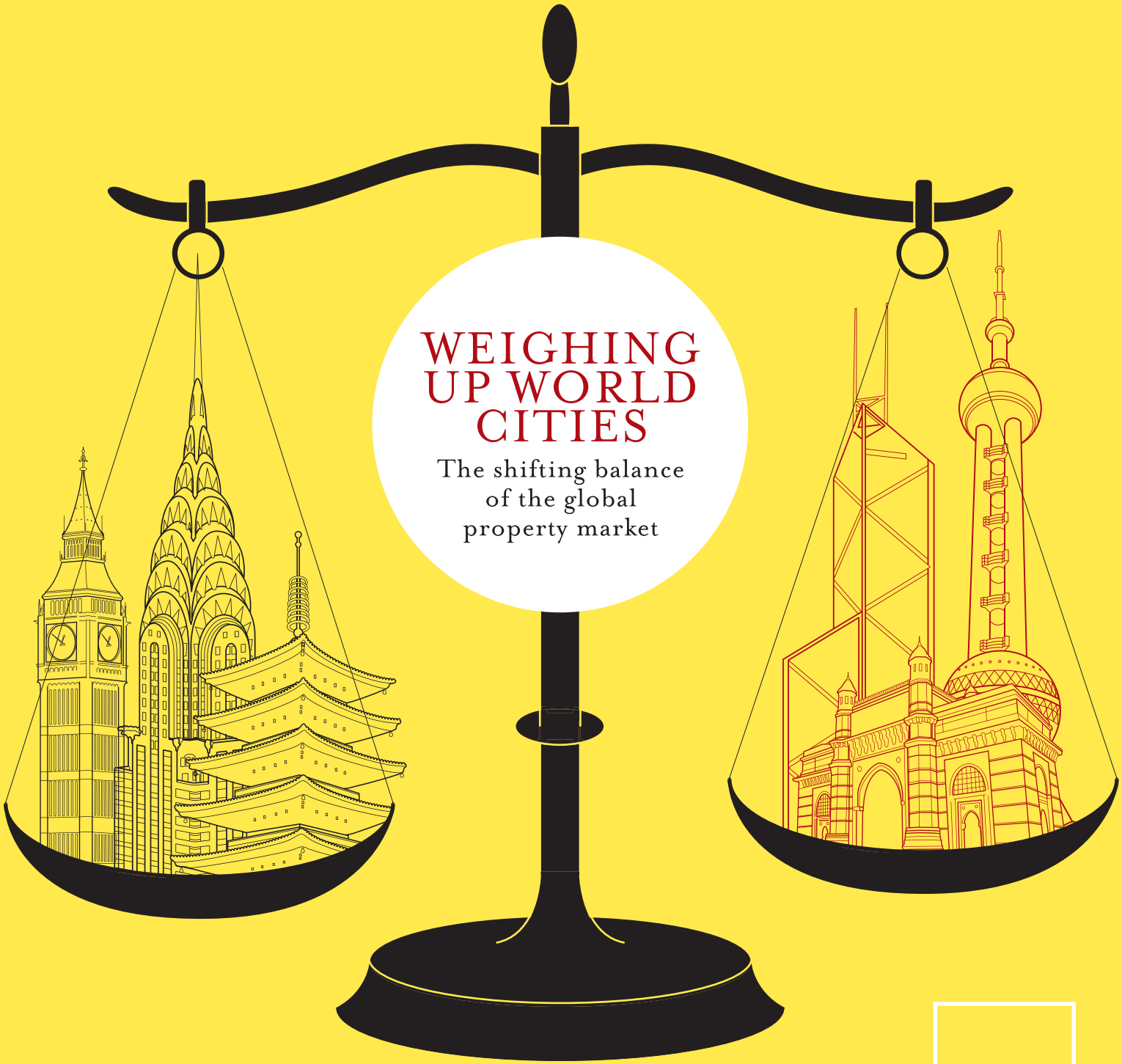
INSIGHTS

| World Cities Review |

H2 2013



WEIGHING UP WORLD CITIES

The shifting balance of the global property market

savills

"A notable re-balancing of real estate took place in the first half of 2013. 'New world' slowing has been matched by 'old world' recovery"

YOLANDE BARNES, DIRECTOR OF SAVILLS WORLD RESEARCH

FROTHY OR FLAT?

Is quantitative easing creating asset price bubbles? Some economic soothsayers seem to think so. Cheap credit has pushed up prices in global commodity markets, the gold market and worldwide stock markets. But has QE affected international property? Are we also facing a global real estate bubble?

The 2008 debt crises heralded an era of all-time low interest rates for many North Atlantic countries. Others such as China, Japan and Singapore, have seen low rates for savers for some time.

It is little surprise then that residential property investments which yield gross income returns in excess of 5% (with expectations of longer-term rental and/or capital growth) have become an increasingly interesting proposition – not only to individual buy-to-let investors but also to funds and institutions seeking inflation-related income.

People have especially sought income-producing assets in countries where there has been little alternative choice. Real estate inflation is exacerbated by a lack of investment alternatives.

In this issue, we look not only at the cost of real estate to global corporations, but have also analysed the extent to which residential capital values have been inflated by investor demand over and above the fundamentals of occupier demand. We do this by analysing bond-adjusted residential yields in each of our world cities. In some places, income returns for real estate are substantially above those available from gilts and so those cities look fairly valued. But in others, rents have not kept pace with capital values and the returns available on 10-year government bonds are higher, so these cities look potentially overvalued. Find out which is which on page 11.

Low yields do not necessarily presage a universal property price crash, but it does seem likely that rents will have to move upward or capital values fall in some cities before significant capital growth can be resumed. Rising rents are most likely in cities where economic growth, inward migration, and hence real estate demand, is increasing against inadequate supply.

The same global forces are impinging on each of our world cities but are coupled with very different local supply and demand conditions. We expect a range of investor experiences in future. Some cities display distinctly frothy traits while others still yield well in relation to local bond benchmarks. Our index of world city values is likely to show considerable variation for some time to come.

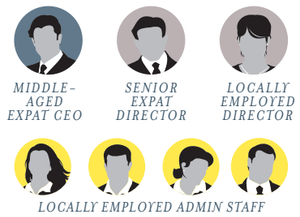
YOLANDE BARNES, DIRECTOR OF SAVILLS WORLD RESEARCH

CONTENTS

OUR TERMINOLOGY

'NEW WORLD' CITIES: HONG KONG, SINGAPORE, SHANGHAI, MUMBAI, MOSCOW
'OLD WORLD' CITIES: LONDON, PARIS, NEW YORK, TOKYO, SYDNEY

SAVILLS EXECUTIVE UNIT (SEU) CONSISTS OF...



In order to compare the cost of residential and commercial real estate across different global cities, we use the Savills Executive Unit (SEU), which measures the cost of housing an identical group of people living and working in various different countries.

By comparing a group of real people, our cost comparison of real estate has a 'real world' relocation story at its heart. We take a typical 'executive unit', a group of people that might start up or expand a global business in any country, and then compare the residential and commercial accommodation that they would be likely to inhabit in each of our world cities.

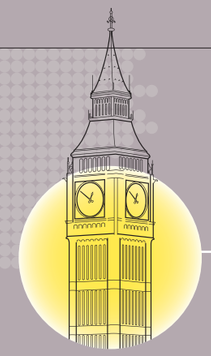
The people who make up our SEU include one middle-aged expat CEO, one senior expat director, a locally employed director and four locally employed administrative staff. They each live in different types of household, some with children, some with partners and some without, and each member of the group chooses different types of locations and different types of property in which to live.

To measure office costs, we place the same seven people in a financial services firm in the best part of the city, and again in a creative start-up in a secondary location in the same city.

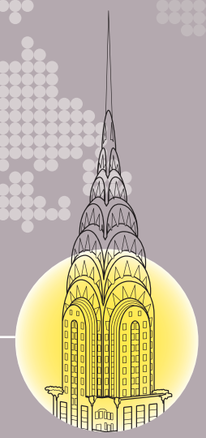
It is by comparing the commercial and residential accommodation costs for these same people around the world that we can truly compare the cost of real estate across some very different global cities.

A WORLD OF NUMBERS

Location is everything. We reveal our key total cost figures for 2013, measuring the total annual rental and occupation costs for both residential and offices for 14 employees and their households.



$1,533,000
LONDON



$1,553,000
NEW YORK

$1,400,000
PARIS

KEY

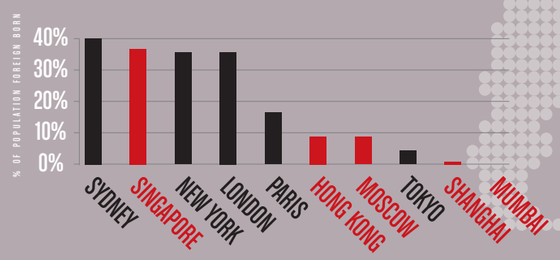
$000,000
CITY

$USD TOTAL SEU RELOCATION COST

NEW WORLD

OLD WORLD

PERCENTAGE OF POPULATION BORN OVERSEAS



SOURCE: NATIONAL CENSUSES AND ANNUAL STATISTICS

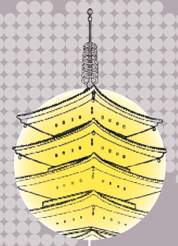
CITY POPULATION DENSITY

SOURCE: NATIONAL CENSUSES AND ANNUAL STATISTICS

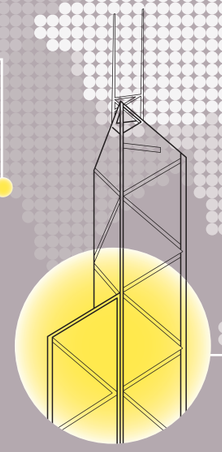
$947,000
MOSCOW

$613,000
SHANGHAI

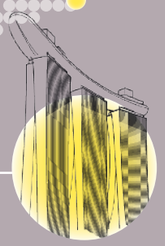
$1,089,000
TOKYO



$444,000
MUMBAI

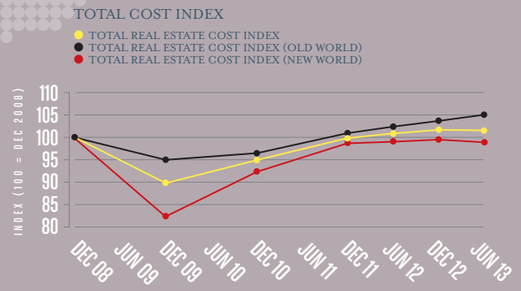


$1,625,000
HONG KONG



$1,005,000
SINGAPORE

TOTAL COST INDEX



SOURCE: SAVILLS WORLD RESEARCH

$878,000
SYDNEY

THE MEASURE OF SUCCESS

WE REVEAL WHY ANNUAL COSTS CAN BE VERY DIFFERENT TO HEADLINE CAPITAL VALUES

The annual cost of locating in a world city can be very different to the capital value of real estate in that city. As a corporate employer relocating across the globe, the cost of rent and annual outgoings is a more important and telling measure than the more commonly quoted headline rent or capital cost. Our total cost measure is more likely to reflect the total outgoings that companies will actually need to accommodate all staff in the workplace and accommodate expat staff residentially as well as rewarding and accommodating other workers with expectations of certain types of housing. We think that it is one of the more important measures of city competitiveness and value.

We measure the total annual rent and occupation costs (including local taxes, service charges etc.) for both residential and offices for 14 employees plus households. Seven are employed in financial services and seven in a creative (tech start-up) industry. Each group therefore occupies a different type of office building and location but both contribute to our total costs measure.

The highest total costs are $1,625,000 per year in Hong Kong and the cheapest is Mumbai at $444,000 per annum. London is no longer the second most expensive city for annual costs in the world, having just been overtaken by New York this year (see chart on p6). The annual cost of locating 14 people in the Big Apple is now $1,553,000, compared with London's $1,533,000.

How expensive a city's costs are to bear in relation to the revenue likely to be driven out of that city are harder to measure, but relating city costs to average annual GDP per capita goes some way to illustrating how sustainable those costs might be.

The figures below show how Singapore's costs, although ranked 6th in the world, are the cheapest of all the world cities in relation to the gross domestic product per head in that country. In other words, the revenue that a corporation is likely (not guaranteed) to drive out of a business located in Singapore is much higher in relation to its employees' real estate costs than in any other of our world cities.

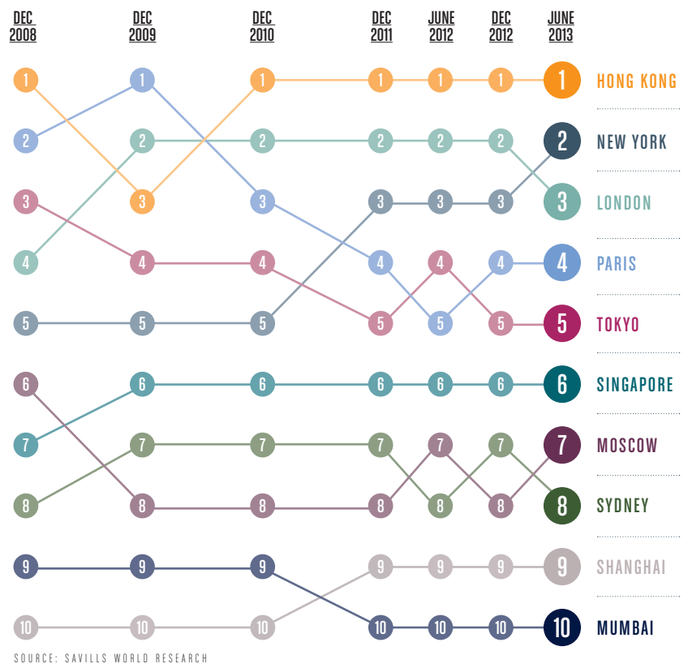
While Hong Kong is still expensive by this measure, real estate costs are actually cheaper in relation to GDP per head than in Mumbai which, although it has the lowest absolute costs, is still expensive in relation to the economic product produced in that city.

Unlike capital values, the total cost measure shows less difference in growth between cities over the past five years than the capital growth of real estate in the same cities. Our total real estate cost measure has grown by just 2.1% since December 2008, having fallen by 10% in 2009 and risen by 14% since then.

'New world' city costs on average fell more since 2008 than 'old world' cities, by -17%, against -5%. New York has seen the biggest changes in total annual real estate costs, which fell by -12% in 2009 and then rose by 36% on the back of high rent rises.

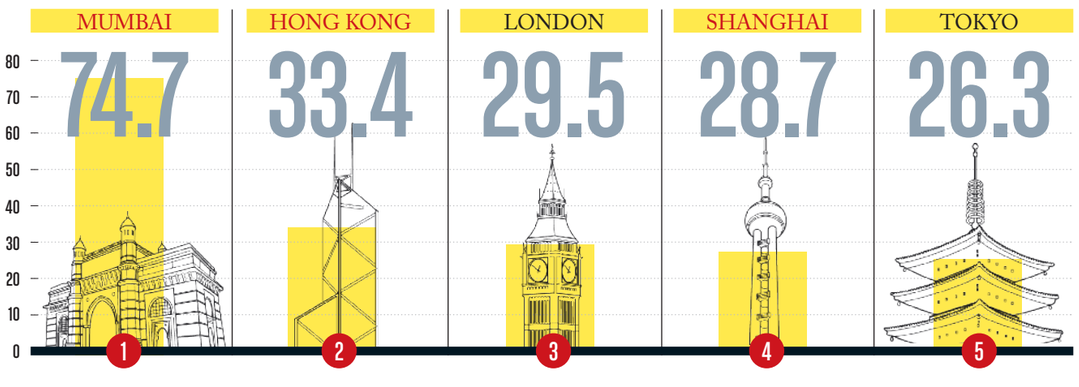
New York total costs are now 19% higher than they were at the end of 2008. At the other extreme, Tokyo has seen the biggest reduction in total costs, which have fallen by -15% since the end of 2008.

CHANGES IN TOTAL ANNUAL REAL ESTATE COST RANKINGS



SOURCE: SAVILLS WORLD RESEARCH

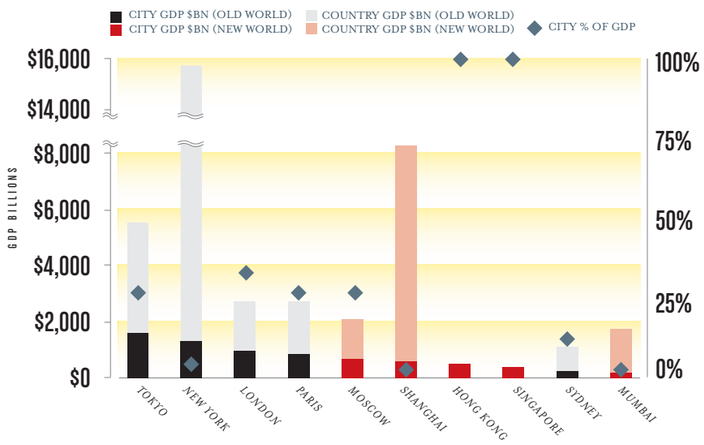
TOTAL COST ($) DIVIDED BY CITY GDP PER CAPITA



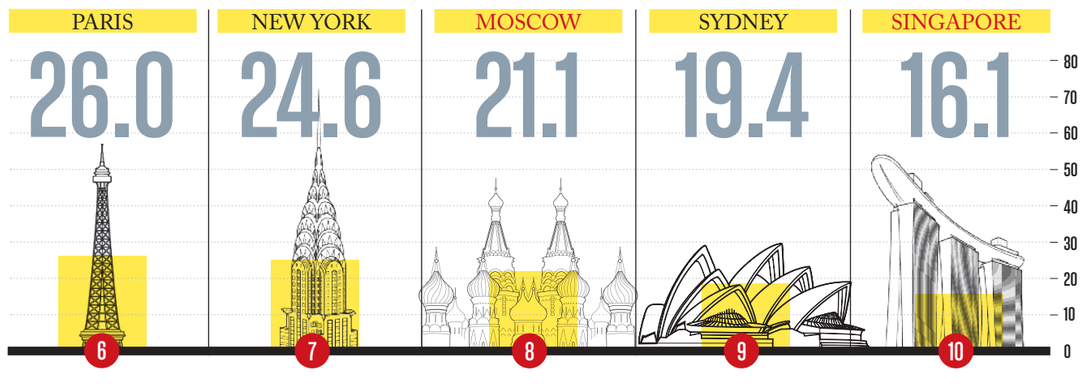
"Our total cost measure is more likely to reflect all the outgoings that companies need to take into account"

PAUL TOSTEVIN, SAVILLS WORLD RESEARCH

COUNTRY VS CITY GDP



SOURCES: SAVILLS WORLD RESEARCH, WORLD BANK, BROOKINGS INSTITUTE



STRIKING A BALANCE

HOW DOES OCCUPIER DEMAND UNDERLINE INVESTMENT QUALITY? WE COMPARE RESIDENTIAL AND OFFICE RENTAL GROWTH

While capital values fluctuate according to investor demand and sentiment in the investing environment, real estate rental values more accurately reflect the fundamentals of occupier demand in a city.

It is notable that rents for both commercial and residential property have been growing at a more modest rate across most world cities than have capital values.

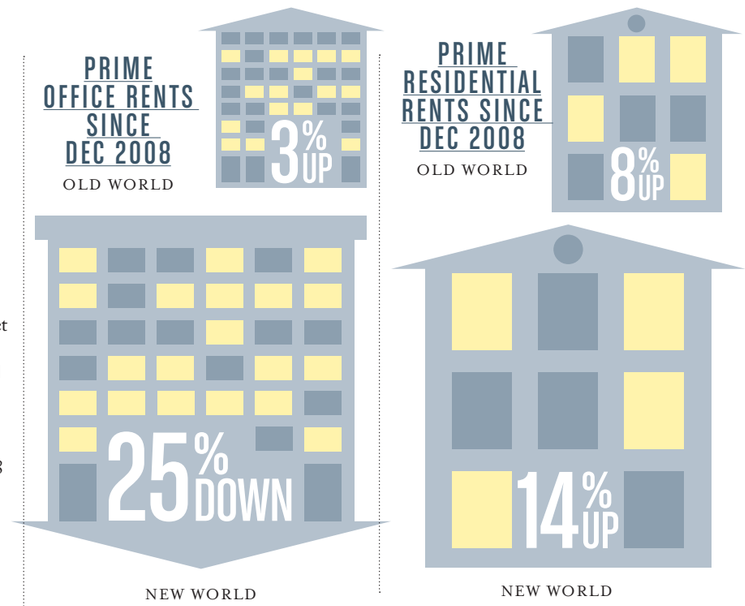
The chart below shows how residential property has become a desirable global asset since markets began to recover in 2009. Overall, the occupier market for residential has significantly outperformed that for offices globally. World prime and mainstream residential rents grew by 11% and 15% respectively from December 2008 to June 2013, but prime and secondary office rents are still below their December 2008 values by 12% and 2% respectively.

A MIXED PICTURE

Worldwide, prime office rental growth across the board appears to be levelling off. This has been led by more pronounced falls in rents in some 'new world' cities and steady growth in the 'old world' cities. 'Old world' prime office rents have been picking up since late 2009, and are now 3% above their December 2008 values.

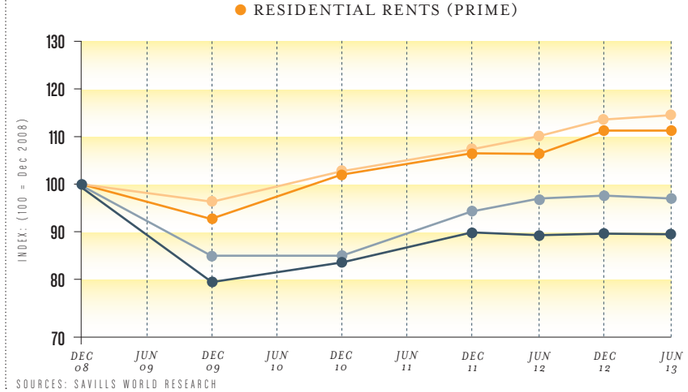
By contrast, 'new world' prime offices, having seen some recovery between 2009 and 2011, have since wobbled downwards and now stand 25% below their December 2008 levels. This would seem to justify

"The occupier market for residential has significantly outperformed that for offices globally"



COSTING THE WORLD

WORLD OFFICE RENTS v RESIDENTIAL RENTS

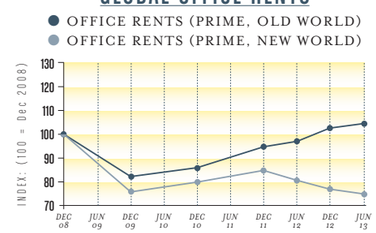


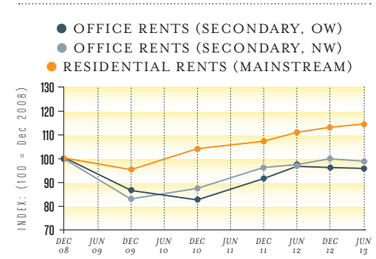
SOURCES: SAVILLS WORLD RESEARCH

CITIES WITH NOTABLE RESIDENTIAL MAINSTREAM RENTAL GROWTH SINCE 2008 INCLUDE...

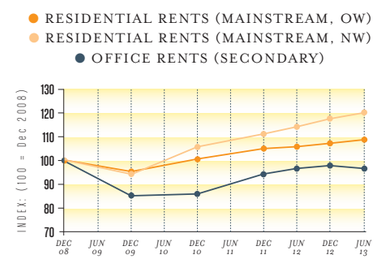
45% HONG KONG **32% SYDNEY** **27% MUMBAI** **25% SHANGHAI**

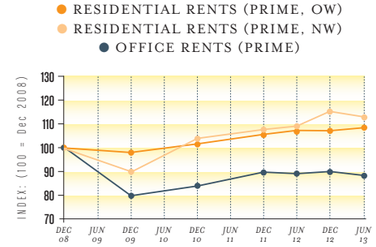
GLOBAL OFFICE RENTS





GLOBAL RESIDENTIAL RENTS





the search for 'old world', 'safe haven' real estate assets by global investors. Meanwhile it raises questions over the fundamentals of demand and supply in many 'new world' locations, notably Singapore, Mumbai and Moscow – especially in the prime sector where it would seem grade-A offices may have been particularly overpriced prior to 2008.

When it comes to secondary offices, the 'new world' and the 'old world' have performed in a very similar way. Having fallen 17% between 2008-2009, 'new world' secondary office rents are now levelling off at their former December 2008 values.

INVESTMENT APPEAL

The fundamentals of mainstream residential across all the cities seem to have been substantially stronger than those for even secondary office. It is interesting to note that globally, all residential rents have significantly outperformed office rents, making this sector look a highly viable investment asset class. In contrast to prime office rents, the 'new world' has outperformed the 'old world' in mainstream residential rents. Here 'new world' mainstream residential rents have grown by 20% and 'old world' mainstream rents by 9% since December 2008.

This pattern also applies to prime residential rents, which at a global level have grown slightly less than mainstream residential rents but are still slightly higher in the 'new world' economies compared to the 'old world', at 14% and 8% above December 2008 values respectively.

THE GLOBAL MARKET

As always, the global averages hide big disparities in rental performance. Some cities stand out as having weak office demand coupled with oversupply of stock. These cities are overwhelmingly concentrated in the 'new world' but notably offset by the odd exception like Hong Kong

"Prime residential rents are behaving quite differently to their mainstream counterparts"

secondary offices, for example, where demand has been very strong and supply limited. Indeed, at 30% above December 2008 values this secondary market has outperformed prime.

When it comes to housing, the consistent growth in all cities (except Tokyo) of mainstream residential rents illustrates how growing populations and limited space are the driving fundamentals of many world cities. Notable residential mainstream rental growth has been seen in Hong Kong (45%), Sydney (32%), Mumbai and Shanghai (27% and 25%) since 2008.

Prime residential rents, on the other hand, are behaving quite differently to their mainstream counterparts. The withdrawal or reduction of rental allowances paid to high-level employees of international corporations across the globe have suppressed rental growth in this sector. In Tokyo, Moscow and Hong Kong, prime residential rents remain lower than they were in December 2008. A notable exception to this is Mumbai, which stands 52% higher than December 2008 (but where rents have fallen slightly in the past six months).

New York also stands out as having seen high prime residential rental growth since 2008 (31%), supported by very limited supply in Manhattan following cessation of development activity over the past five years, coupled with strengthening demand. This further supports our assertion that the Big Apple is a compelling investment case.

A CHANGING MARKET

WILL THE SUBSTANTIAL RISES IN RESIDENTIAL CAPITAL VALUES SEEN IN SOME CITIES PROVE SUSTAINABLE?

The absolute gains in residential capital values in some world city housing markets have been very large in the past five years. This is particularly the case in 'new world' cities where residential capital growth has averaged 58% since 2008. There are some examples, for instance mainstream residential in Hong Kong, where growth has been even higher (103%) and in Shanghai (70%).

The question is whether this type of growth is sustainable. We have compared fundamental demand for housing, as revealed by rental growth, against the rate of growth in capital values. This analysis reveals that some capital value markets have risen substantially ahead of rental values and this indicates a possible investor bubble. Demand for assets has driven values ahead of the income that might be produced by a property.

Further analysis of this phenomenon looks at the annual income yield from housing in different cities and assesses whether these are high or low in relation to alternative forms of investment. It reveals that some cities are still very fairly valued, or even good value, for investors, producing substantially more income than is available from 10-year government bonds.

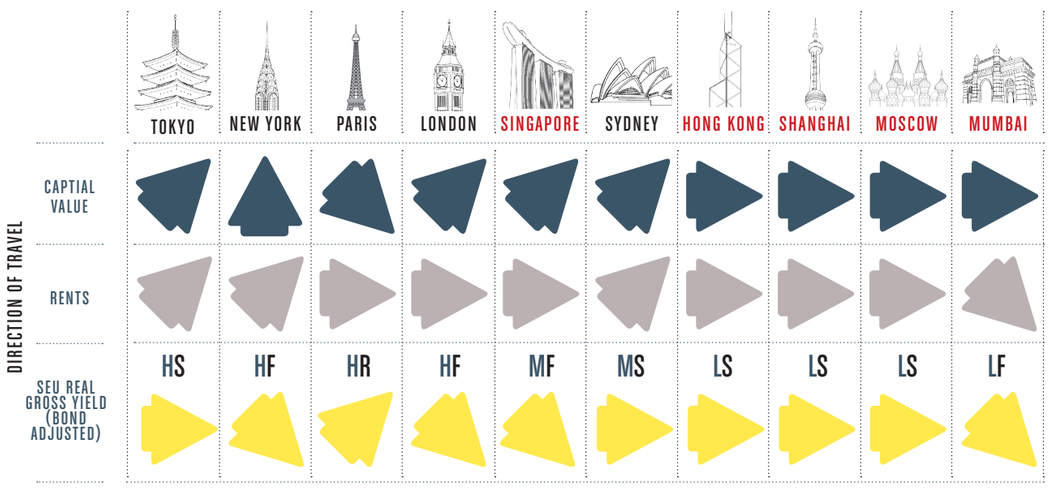
The 'old world' cities of Tokyo, New York, Paris and London stand out as looking fairly valued because gross yields are still at least 2.5 percentage points above bond yields. In these cities both rental growth and capital growth have more closely resembled each other.

Meanwhile, the 'new world' cities of Hong Kong, Moscow, Shanghai and Mumbai look expensive in relation to their rental markets as gross yields are well below the rates available from government bonds. This does not mean that capital values have to fall but does make it more likely that they will be subdued until rental growth raises yields.

The table below shows the current direction of travel in capital values, rents and yields. The combination of these measures suggests how desirable or undesirable different markets might be to residential investors. By this measure Tokyo, with its improving rental outlook, slight capital value growth and stable yields looks to be one of the more sustainable prospects. New York shows similar promise although recent purchasing activity has pushed capital values substantially upward. However, yields have the capacity to fall much more before this city looks overvalued. Falling capital values in Paris may make this city look more like a good buy for those seeking income. Meanwhile London and Singapore are showing signs of an aging market despite continued capital growth and level rents.

The chart below shows how gross residential property yields differ from bond yields in each country and the direction in which rental growth is currently moving. It illustrates how a combination of relatively high yields and moderately upward rental growth makes the Tokyo and New York residential markets appear ripe for investment while moderately negative rental growth in Mumbai, combined with very low net yields, means that this market will be unlikely to see substantial investor activity and capital growth in the near future.

TRENDS IN CAPITAL VALUES, RENTS AND YIELDS



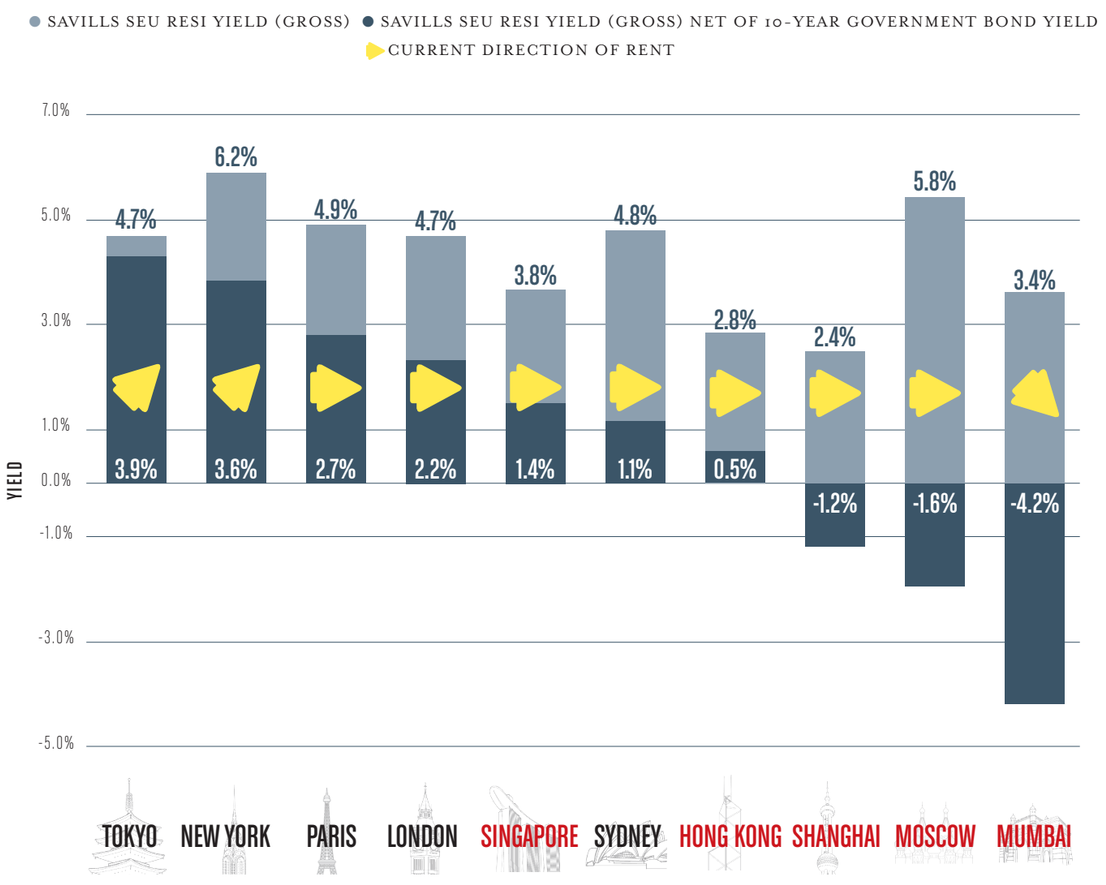
H = HIGH YIELD M = MEDIUM YIELD L = LOW YIELD R = RISING YIELD S = STABLE YIELD F = FALLING YIELD

SOURCE: SAVILLS WORLD RESEARCH

"Some capital values have risen substantially ahead of rental values, indicating a possible investor bubble"

YOLANDE BARNES, SAVILLS WORLD RESEARCH

YIELDS: GROSS RESIDENTIAL AND NET OF 10-YEAR BOND RATES



SOURCE: SAVILLS WORLD RESEARCH, TRADING ECONOMICS

LONDON RESIDENTIAL

THERE ARE STILL OPPORTUNITIES FOR INCOME-SEEKING RESIDENTIAL INVESTORS

An international centre of business and culture at the confluence of the world's time zones, London is arguably the most global of the cities we monitor. The city enjoys a stable, transparent real estate market. Its residential market has seen price growth of 44% (for the SEU) since 2008, when its contemporaries in our 'old world' index increased by just 19%.

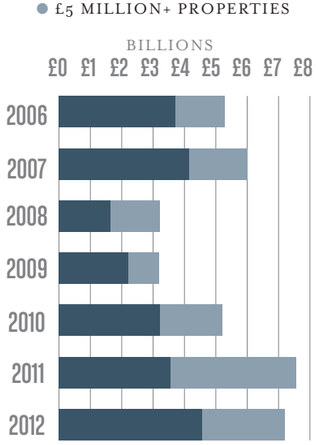
In a post-credit crunch environment, both domestic and overseas buyers have been attracted by this established, 'safe haven' market. Always an international market, international buyers now account for 39% of the prime London residential market. Most of them (85%) live and work there.

Overseas equity, combined with domestic wealth generated by London's global economy has fuelled price growth in its prime residential sector, up 58% since 2008. We estimate that approximately £37 billion has flowed into London property from overseas buyers since 2006. Recently implemented tax changes, most notably an increase in stamp duty on properties over £2 million, have had only modest, and probably temporary, impact on growth.

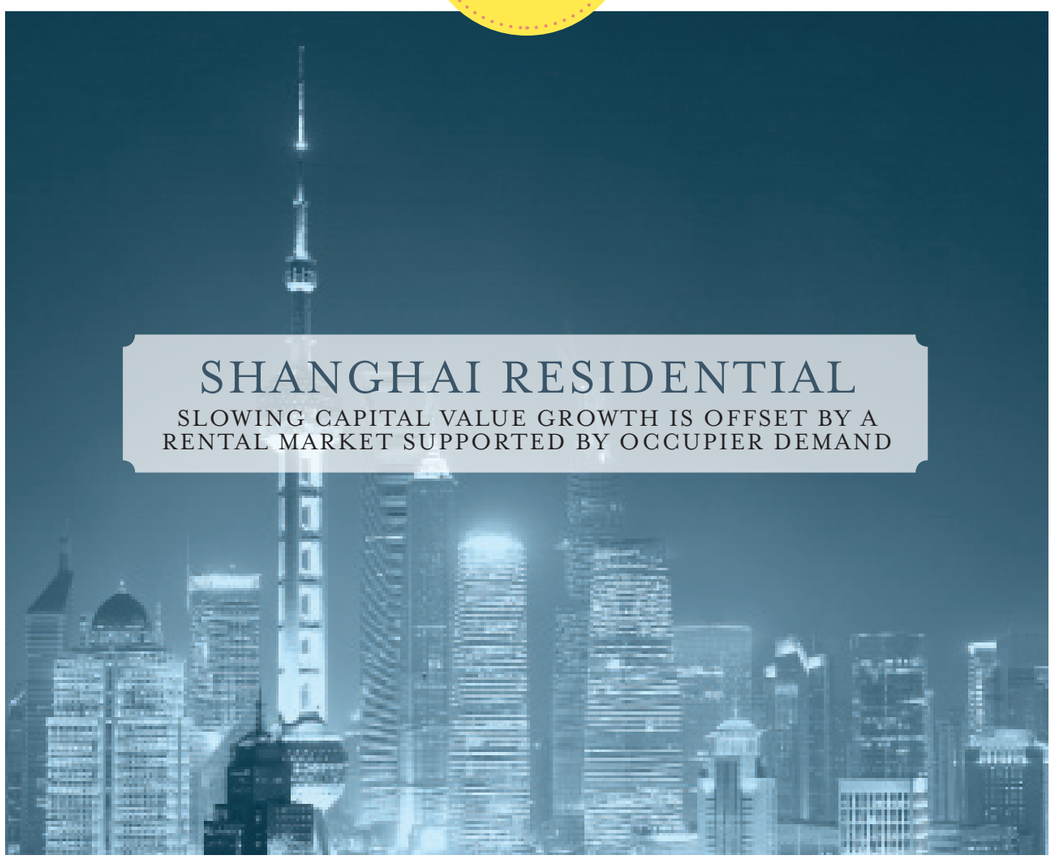
Such sustained capital growth is diminishing yields in the prime sector where rental growth has failed to keep pace. This is weakening prime London residential as an investment proposition although prospects for secondary locations still look very strong. Yields for resale properties outside the core are generally high and in mainstream markets rents are up 9.3% over the past two years (while prime rents have increased by only 0.8%). Rents have been driven by strong demand from households shut out of the sales market by high deposit requirements and mortgage restrictions.

In the prime markets, weak corporate demand and increased levels of stock have constrained rental growth, as prime gross rental yields now stand at just 3.7%. By contrast, mainstream property is looking an increasingly investible proposition with average yields at 5.1%.

INTERNATIONAL EQUITY INTO PRIME LONDON RESIDENTIAL



SOURCE: SAVILLS WORLD RESEARCH



SHANGHAI RESIDENTIAL

SLOWING CAPITAL VALUE GROWTH IS OFFSET BY A RENTAL MARKET SUPPORTED BY OCCUPIER DEMAND

Shanghai's residential market has proved very resilient to the cooling measures enacted by the Chinese government. While the rate of price growth has slowed from the dizzy heights of 2009, market indicators remain positive and capital values grew by 2.1% in H1 2013. This is despite an underlying slower economy, higher deposit requirements and restrictions on second home ownership.

By comparing rental value growth (an indicator of occupier demand) to capital value growth (signalling investor demand) we can evaluate the underlying occupier demand for housing. While capital values in Shanghai have risen by 148% since 2005, rental values have grown by just 15%. Yields stand at just 2.4%. This leaves a wide gap between rents and capital values, suggesting that rental growth has a long way to go before a more sustainable ratio is reached.

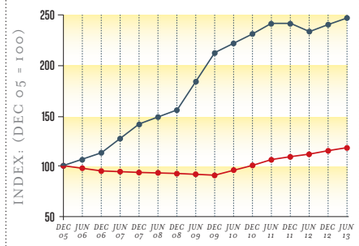
It is apparent that Shanghai's future prosperity as a financial centre is already fully factored into real estate values, which have been driven by extraordinary domestic demand from a wealthy population with few other options for investment.

A growing tenant base and corporate occupier demand from the city's burgeoning financial industry will underpin future rental value growth, but it will be some time before rents catch up with capital values. Any rebalancing will also be complicated by investors' tendency to leave new property vacant to avoid the 'new car effect' – the sharp depreciation that follows the occupation of any new property in China.

While regulations have not had a meaningful impact on suppressing market demand, measures designed to increase land supply and limit price growth through increased housing delivery will probably be more successful over the longer term. This option is not available in many of the more land-constrained of our world cities but is expected to increase Shanghai's supply.

China's residential markets are too important to the economy for its government to allow any major price corrections. Real estate investment accounted for 11% of China's gross domestic product in 2012 and affects over 40 other industries. Careful tinkering at the market's edges is thus likely to continue.

SEU PRICE GROWTH: SHANGHAI'S CAPITAL VALUES AND RENTS DIVERGE



SOURCE: SAVILLS WORLD RESEARCH

FORWARD THINKING

WHAT ARE THE PROSPECTS FOR FUTURE GROWTH IN WORLD REAL ESTATE MARKETS?

The various so-called 'cooling measures' that have been imposed to subdue markets that were perceived as being overheated, in places like Hong Kong and Singapore, do seem to have had an effect on transaction levels and may have contributed to some of the slowing in residential price growth seen in these cities during the first part of 2013.

However, studies of previous cooling measures suggest that the one-off imposition of these various taxes and limitations tends to have a short-term effect rather than a lasting one. The signs are that while the market adjusts to the measures, values are re-aligned with cost, there is a fall-off in market activity and values soften but, having adjusted, markets then resume their former trajectories.

The future for real estate values in many of our 'new world' cities will therefore depend not so much on cooling measures but on the fortunes of the country's economy. This not only governs how much wealth is created and thereby gives rise to investor demand but also how much is produced and how much demand is created for both new living space and work places.

"The trends we have started to see in 2013 are portentous"

We therefore foresee that the more subdued growth currently seen in many of the emerging and recently emerged world economies are going to have a more profound impact on real estate values than legislation and taxation.

The impact is more likely to be felt in the low-yield cities of our 10 than the higher yielding ones. Capital value growth (both residential and commercial) will continue to be more volatile where prices are not underpinned by income.

This means that the trends we have started to see in 2013 are portentous. The stability and underlying strength in the fundamentals of real estate, namely rental growth, in many of our 'old world' cities will continue to be an attractive feature for investors.

We have said over the past two years that New York looked good value. Sure enough, global investors – as well as locals – do now seem to have picked up on this so that the first half of 2013 saw substantial capital growth in many real estate asset classes. Our analysis suggests that there is still room for further growth, driven by domestic occupier demand as well as further downward yield shifts as investors respond to brightening US economic prospects.

Perhaps more unexpectedly, Tokyo has also appeared on our radar as a prospective 'buy'. The combination of moderately rising rents, more positive capital growth and high yields, in relation to bonds, are likely to encourage more domestic investors into the real estate markets. For overseas investors, Tokyo remains challenging but the cheaper Yen, recovering economy and stable real estate markets may start to encourage those looking for 'old-world' exposure and stable, long-term income streams.

There will still be opportunities for out-performance in some of the 'new world' cities. The underlying strength of secondary office rents suggests, for example, that there may be value-add opportunities if overpriced 'trophy assets' are avoided.

SEU PRICE GROWTH H1 2013

	NEW YORK	SINGAPORE	HONG KONG	LONDON	SHANGHAI	TOKYO	PARIS	SYDNEY	MOSCOW	MUMBAI	ALL CITIES
RESIDENTIAL CAPITAL VALUES	4.8%	5.5%	1.9%	4.5%	2.1%	1.2%	-1.4%	1.7%	0.7%	3.1%	2.4%
RESIDENTIAL RENTAL VALUES	2.0%	0.1%	1.8%	0.5%	2.1%	0.0%	0.5%	0.8%	3.3%	-4.3%	0.7%
OFFICE RENTS & COSTS	3.1%	1.5%	2.8%	1.0%	1.5%	2.6%	1.2%	-3.3%	-9.3%	-10.1%	-0.9%

SOURCE: SAVILLS WORLD RESEARCH

EXPERT COMMENTARY

SAVILLS AGENTS ARE AT THE HEART OF THE GLOBAL PROPERTY MARKET

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"Cooling measures have softened Hong Kong's prime markets, but mainstream markets are buoyant."

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"An investible proposition, mainstream markets are resurging with strong demand and solid yields."

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"Falling commodity prices have tempered the prime markets. This has been offset by tight supply."

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"A slowing Indian economy has reduced demand and short-term prospects have weakened."

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"Investment activity has slowed in the wake of further cooling measures, but underlying demand is strong."

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"Investors are returning to Sydney real estate amid low interest rates and positive market sentiment."

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"Assertive monetary policy is improving consumer attitudes, and a stabilisation of prices has been observed."

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