the credit crunch has provided an opportunity for buyers and vendors to take stock following a decade of strong price and demand growth.

Knight Frank Newmark Global

Courchevel, France

Executive Summary

- Global property markets are seeing slower price growth compared to the rate seen in 2007. Prime property still outperforms the mainstream.
- Of the prime markets covered in our analysis, Moscow recorded the strongest price growth during 2007.
- The credit crunch is affecting markets differently according to location and market segment. The market for super-prime property appears to be relatively unaffected by the tightening of lending conditions.
- We expect that most prime markets will begin to slow as confidence weakens due to recent turmoil in financial markets. The next 12 months will see a gradual slowing of price growth in the main international markets, especially France, Italy and the Caribbean. We expect to see better news from the US by mid 2008; within the US there are some prime niche markets where higher property values have remained stronger than the mainstream – central New York being an example.
- The likely continued weakness in the value of the US $ (allied to the longer term expectation of recovery) will make purchases in dollar denominated markets particularly attractive from a European perspective.
- Slowing growth in the mainstream markets means that the quality of stock is becoming increasingly important for buyers. Equally, a shortage of good quality is helping to maintain prices in prime locations.
- London remains the most expensive city in the world – just pipping Monaco to the top spot – with prime property prices in the UK capital averaging just under €37,000/m² (see table 1).

Table 1 – Knight Frank Prime International Index, Q4 2007

Location	Average purchase price (€/m²)	% price change over last 12 months	Average gross rental yield (%)	Mortgage rate (%)	% currency movement in last 12 months against: £	€	$	Cost of living (London = 100)
London	36,825	30.8%	4.1%	5.5%	n/a	-6.12	4.61	100
Courchevel, France	35,000	5.0%	n/a	3.0%	6.52	n/a	11.44	89
Monaco	32,500	25.0%	2.5%	4.5%	6.52	n/a	11.44	120
Paris	15,500	10.4%	3.0%	3.0%	6.52	n/a	11.44	89
Moscow	13,250	35.0%	5.4%	10.0%	2.9	-3.4	7.65	81
Valais, Switzerland	10,200	6.4%	n/a	3.2%	7.96	1.35	12.94	87
Florence	9,750	3.5%	2.0%	3.7%	6.52	n/a	11.44	75
Dublin	9,250	-17.5%	4.2%	5.2%	6.52	n/a	11.44	92
Barbados	7,900	12.0%	3.0%	8.4%	-4.89	-10.71	-0.5	107
Cote d'Azur	7,763	5.0%	3.5%	3.0%	6.52	n/a	11.44	115
Madrid	7,350	4.8%	2.5%	5.4%	6.52	n/a	11.44	82
Mallorca	6,325	0.0%	3.3%	5.4%	6.52	n/a	11.44	113
Tuscany	5,500	2.0%	2.0%	3.7%	6.52	n/a	11.44	75
Sydney	5,335	9.5%	3.8%	7.9%	5.8	0.76	11.8	71
Dordogne	4,500	7.1%	4.5%	3.0%	6.52	n/a	11.44	94
New Zealand	4,300	12.0%	4.0%	10.3%	7.96	1.35	12.94	98
Cyprus	4,250	5.0%	5.0%	5.9%	4.86	-1.56	9.7	n/a
Silver Coast, Portugal	4,150	5.5%	3.8%	5.4%	6.52	n/a	11.44	75
Marrakech	2,710	12.0%	n/a	n/a	4.74	-1.67	9.58	n/a
Croatia	2,555	10.0%	n/a	7.0%	6.55	0.02	11.46	74
Phuket	2,265	11.0%	6.8%	n/a	11.79	4.94	16.94	85
Cape Town	1,780	14.0%	5.0%	12.0%	1.17	-5.03	5.84	61
Black Sea, Bulgaria	1,350	21.0%	5.0%	7.5%	6.2	-0.3	11.1	73

Assumptions: Price and yield data relate to "average prime" and exclude exceptional deals.
The annual rental yield is a gross figure based on the annual gross income divided by the purchase price. The currency movement is the % movement over the last 12 months.
The Cost of Living figures are based on the price of a shopping basket containing identical goods in each location, valued on 19th December 2007.
Source: Knight Frank

Lasdargues, Lot-et-Garonne, France

- International buyers feature prominently as a source of purchasers of prime property. This demonstrates how it is international high net worth individuals (HNWI) that are driving the upper end of the property market around the world.
- Those cities with international appeal are again the most expensive, and hence London, being the leading global financial centre, is amongst the most attractive.
- Monaco ranks highly, thanks to its tax status which attracts HNWIs from around the world, while Moscow prices reflect the sustained volume of private capital looking to invest in property.

Local market summaries

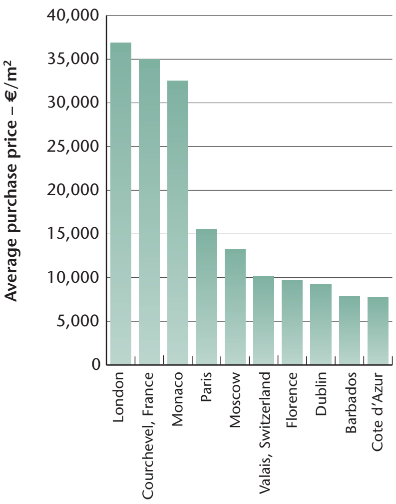
European cities

- Some prime residential markets that have experienced strong growth over recent years have continued to see healthy price rises, **Monaco** is a prime example. Demand remains exceptionally strong and properties in the principality are amongst the most expensive in the world. Price growth was 25% over 2007. The tax status afforded to the super rich attracts multi-millionaires from Britain, Ireland and Russia amongst others. Land reclamation efforts, which have proved successful in the past, will be repeated to provide new building land in order to overcome the supply constraints that have contributed heavily to high property values.
- **Moscow** has seen price growth in the mainstream market slow, although to date there has been relatively little impact on the prime market. Property in prime areas is in short supply, and new developments outside the traditional prime locations tend to be relatively high density due to the lack of city centre development sites. Prices in established prime areas are inflated by a lack of new stock.

"Prices in established prime areas of Moscow are inflated by a lack of new stock."

- After two very strong years, the **London** residential market began to slow in the final quarter of 2007. Growth in prime market areas during 2007 ranged from 28% for apartments to 34% for houses. The sellers' market of recent years has been quickly superseded by a buyers' market where vendors have been forced to compete to achieve quick sales, and ambitious pricing has effectively ended across the mainstream and prime markets. The credit crunch has affected consumer sentiment and there has been a subsequent impact on prime markets in some areas of the capital.
- Prices across the **Paris** prime residential market increased by 5% during 2007. This represents a slowdown from the previous year, although price growth for prime properties outstripped that of the mainstream market. Over the last decade, the proportion of international purchasers active in the Paris markets has doubled, to stabilise at between 8-10% of all transactions, although indications are that the weight of foreign buyers has begun to tail off slightly over the last year or so. The Italians are the most active foreign buyers in Paris, followed by US and UK buyers. Italians tend to prefer the 15th arrondissement (Montparnasse), while US purchasers have exhibited a preference for the 6th (St Germain des Prés) and 16th (Auteuil and Passy) arrondissements. British buyers tend to opt for more 'French' areas, such as the 18th arrondissement (around Montmartre).
- The continued momentum that has kept the London prime market moving along has bypassed the **Dublin** market. Values have been falling since the market peaked in mid-2006. The mainstream market situation has deteriorated as a result of an oversupply of properties, uncertainty over stamp duty rates, an increase in interest rates, together with a weak stock market. Towards the end of 2007, the prime market was reported to be experiencing difficulties, with extended marketing periods and substantial discounts being offered to attract buyers. However, yields for prime properties rose during 2007, particularly for period properties close to the city centre. Rental demand remains strong and prime properties are in relatively short supply which over the short to medium term should attract investors back to the Dublin market.

Figure 1
Knight Frank Prime International Index, 2007



Source: Knight Frank

European country and coastal

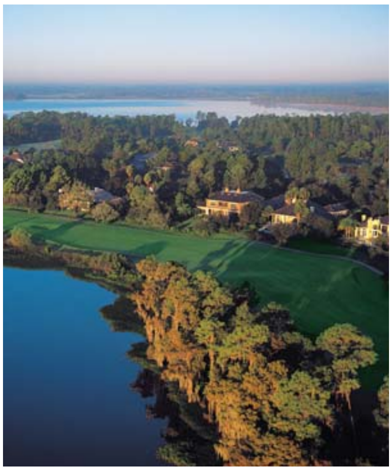
“Buyer demand has become more balanced as an increasingly diverse range of buyer nationalities are moving into the Italian market.”

- Tuscany, including Florence, has seen a relatively strong supply of prime properties. High sales prices have prompted an increase in sellers, especially US owners looking to capitalise on the weakness of the dollar. International buyers are largely interested in older properties. Balance has returned to the market as an increasingly diverse range of buyer nationalities have moved into the market. As in other core European markets, prices have already reached a relatively high level in Tuscany. Other locations such as Umbria and parts of Lazio within striking distance of Rome’s airports, are now providing real alternatives to Tuscany.
- In recent months the Portuguese apartment sector has seen a notable slowing of growth as a result of perceived levels of oversupply in the new-build apartment market, although the prime segment of the market has not so far been greatly affected. In common with the Italian market, the main source of demand comes from the UK, with Irish investors also featuring prominently in the Algarve. In common with Italy, there has been a noticeable growth of international demand in emerging regions; for example the Silver Coast and the eastern Algarve offer additional options to the established market of the western Algarve.
- Spain is experiencing a well-publicised residential downturn which is impacting negatively on buyer confidence. Price growth has been slowing for several years and in some southern coastal locations values have fallen over the past year. Areas which are less heavily reliant on foreign buyers and those where new supply has been limited (such as Madrid and Mallorca) are proving more resilient. 2008 is likely to be another difficult year for the Spanish market.
- The Cote d’Azur market is in relatively good health. Demand has remained strong with a notable flow of buyers from northern Europe. Increasingly, buyers are looking for property as more than just a holiday home. Modern technology and communications enables buyers to justify a higher purchase price for properties which effectively can either become a work-from-home property, or lie within commuting distance of Europe’s principle commercial centres. The market is entering a new phase. Buyers are increasingly discerning, demanding more for their money and are less likely to be impulsive, yet sellers are reluctant to sell below what they regard as a premium price.
- Other regions of France have also continued to perform well, with for example prices in the Dordogne increasing by approximately 7% in the last twelve months. In part this may be a reflection of the continued difficulties experienced in the ‘overseas’ locations of Spain; buyers previously looking in the Costas have in some cases broadened their search to France.
- Prime locations in both the French and Swiss Alps remain some of the strongest markets across our survey areas. Places such as Courcheval are now seeing prices in excess of €30,000/sqm, partly driven by Russian interest. In Switzerland, the permit restrictions in more established cantons such as Valais have helped to strengthen prices. Such increases in both France and Switzerland are likely to result in interest spreading to Austrian and Italian Alpine locations.
- Emerging markets have also seen relatively strong growth in the overseas homes market. By way of an example, prime areas of the Black Sea coast of Bulgaria saw price growth of over 20% in 2007. Price inflation in these areas has increasingly been driven by interest from Russian buyers who comprise up to 80% of demand in some resorts. Other sources of demand include German, Scandinavian, UK, and Irish buyers.

Les Salines, Mauritius
(computer generated image – details may vary)

Rest of the World

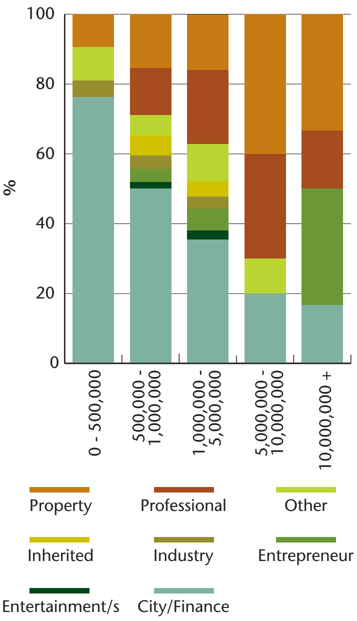
- **Marrakech** is a good example of a rapidly expanding residential market. It is particularly popular with French and UK buyers, and there is also strong domestic demand for second homes; an unusual feature in emerging markets where the indigenous population typically struggles to keep pace with foreign purchasing power. There are however, some signs that the level of development in Marrakech is starting to affect values with supply rapidly rising to meet and possibly surpass demand. Reputable developer branding and quality products will be the key to commanding higher premiums.



Lake Nona, Florida, US

"Prime areas of Sydney's waterfront eastern suburbs have seen price growth of up to 30%."

Figure 2
London Property purchasers by price bracket 2006-2007



Source: Knight Frank

- **Barbados** has seen strong price inflation in its prime sector over the last two years. Demand has been driven by purchasers from Europe, notably British and Irish. The decline of the US dollar has meant that property here has become increasingly affordable to European purchasers. New supply is forecast to be limited by government restrictions on converting land to residential developments. Regulatory changes, including a reduction in local Property Transfer Taxes from 7.5% to 2.5% and the removal of restrictions on exchange controls relating to property transactions between non-residents will increase the attraction of Barbados.
- 2007 has seen emerging destinations becoming increasingly established as luxury residential property markets. Amendments to legislation in **Mauritius** and the **Seychelles** over the last five years enabling foreigners to purchase property on the islands have prompted the development of luxury residential resorts. Both countries offer a limited residency status and certain tax advantages which have added to their attraction for foreigners, notably South Africans.
- In **Sydney** there does not yet appear to have been a slowdown in the residential market. Domestic demand has remained strong, though a small but increasing proportion of demand originates overseas. Purchasers come from the UK, China, Singapore and Hong Kong. Demand for prime property remains strong, with the Australian price record having been broken twice within the space of six weeks, reaching AUS $29 million (€17.5 million) for a single unit in October 2007. Price growth in the prime markets of Sydney has been around 14% over the last 12 months, while the waterfront eastern suburbs have seen average growth rates range from 15-30% in 2007. Older properties, particularly those with views or in good locations, are particularly sought after.
- The prime market in **New Zealand** has been driven by local purchasers, although overseas purchasers are beginning to participate in the prime residential market. Furthermore there is currently no stamp duty or capital gains tax on the sale of property in New Zealand.
- In **South Africa**, prime property prices have been rising at a slower pace than the mainstream market. Price growth in the Cape Town area has been lower than across the majority of the country. Mortgage rates have been on an upward trend since the beginning of 2006 as interest rates have risen in an effort to rein in inflation. To the end of December 2007, price inflation had slowed to its lowest rate since 1999.
- In **Phuket**, Thailand, most purchases of property by overseas residents have been either for investment purposes or as a retirement home. Older properties are popular among foreign buyers, whereas in the wider market the preference is for new build properties which command higher premiums.

The Credit Crunch and its impact on international residential markets

The full impact of the US sub-prime crisis, and the number of banks and lending institutions holding bad debts, remains unknown. Some analysts have estimated that the $50 billion of sub-prime losses so far written off by the major banks is merely the tip of the iceberg, and the actual figure could rise to as much as $400 billion.

The impact of the credit crunch varies from market to market. Property prices in hotspots for the super rich, such as Monaco, continue to increase, while our experience in London suggests that there is no impact in terms of the volume of sales of property over £5 million. However, below this price level, a cyclical slowdown following a period of rapid price growth coincided with negative media coverage of the credit crunch. Certain segments of prime markets are heavily dependent on the health of financial services. While in London over the last 12 months nearly 50% of sales were to purchasers working in the financial services sector, agents in European markets, notably the French prime market, observe that a smaller proportion of buyers derive their income from this source.

The reduction of income and bonuses from the financial services sector, in Europe and the US in particular, will undoubtedly impact on the pricing potential for some markets. This impact will be concentrated at the lower end of the market. Knight Frank data for London shows that during 2006-2007 while purchasers whose income was derived from financial services accounted for over 75% of purchases in the sub £500,000 price bracket, they accounted for just 20% and 16% of purchases in the £5-10 million and £10 million plus price brackets respectively (see figure 2).

Monte Rei, Eastern Algarve, Portugal

However, while bonus payments in the financial and business services sector are below those paid out in 2007, the greatest impact has been caused by a climate of caution engendered by uncertainties in the global financial and UK housing markets. This has made those who would leverage against their principal residence here, less likely to act.

Outlook

There is no doubt that 2007 saw a slowing in price growth, and even some falls, most notably in the US and parts of Spain. As we review the last 12 months and look forward into 2008, the key theme is that the international market is rapidly maturing. Double digit price growth is never sustainable in the long-term and a lowering of expectations is a healthy process.

The international residential market has seen considerable expansion over recent years. Demand and prices for property have risen strongly with the market driven forward by a combination of rising wealth (assisted by greater access to low cost finance), improved accessibility to new locations and a clearer focus on lifestyle expectations which increasingly involve the acquisition of second homes.

We see no evidence of a loss of appetite for international property among buyers and we continue to expect price growth in prime markets to exceed that of mainstream markets. We expect, however, that transactions will take longer to complete as buyers become more cautious about the shorter term direction of markets.

Hotspots

Against this backcloth it may be harder than in previous years to find stand-out hotspot locations in 2008. Nonetheless some markets appear to have better prospects than others. Among emerging locations, the dynamic of combined regulatory relaxation, increased infrastructure investment and accessibility is bringing about the beginnings of integrated resort development. Within this category, the natural beauty and favourable climate of locations such as Croatia, Greece, Brazil and emerging Caribbean islands, together with competitive pricing are likely to prove attractive to international buyers.

"There is no impact in terms of the volumes of sales of property over £5 million."

We expect Morocco to become an increasingly popular destination for purchasers. Relatively low prices from a European perspective, easy access from European cities, an attractive climate and extensive improvements to infrastructure have made Marrakech the focus for prime residential property development. Interest is likely to spread to other Moroccan locations as people look for alternatives to Marrakech. We also expect to see locations in the Eastern Mediterranean region emerge as prime property hotspots in the near future with the arrival of a number of high quality schemes in places such as Greece, Croatia and Turkey. This should be driven by the increase in quality stock and buyer familiarity with such well-established travel markets.

In the mainstream markets, Paris, although having seen capital value growth slow over the last year, has sound longer term prospects thanks to strong rental demand and limited new supply of prime properties. Germany's strong rented sector (Europe's largest), and the return (albeit gradual) to capital value growth means that the prime districts in Berlin and large cities in the western part of the country such as Munich and Hamburg are worth investigation.

Trends to watch

As in 2007, we expect prime property to significantly outperform mainstream property in 2008. However, growth rates are expected to be considerably lower across most markets compared to those seen last year. Consumer confidence has been dented by restrictions on credit availability and a gap has opened up between buyer and seller expectations in markets perceived to be approaching cyclical peaks.

Superior Ink, New York
(computer generated image – details may vary)

Integrated resort developments are increasingly popular among many categories of buyer, offering purchasers the use of a wide range of leisure and increasingly, business facilities, within a serviced and managed environment. Purchasing decisions are influenced by a variety of factors including lifestyle, security, often the option of a rental pool, as well as the benefit of a self-contained community should they wish to avail themselves of it. The age of second home purchasers is reducing. There has been rapid growth in the HNWI population of a younger age globally, particularly among those employed in the financial services sector. Purchasers of second homes are not necessarily retirees but are relatively recent entrants to the second home market with different priorities to the older generation.

Increasing restrictions on residential development will limit the growth of supply in a number of locations. The anticipated tightening of planning regulations on the Cote D’Azur will limit the new supply of property. Sardinia has also seen new developments in waterfront locations refused permission, and authorities in Croatia are keen to protect their environmentally sensitive coastline from being exposed to the level of development that has occurred in other locations.

We expect UK and European based buyers to continue to be attracted to dollar denominated assets over the next twelve months; this should also bolster demand for property in the Caribbean, Mauritius, the Seychelles and prime US markets.

Outside western Europe, the US and the more established purchaser markets, there is a huge change taking place across the property market. This change reflects the economic transformation of China, India, Russia and central and eastern Europe – new wealth means new buyers for aspirational property. Rapid growth has occurred in the HNWI population from Asia, including China, India, and Korea, as well as from the established economies of Hong Kong and Singapore. With the exception of central London and the south of France, the potential impact of this emerging global wealth has barely begun to be felt in the residential market – we can expect far more competition for prime property in Europe, the Americas, Africa and Asia over the next decade.

Best Investments

Investments in property are motivated by different criteria depending on the priorities of the investor. In general, investors are interested in locations where the markets are transparent, where there is strong demand from tenants, where there is potential for capital growth, where access is improving, and of course where there are no obvious downsides. Markets with potential for strong capital growth are increasingly located away from the core markets. Within a number of European countries, there has been a subtle shift in emphasis away from the established centres to emerging locations. We expect this trend to continue, particularly in countries such as Portugal, where the Eastern Algarve and the Silver Coast markets are providing alternative options to the Western Algarve for purchasers of prime residential property.

Further afield, this trend is increasingly evident in locations such as the Caribbean, where islands such as Nevis & St Kitts, Antigua and Grenada are increasingly attracting interest from international investors. Improving accessibility and infrastructure, lower prices and the increased availability of quality residential property are beginning to attract a greater number of buyers.

While many markets have experienced slower growth, or indeed some decline, it is clear that the prime markets continue to perform well; ultimately the ever increasing pool of international buyers is helping to maintain the strength of such locations, but such buyers are increasingly discerning, their choices driven in part by fiscal considerations, but also by a very real requirement for the best locations and the highest quality properties.

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