Luxury Home Report: Looking Up at Last

An exclusive city-by-city analysis of the high-end residential real estate market suggests that those waiting for a meaningful recovery to set in need wait no longer.

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After a complete collapse and years in the doldrums, the U.S. residential real estate market is coming around. As just one example of positive news, home prices in the second quarter of 2012 rose 7% nationwide from the previous quarter, marking the largest quarterly increase since 2005, according to California-based market data company CoreLogic Inc. More heartening than any individual set of numbers, though, is the realization that a sense of clarity, combined with some meaningful momentum, has finally returned to a housing market that for years left would-be buyers at all income levels inclined to stay on the sidelines.

The Clickable Luxury Home Market

The nation's housing market finally seems to be on mend. But how are luxury homes faring in *your* area? Click here for an interactive look at the top 5% of the market in terms of home values in the 50 largest metro areas in the U.S. The numbers in this report were prepared exclusively for Merrill Lynch by Zillow Inc., creators of the Zillow Real Estate Market Report, one of the most comprehensive overviews of the national and local real estate markets.

Several factors now point to our being in the fitful, early stages of what should prove to be a prolonged housing recovery, says Michelle Meyer, senior U.S. economist at BofA Merrill Lynch Global Research (see video). Spurred by the lowest mortgage rates in decades and strengthening investor demand, sales of existing homes are rising and the glut of foreclosed properties has begun to clear. New home construction, meanwhile, has only recently started picking up after its precipitous 2009 decline. Accordingly, Meyer says, BofA Merrill Lynch Global Research forecasts that home prices will increase by an average of 45% over the next decade.

To be sure, a 10-year 45% jump (which amounts to only a few percentage points per year) isn't likely to attract the sort of investors who bought real estate during the boom for the sole purpose of reaping immediate, sizable financial rewards. That type of market may be decades off, if it ever returns. "Since the financial crisis, we've seen a fundamental change in how people perceive housing," Meyer explains. "For the majority of buyers, it is now considered more of a consumption good than a short-term investment. Most people today buy a house because they want to use it, rather than buying with the expectation of selling for a big gain in a few years."

But for those looking to make major purchases to enhance their own quality of life — especially those in the market for high-end properties — now may be the best time in years to consider moving forward with that dream home or vacation getaway. Prices, while rebounding, remain low; mortgage rates are still highly favorable; and there's plenty of room for a property's value to grow over time. Perhaps best of all is the sense that buyers are investing in a market that seems to have finally picked itself up off the bottom.

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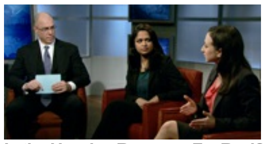

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MORE IMPETUS TO BUY

With interest rates on fixed- and adjustable-rate mortgages at all-time lows, the real carrying cost for most people purchasing a home—taking into account home prices and mortgage costs—is as close to affordable as it's ever been.

Source: National Association of Realtors

Prime Properties Lead the Way

There may be even more reason for optimism for higher-end properties. More expensive houses held their values better than most during the depths of the recession, says Stan Humphries, chief economist at Zillow Inc., who heads up data and analytics for the company, including its Zillow Real Estate Research division. Zillow, which typically tracks home values across different geographies and three tiers — the top, middle and bottom third of the market — recently worked with Merrill Lynch to produce an exclusive analysis of the top 5% most expensive homes in the country's 50 largest metropolitan areas. (See The Clickable Luxury Home Market.) By August of this year, home values in this 5% top tier had dropped 22.6% since the market's peak in April of 2007, considerably less than the 33.4% decline for the bottom third in Zillow's usual breakdown.

Of course, location remains as much a factor as it's always been. Cities such as New York, San Francisco and Boston, whose high-end areas have been well defined for decades, have bounced back with the greatest confidence. New York's residential market dropped 18.5% for high-end homes and 25% overall during the crisis, according to Zillow — yet has already seen prices in many neighborhoods return to pre-crash levels, says Diane Levine, senior vice president and brokerage manager in the downtown Manhattan office of Sotheby International Realty. "We were one of the last markets to drop and one of the first ones to jump back," she says.

In a few top Manhattan markets — Greenwich Village, Chelsea and some neighborhoods on the Upper East Side — bidding wars have even become commonplace again. "The high-end buyer who wants a townhouse has just a few areas to choose from with very limited inventory," Levine says. "So when something comes on the market, there are likely to be a good number of people interested."

But there's definitely a different tenor to this market compared to the height of the housing boom. As Levine notes, today's high-end buyers "are very focused and sophisticated about what's going to work for their needs. Even when they see a property they like, their enthusiasm is more tempered."

A Bounce Back for Boom Towns

While sun-drenched metropolises such as Miami and Phoenix have plenty of natural appeal for buyers, their spectacular buildup as the bubble expanded left them particularly exposed during the crisis. Between 2003 and their peaks in 2006, Phoenix posted a 97% rise in home values, and Miami's prices jumped 101.8%. When the bubble burst, both cities saw their home values tumble more than 55%.

Yet even here, high-end homes held up comparatively well through the worst of the downturn and have turned around more quickly. In Miami, for example, the top 5% of the market dropped only 33.6% from its peak. Though painful, the decline helped entice a wave of overseas investors to what was already one of America's most international cities — with many of those buyers offering cash deals, notes Gary Hecht, an agent at Coldwell Banker Residential Real Estate in Coconut Grove, Fla. "It might sound surprising, but most of us who do high-end real estate have enjoyed the best years of our careers over the past five years," he says.

Year over year through August 2012, home values for the top 5% are up an average of 6% in Miami, compared with a 1.7% climb nationally. In Phoenix the high-end market dropped 35.9% from its peak in 2006 and has rebounded 13% year over year through August 2012. Tight inventory, driven in part by homeowners awaiting a more complete recovery before selling, is helping to boost high-end home prices, says Mel Reese, a Coldwell Banker agent specializing in Phoenix's luxury market. "Anything below $2 million is selling pretty quickly," he says, although the market above $2 million remains sluggish.

Still, says Zillow's Humphries, continued recovery in former boom cities can't yet be considered a given. Deep discounts propelled by the foreclosure market have pulled overall home prices down so far that even with the recent price rebound, more than half (52%) of Phoenix homeowners with mortgages owe more on their homes than they are worth, as do 44% in Miami. Those figures make the cities inherently more vulnerable to any further economic shocks, Humphries adds. "Prices can be very volatile," he warns.

Resort Report Mixed

Venerable high-end resort towns, while too small to be included in Merrill Lynch's survey of Zillow data, share the same long-term appeal of properties in Manhattan or San Francisco: a natural supply limit. As Michael Feder, president and CEO of research and analysis firm Radar Logic Inc., puts it, "They aren't making new oceanfront property in the Hamptons anymore."

That's not to say such areas weren't hit hard during the crisis. Prices in Aspen, Colo., dropped 25% to 40% after 2008, says Tim Estin, a broker at Coldwell Banker Mason Morse Real Estate in Aspen, Colo., and the publisher of the *Estin Report*, a monthly and quarterly analysis of the Aspen/Snowmass home market.

Since then, the recovery has been a bit all over the map, Estin says. The total amount of money spent on Aspen homes surged 20% year over year in 2011, then retreated 37% year over year in the first half of 2012, then surged 55% this past summer. A lot of this has to do with the degree to which a very few number of very expensive homes can skew the market in an area like Aspen. For example, through the first half of 2011, 12 properties sold for more than $10 million, whereas during the same period this year, there were just five transactions of that magnitude.

But perhaps a more telling statistic is the total number of units sold. That number — which was up 26% for the summer of 2012 vs. the summer of 2011 — suggests to Estin that while some high-end buyers may still be putting their vacation dreams on hold amid lingering uncertainties about the economy, more are recognizing that now may represent "an unprecedented opportunity" to acquire properties at prices not seen in nearly a decade.

Climbing the Paper Mountain

Location isn't the only golden word in real estate. Patience counts too, especially now and especially as it relates to the process of financing a home purchase. While record-low interest rates make mortgages attractive from a financial perspective, gone are the days when a wealthy buyer was able to secure a "no doc" loan with little more than a net worth statement, says Paul Fox, managing director and head of Global Wealth and Investment Management Mortgage Solutions at Bank of America Merrill Lynch. Even the wealthiest applicants will need to document a steady income stream, Fox explains. And if most of your annual income is based on bonuses, three to five years' worth of pay stubs will generally be required.

And there are other complications to this market. The relative dearth of recent high-end home transactions, for example, can skew the appraisal process. "Comparable sales are hard to come by, and if there hasn't been a sale for a few months, you may find yourself disappointed by the appraisal," Fox explains. When an appraisal comes in significantly below the agreed-upon sale price, buyers may be required to come up with extra cash to get the deal done. On the flip side, of course, they may have more leverage to renegotiate.

Finally, with interest rates so low, mortgage lenders are being bombarded with applications. "Everyone has capacity issues," Fox says. "You won't do a quick close on a co-op in Manhattan anymore." The backlog has stretched the average closing time on homes nationally to around 75 days.

It's another example how this recovery is proving to be a slow one in almost every way. Even as the real estate market stabilizes, caution and careful selection remain the watchwords. "A negative response to economic news, either in the U.S. or elsewhere in the world, could still undermine housing demand and seriously hurt home prices," Feder cautions.

The good news is that a more tentative market means there's time to scout available properties in the best locations, find the right home and make a favorable deal. "Do I think prices or mortgage rates will suddenly take off during the next few years? No," Meyer says. "But I do think it's a good time to start considering a move."

Enhancing Your Purchasing Power

With innovative financing solutions, you may not have to choose between your house or your assets.

Concerns over the still-fragile economy may make real estate buyers hesitant to liquidate large chunks of assets, even as a down payment on the home of their dreams. But that may not be necessary, says Paul Fox, managing director and head of the Custom Mortgage Group at Bank of America Merrill Lynch, who notes that persistently low interest rates give home buyers several alternatives. For example, they may be able to pledge eligible securities as collateral for home financing, rather than selling those investments. That way, the securities can stay in the buyer's portfolio, potentially benefiting from rising prices as the recovery takes hold.

Bank of America's custom lending group can tailor a structured mortgage program to meet any number of individual financing needs, Fox adds. For instance, if you anticipate selling a closely held business or another major liquidity event, you may be able to construct a laddered mortgage that allows you more flexibility than the traditional mortgage process. Suppose the sale of your business is structured so that you receive half the money up front and the rest in three years. The first rung of the ladder could be an interest-only, one-year bridge loan. When you receive the first of the delayed payments, you could pay off part of the balance and restructure the rest into a three-year loan. Then, after collecting the final payment, you could pay down more of the principal and move the outstanding balance into a more conventional 30-year mortgage.

"We can write all three mortgages and execute them simultaneously," Fox says. "You don't have to go back each time to get a new loan. We can just get it done."

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