

# Residential Market Review

Commentaries and analyses by REAS



>> The period of boom on the residential market featured a certain measure of "forbearance" towards developers' shortcomings. The current market's slowdown is the real test for developers - writes **Adam Bechciński** // pp. 2-3

>> Market comparisons are of key importance for developers and investors. However, due to the differences in standards across the region, data is not always easily comparable. Article by **Maximilian Mendel**. // pp. 4-5

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REAS concluded its **research of Bucharest residential market** **Joanna Iwanowska** to speak during the **CEDEM CEE** (17-18.09)

**Paulina Starzyńska** granted the **MCIM title** by the Chartered Institute of Marketing

## Risk in development business



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The period of boom on the residential market featured a certain measure of “forbearance” towards developers’ shortcomings. Yet the market’s slowdown and entering the stabilization phase turn out to be the real test for developers

The year 2007 had proven that successful residential development requires thorough analysis of the planned project at its pre-development stage, which enables appropriate identification and reduction of risks. It seems worthwhile to take a look at the residential market’s current condition from the point of view of the risk that developers must consider when implementing their projects under the present circumstances.

The period of boom on the residential market featured a certain measure of “forbearance” of buyers and even of development financing banks with regard to developer’s shortcomings; high selling prices and dwelling absorption rates justified high costs of land acquisition and construction; and even projects conceived after erratic marketing concepts could nevertheless find buyers at the market hungry of new housing.

And yet the market’s slowdown and entering the stabilization phase turn out to be the real test for developers. It is now that thorough market analyses, that facilitate making an informed decision on selection of the project location, gain real relevance.

When implementing a residential project, the developer should monitor various risk areas, in particular the operating, market, and financial risks. Each of these may decide on a development project’s success or failure.

The operating risk is a development project’s immanent feature that appears irrespective of market circumstances. It includes organization of industry-specific internal processes such as appropriate selection and acquisition of the land, selection of the architect and general contractor, and efficient coordination of the construction process.

Developers must also take into account the state’s interference with market economy mechanisms. An example may be the currently discussed in Poland draft of the act on obligatory trust account that has encountered adverse opinions of most developers. High level of bureaucracy that manifests in requirements of lots of permits, approvals, and opinions in most cases issued as administrative decisions exposes investors to slowing down, and in the worst case scenario even paralyzing, of the investment processes.

Under the present conditions, the market risk has become particularly relevant for developers. Every entrepreneur operates in a variable market environment, but long duration of a development project’s implementation makes the development business especially sensitive to the market conditions’ variability.

The risk of changed economic prospects directly affects the selling price levels and the relation between demand for housing and its supply. Economic indicators such as the GDP growth rate, inflation rate, and interest rates directly translate into the real estate market players’ behaviors and into the prospective buyer’s purchasing power in particular. A current example is the decline in dwelling absorption rates and price adjustments noted by REAS on the residential markets of Poland’s largest agglomerations. This trend may cause problems for these developers, who started their projects in 2006 or 2007 having acquired expensive land for the development when they hoped for the upward trend to stay in the sector. These investors will suffer the most because of the present decline in dwelling absorption rates. Under such circumstances indirect price cuts by way of various bonuses for buyers, such as a dramatic discount of a parking space price for instance, may turn out im-

possible from the project's profitability point of view as basically different from the respective developer's previous forecasts and profit generation options.

The last year had shown more examples of risks to which a developer might be exposed, i.e. the rise of building material prices and scarce availability of skilled labor resulting in its prices rising unexpectedly, both experienced in 2007.

Yet another phenomenon that increases the developer business' risk is an evident increase in supply that manifests in a large number of apartments delivered now and scheduled for delivery in the next year. Here comes another market risk – the risk of competition. This competition is additionally increased with apartments purchased in previous years for investment, which are now reentered to the market. However the competition risk may also be treated as a potential advantage; the prestige of a location is undoubtedly boosted or even created (if hitherto unknown), where a renowned developer implements a project in its neighborhood. This way such developer helps other developers to increase value of their nearby projects.

A developer must also consider the marketing risk. A residential project's location, as well as an unit's floor area, layout, and/or finishing standard that rules its final price, may turn out inappropriate or may fail to meet the market's expectations. The final product's inflexibility that grows in the course of construction process also adds to this risk.

The marketing risk is strictly related to perception of the developer company itself by a prospective customer base. This is the so called reputation risk. Where there are many developer companies active on a market, even minor slip-ups publicized in the mass media may endanger the company's market existence. This especially concerns small companies with no large PR capabilities

which could quickly and effectively counteract such situations.

The last risk area is that related to project financing by banks and other financial institutions. This risk is particularly relevant at the moment of sudden deterioration of the market condition. These developers who have not paid attention to establishing good relations (track records) with banks and financial institutions when prospects were auspicious are now in much more difficult situation than companies maintaining efficient liaisons with their respective lenders. Underestimating of this risk may expose some developers to disposal of their businesses or bankruptcy.

Now most investors finance their projects, from the construction start on, with revenues from sales. This makes the risk of financing shortage inevitable in the event of customer payments delayed or denied, when the respective contracts are broken. This results in delayed implementation of the project and its reduced financial liquidity. Where a project is financed with an investment loan, a risk may result from rising interest rates leading to rising debt servicing costs.

As can be seen, the developer business is exposed to many risks because of its capital intensity, duration of the investment process, necessary interaction and coordination with many market players, and – finally – reduced flexibility of the final product that decreases as its completion progresses – because no apartment built at the foot of the Carpathian Mountains can be "transferred" and sold in Warsaw, and no architectural concept once determined can be significantly altered at an advanced stage of the construction. Undoubtedly large market players will find survival through the toughest time on the market easier, yet everyone in the industry with no exceptions whatsoever will have to cope with some problems and to manage related risks.

# Cross-border comparisons

## How to not compare apples to oranges?



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Market comparisons are of key importance for developers and investors in their search for markets suiting their investment strategy. However, due to the differences in standards across the region, data is not always easily comparable and for instance dwellings of similar prices may represent entirely different values.

In recent Polish newspaper articles, one could read that prices for apartments in Warsaw are already higher than in Berlin. At the same time, media releases in Romania declared that prices in Bucharest are already on the same or even higher level than in Warsaw. These statements are of course not mere ideas of journalists looking for sensational news. Quite the contrary, such announcements are based on varying researches made by renowned global property companies. The question is however not only if these declarations are really true but also how reliable such comparisons are and whether apples are not being compared to oranges.

There is no common standard with respect to terms used on different European residential markets. Prices may refer to entirely differently defined floor spaces. Depending on the market, prices may include or exclude land plots, terraces, balconies or gardens – not mentioning other amenities. Sometimes homes are sold in turn-key finishing standard, while buyers on other markets or in certain segments have to be prepared that they purchase a residential unit which has no interior finishing at all. Then there is the problem with comparing prices across the Central European region due to changing exchange rates. Affordability is another question – relating rather to purchase power and mortgage accessibility than to simple pricing.

In order to compare prices correctly, we need to make sure we are talking about the same market segment. Let us assume that we are interested in comparing prices for new apartments throughout Central Europe, i.e. the multi-family primary market. Taking Polish standards as granted, the multi-family market would exclude not only detached and semi-detached houses but also terraced housing units, which are sometimes included in indices offered by other countries.

It gets more complicated when it comes to the fact that prices are being quoted per square meter. Almost all markets in Continental Europe typically quote prices per square meter, though there are entirely different standards in terms of the definition of floor space used for the calculation. While prices in Poland and Germany commonly refer to one sqm of net usable area (excluding space needed for walls), developers in Romania typically quote prices for an area including not only space of walls but also a part of the common circulation space. Prices in Ukraine are moreover sometimes even comprising space of balconies or terraces.

In the case of single-family houses, in Poland land is usually included in the price offer, while in Romania the situation varies greatly. Some developers active on Romania's residential market often sell land plots and only in addition offer ready architectural designs and optional construction. Characteristic for Ukraine is that the owner of a building may be different to the landlord of the land on which the building stands. Also there are limited legal rights for foreign individuals and companies (of at least 10% foreign capital) regarding the right to acquisition and ownership of land. So typically developers lease land from the public for the construction period and then sell their residential project without land, which the future owner, or owners in the case of condominiums, will later on have to lease again from the public owner.

Moreover, there are completely different market customs when it comes to the finishing standard of a new dwelling. In Poland the common delivery standard of developer-built apartments includes external doors, white coat finishing, internal electric, heating and plumbing installations, windows and window sills, but goes without flooring, tiling and internal doors. In Ukraine finishing standards vary greatly from segment to segment: while

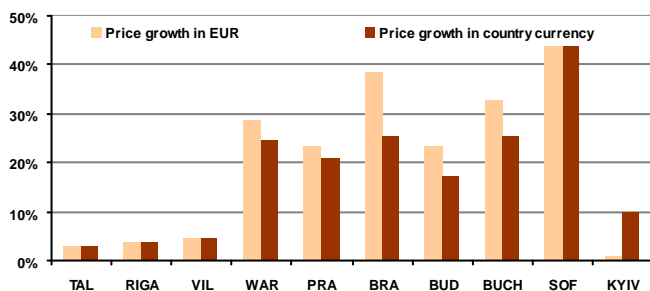
in lower market segments an internal division by partition walls is usually set, this seems not acceptable in the premium or de-luxe segments where apartments are typically sold as “open space” to allow the client the greatest possible individuality. In general, there are only few turn-key products on Central European markets and most of them are offered optionally. Due to the differences in standards across the region, dwellings may cost a similar amount of money but may represent entirely different values and standards.

Another problem in cross-border comparisons is made of the question, whether price offers include VAT or not, which varies not only on different markets throughout Central Europe but also from developer to developer. With only Slovenia being member of the Eurozone in CEE, it is however more difficult to tackle the issue of changing exchange rates in the region. For instance, the measurement of price growth rates looks entirely different when calculating in Euros or in the local currency. Besides difficulties in comparisons, exchange rate developments also have an effect on the buyer’s purchase power which is inversely beneficial for local buyers compared to foreign investors.

Hopefully, it was made clear that a simple comparison of prices is not enough. Moreover, the media discourse refers mostly to average prices which again raises the question of comparability in terms of the used methodology and the representativeness of the sample. In some

cases the entry or disappearance of a single luxury development may distort the picture of a whole market, thus outliers to both extremes should be excluded. Finally, in order to meet the reader’s expectation to present some hard facts, I would like you to consider if it makes sense to compare average square meter prices for new apartments in Warsaw, Bucharest and Berlin – for instance as for the Second Half of 2007 at EUR 2,250, 1,725 and 1,500 respectively (Berlin Housing Market Report written by JLL and GSW in March 2008) – even though, as in this case, prices are already on a common basis regarding the floor area, namely referring to net usable area. Also it would be wise to consider the reasons why Berlin has a relatively low price level. For instance one could think of the incomparably better situation in terms of the quality and quantity of the existing housing stock, the surplus of housing compared to need and demand, the integral importance of the rental market, or also the significance of Berlin within the highly polycentric urban pattern of Germany – as prices in Munich, Hamburg, Stuttgart, Frankfurt or Düsseldorf are much higher than in Berlin. Furthermore, you should ask yourself, if the fact that Warsaw and even Bucharest surpassed Berlin in this price indicator is a healthy sign for homebuyers indeed.

The aim of the article was to present a selection of matters which should be taken into consideration when analyzing and interpreting analyses about residential markets in different countries. There are certainly many more matters which could have been raised in this context. It will be a pleasure for REAS to give further advise depending on your specific needs. Also we invite you to see our comparative report on twelve Central European capital cities.



Average price growth between 2006 and 2007

# Research of Bucharest residential market: conclusions and comments



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REAS research of Bucharest residential market showed significant suburbanization trend. The largest group of projects offered is priced at 1,200 - 1,800 EUR / sqm. Prices in the luxury segment start from ca. 2,000 EUR / sqm.

At the end of July 2008 REAS had concluded a fully independent analysis of the primary residential market in Bucharest. The research scope covered nearly 220 residential projects, 180 out of which represented the multi-family market's sample at various stages of development progress, from still planned to almost complete projects.

In Bucharest itself slightly more than 2,500 apartments and houses were delivered in 2007, which is not much in view of the city's sizeable scale and the relatively high demand. In Warsaw, for instance, being more or less of the same size, 15,700 apartments were delivered in 2007 and 16,200 are planned for delivery in 2008. It is different with current offering of housing already on sale yet scheduled for completion between 2008 and 2010, according to which yearly delivery of 6,000 -8,000 apartments may be expected in the next few years.

A significant suburbanization trend is worth noticing in the market supply that results from deficit of developable land in the city as well as from local buyers' high interest in out of town dwelling. In 2007 over 60% more apartments were delivered in the county of Ilfov that

surrounds Bucharest than in the Romanian capital city itself. Building activity focused in Bucharest's suburban zone with definite predominance of north of the city locations, such as Pipera, Voluntari, Buftea, Otopeni, Corbeanca.

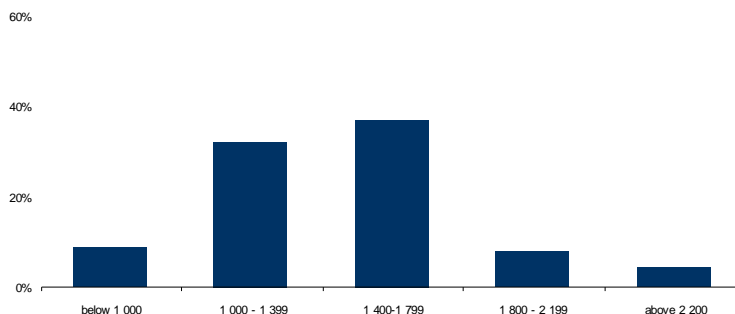
In terms of number of projects and expected number of apartments to be delivered, the city's northern part still prevails, although there is an evident shift of developer activity's gravity centre from locations north of Bucharest towards some better accessible districts near the city's centre in its western and eastern, as well as southern parts. The REAS study indicates clear deepening of the market's segmentation and widening of the residential offering targeted at potential middle class buyers. Two and three-room units now predominate in developers' offerings.

Only 48,000 apartments have been delivered in Bucharest since 1990, i.e. 2,600 new units yearly on average. At the same time ca. 15,000 marriages were wed each year. This added to the current housing deficit measured by significant surplus of the household number over the existing housing stock indicates that the general funda-

mental demand is extremely high and as high is its long-term potential.

The city's excellent economic standing manifests first and foremost in the very low and for many years declining unemployment rate (currently 1.8%), large demand for labor, and high growth rate of compensation

that in the capital city is by over 20% higher than the national average. This translates into relatively high pur-



Average asking prices of multi-family dwelling in Bucharest in July 2008, source: REAS



chasing power and credit worthiness of the capital city's population, although today the average monthly burden of housing debt may be assessed at ca. 8-12 EUR per one square meter of purchased apartment. *(Calculated subject to assumption of 75% LTV, 30-year loan period and loan drawn in equal installments in EUR, at the current interest rates)*. The debt so high relative to the average official income and the fact that the Bucharest market is now experiencing a clear slowdown in foreign investment demand, have brought about a significant decline in the housing absorption rates.

The young mortgage loan market in Romania underwent a significant metamorphosis in the recent years and now has become one of the residential market's relevant growth factors. Despite the recent rises in the interest rates and the evident slowdown in the loan market's dynamics, the market's high growth prospects are indicated by the housing debt to GDP ratio published by the European Mortgage Federation. As of the end of 2006 it amounted to 2.3% in Romania compared to 49% average

in the EU's twenty seven countries. According to the National Bank of Romania the housing loan market is predominated by Bucharest, which accounts for as many as 42% of the total amount of housing loans extended in Romania. In the recent months the rates of absorption of dwellings in individual projects declined, which has been confirmed by slowing down of the month to month dynamics of housing loans. However in the last year (June 2007 – June 2008) the volume of loans drawn by households to finance dwelling purchases increased by ca. 100%.

The range of asking prices now offered on the Bucharest residential market is very wide. Projects of average gross prices below 1,000 EUR per one square meter are difficult to find within Bucharest's administrative limits, and definite majority of dwellings now offered are sold at less than 2,200 EUR per one square meter. The largest group of projects now on offer is priced at 1,200 – 1,800 EUR per one square meter, depending on the project's class and location, and just this market segment is targeted at the middle class clientele. Prices in the luxury segment start from ca. 2,000 EUR per one square meter.

Comparison of the current pricing level with historical data clearly shows that projects now entered to the market are priced higher than those that have already been on offer for a longer period. Stagnating absorption rates and declining share of the luxury segment in the residential offering in Bucharest are bringing the market closer to adjustment of its supply to demand.

The foregoing description is a mere introduction to the Bucharest residential market's comprehensive profile. The most important issues that can not be neglected in such profile include demand and supply directions and trends, pricing prospects, and potential and conditions of new dwelling's absorption. Also considered should be how changes in the purchasing power will translate in emerging of new market segments, and how growing customer requirements will affect the product absorption rates.

