Notes:

HNWI
Knight Frank and Citi Private Bank define High Net Worth Individuals (HNWIs) as being individuals who hold more than US$10 million (£5 million) in investable assets. Investable assets exclude primary residences. Due to the nature of the subject matter contained in this report we have included primary residences in the calculation of HNWI asset allocation.

Prime property
Prime property equates to the most desirable, and normally most expensive, property in a defined location. Commonly, but not exclusively, prime property markets will be areas where demand has a significant international bias.

Research overview
Knight Frank Residential Research carried out face to face or telephone surveys of HNWIs during January and February 2007. Our selection of HNWIs concentrated on UK residents.

We introduce the Knight Frank Prime International Index in this report. The index comprises a basket of real properties that are valued throughout the year to provide the most accurate and timely guide to prices and price movements in prime global markets.

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Citi Private Bank is a leader in residential lending to the high net worth community.

We offer competitively priced, multi currency facilities, available both on and offshore and specialise in high value lending in prime locations to individuals, private companies and trusts. A dedicated private banker will ensure that your loan is tailored to meet your specific situation.

As one of the world’s leading private banks, we have a history of expertise and intellectual leadership that few institutions can match. We understand that our clients seek to build upon the successes of their own hard work. We provide capital as well as investment opportunities and act as trusted advisors, designing and coordinating insightful solutions for our clients’ needs.

Please contact Andrew James on +44 (0) 207 500 1550 or andrew.james@citigroup.com
Yet all too often, a little knowledge is a dangerous thing. With constant market and media speculation, you’d be forgiven for thinking that every property you bought would deliver outstanding returns.

Rarely are constant, significant returns that easy.

Knight Frank’s Prime Property Consultancy Service maximises property assets. With the expertise, the experience and the contacts across European and international markets, we can help you to build a property portfolio that works hard for you.

So you can watch your assets grow.

For further information please contact:
Andrew Hay on +44 (0) 20 7861 1077 or email andrew.hay@knightfrank.com
As part of the largest ski area in the world, Courchevel, in the Savoie region of the French Alps, has seen interest in its property market expand hugely. Top properties now easily exceed €20,000 per sq m.
Introduction

There has been an unparalleled growth of significant personal wealth in recent years. This development is a crucial trend, influencing consumption and saving patterns across the globe.

The most noticeable result has been the concentration of wealth and the growing influence of high net worth individuals (HNWIs), defined as people with net assets in excess of US$10 million. This phenomenon has been felt across the entire economy with the private equity boom being a high profile symptom. Away from financial investments, one of the key components of the HNWI portfolio is residential property and in particular prime market property.

To date the relationship between HNWIs and prime property has been overlooked, an omission that is remedied by the publication of The Annual Wealth Report: Prime Residential Property. This report marks the collaboration between Knight Frank, property consultants, and Citi Private Bank, a market leader in high value European residential lending, bringing together our respective expertise in the property and financial sectors.

In this report we study the increasing importance of residential property as an asset class and consider the role of second homes, investment properties and development potential. For the first time we examine the attitude of the wealthy towards risk and opportunity arising from their residential portfolios.

There are three themes underpinning our analysis:

- what do the wealthy expect from residential property;
- how has rising wealth influenced prime residential performance in the UK, Europe and globally over recent years; and
- where trends are pointing to over the medium term.

The HNWIs are market leaders, making decisions to stay ahead of the competition. Their activities influence behaviour far beyond the prime markets, making the study of their motivations and attitudes of critical importance to understanding future trends in the residential property sector. Our understanding of this market helps us advise HNWIs in maximising their portfolio returns.

Patrick Ramsay
Head of Residential
Knight Frank

Peter Charrington
Managing Director, UK
Citi Private Bank
Liam Bailey, Head of Residential Research at Knight Frank, presents the findings of The Wealth Report.

The growth of wealth in recent years is a real and substantial trend. Residential property markets have been the astute witness to this wealth creation. The dramatic increase in central London prices against the background of a more sober market has demonstrated the influence of high net worth individuals (HNWIs) upon property.

This report by Citi Private Bank and Knight Frank investigates the behaviour and attitudes of HNWIs to the residential property market. It reports on their current views in a way that will significantly inform how we advise on their residential portfolios.

To undertake this research, we first interviewed HNWIs based in the United Kingdom (UK) and asked them questions about their existing residential portfolios, motivations for purchasing and disposing of property and their views on the risks and opportunities associated with the property sector. The second part of our research involved the completion of our Prime International Residential Index. The index comprises a basket of properties located in more than 70 prime market locations worldwide. The properties are valued over time to provide an accurate guide to average prices and price movements.

When we first undertook this investigation, we expected to find that HNWI property portfolios would be more varied and more geographically diverse than other investment portfolios. We were right, but this result is not just a function of wealth.

HNWIs are positive about property. They view their residential portfolio as an opportunity for lifestyle enjoyment, individuality and exclusivity. They are more aggressive in their investment strategies and are likely to have exposure to a range of what might be termed alternative investments such as hedge funds or private equity projects. They have a very confident attitude towards property in terms of locations and investment opportunities. One of the key differences between HNWIs and other investors is this attitude toward risk and reward.

The results of our report clearly indicate that HNWIs have a higher than average weighting in residential property, with the vast majority being in prime markets. Their portfolio is internationally diverse. They are happy to invest in emerging economies and are open-minded to alternative investment locations. This wider global reach is reflected in property assets and the lifestyle drawn from more diversified portfolios.

There is no such thing as a typical HNWI portfolio. As investors they are incredibly diverse and this is reflected in the make-up and objectives of their portfolios. Some have a highly geared investment model aimed at highly leveraged returns. Others are content with prime and second homes. The one constant is that in almost all cases the residential element of their net worth has become more significant over time and is set to grow in the future.

We introduce the plutonomy economic model in this report to explain some of the key drivers behind this growth of wealth and to help examine the implications on the residential market.
The model provides interesting insights including the recognition that while property prices have grown steadily in most countries, the prime markets have seen growth well above the mainstream market rate.

As the wealth of HNWIs rises, so does the cost of their desired property, goods and services. It really has never been so expensive to be wealthy.

What motivates purchase activity in the prime market?

Our experience is that HNWIs have several drivers underpinning their activities. The purchase of either a prime residence or a second home has to satisfy:

- **Time poverty:** The one thing that cannot be bought is time. Convenience and accessibility are key motivators not simply for the convenience of the commute to work, but also access to leisure pursuits.

- **Luxury:** There is a real, almost tangible sense of luxury that is attached to very high priced property. This quality increases continually with price. It doesn’t matter how expensive a property is, another more expensive either exists, or will in the future.

- **Prestige:** This quality is arguably one step above luxury. Modern iconic buildings and architects appeal as do historic buildings. Such properties make statements about their owners and how they wish to be perceived. Privacy can be a mark of both luxury and prestige; together with time it is one of the most significant issues for HNWIs.

All of the above become harder to maintain as wealth grows. HNWIs try to keep ahead of the market either by bidding up prices to remain exclusive (London) or exploring new areas (Brazil).

This pushing at the edge of the market makes HNWIs so crucial to understand. Where they go in terms of location and property types, the rest of the market will follow.

Where to next?

Over the next five years, we believe the trend of growing wealth and greater wealth concentration will continue. London will be a key location for future investment and will be a conduit through which this wealth will be invested. The prime markets will continue to outperform here in the UK, Europe and internationally.

There will be a significant demand and supply imbalance in the best prime market locations. Price growth this year will be lower than in 2006, although we predict prime markets will outperform mainstream markets by quite a margin.
Figure 01 The plutonomies: the income share of the top 1% has risen dramatically since the late 1970s in the US, UK and Canada

Figure 02 Of egalitarian bent: the income share of the top 1% is not rising significantly if at all in France, the Netherlands, Switzerland and Japan
Plutonym central

Take a short walk around central London, past street after street of £5 million and £10 million houses, and there will be little doubt that the wealthy have become very wealthy in recent years. The rise of serious wealth has been characterised, in London at least, by the property buying habits of the City banker and the Russian billionaire.

The property page headlines are not exaggerated. Wealth has been growing and its growth has been fastest for the super-wealthy. London is a good starting point for our investigation as it is the de facto capital of the new plutonomy.

Citi Investment Research first used the term plutonomy to define the emergence of a more stratified society in the late twentieth century in the US, UK and Canada. They noted that while the majority of the population had become more affluent, the top proportion of households (by income) had witnessed a more substantial and rapid increase in wealth.

Plutonomies are countries where the wealthy have a disproportionate slice of economic wealth. This is not a unique historic phenomenon. In some ways the drift towards a much more egalitarian wealth structure in the twentieth century could be seen as an aberration. It certainly is not the pattern of previous centuries.

Such concentrations of wealth in plutonomies have a huge impact on savings and consumption patterns. In these economies, growth is powered and consumed by the very wealthy. Its opposite model, the egalitarian economy, has simply not seen such wealth concentration. Japan and most of continental Europe are examples of such egalitarian economies.

To illustrate this trend, the top 1% of households (by wealth) in the UK have increased their share of national income dramatically in recent years, from a low of 6% of national income in 1978 to 13% in recent years. This is not far short of the 15% seen in the US (Figure 01). This experience is totally unlike continental Europe, where the share of wealth held by the top 1% of households has declined or at best stabilised in recent years (Figure 02).

What drives an economy to become a plutonomy?

Plutonomies rely on the presence of several factors to invigorate wealth. These include creative financial innovation, technologically driven productivity gains, capitalist friendly government, light touch regulation and an open attitude to sourcing international talent via immigration.

The UK and the US have been very successful in two critical areas for plutonomy development. New media technologies have had a significant impact on wealth creation (internet downloading, cable and satellite TV). These outlets have massively increased market size and media audiences. The result has been the creation of new types of high wealth occupations in sports, music, television, film, fashion and design.

The second area is the rise of occupations such as the legal and financial intermediaries, seen crowding into central London, who help realise the potential for the globalisation of production and consumption. All contribute to the development of the plutonomy model.

The future...

We predict that such wealth inequality will only increase. The UK will see a continued development in this direction. Wealth from the US, Europe, Russia, Middle East and Asia circles the world and a large proportion is invested either through, or in London. The ranks of the wealthy in the plutonomy are growing. It is in cities and locations characterised by global outlook and activity where we will see this trend most.

Where are the next plutonomies?

Eastern Europe appears to be embracing many of the characteristics of a plutonomy. Russia is the classic emerging plutonomy, and China and India are following closely.

Over the last two decades where the plutonomy model has been developing, the wider population has seen the benefits of economic growth. The wealth pie has become larger for just about everyone. This growth will continue and we will see ongoing serious wealth concentrations in the plutonomies. Only significant political change will affect this trend.
Figure 03 The expense of wealth: general inflation (US CPI) against luxury goods inflation (The Forbes Cost of Living Extremely Well Index)

Source: Citi Investment Research, Forbes, Datastream

Figure 04 Unattainable luxury: average UK house price growth (HBOS all property) against prime central London house price growth (Knight Frank)

Source: Knight Frank Residential Research, HBOS
It has become harder to keep up

There has been a growth in the number of wealthy people and their level of wealth has become ever larger. Unsurprisingly, HNWIs are confident about their ability to generate future income. They spend a larger proportion of their incomes than average and they have very low, if not negative, savings ratios. These two factors mean that not only is there more potential wealth to spend but that the desire to spend is being acted upon.

This phenomenon has already been played out in the markets. Figure 03 compares general goods and service inflation, in this case US Consumer Price Index (CPI), with luxury inflation based on The Forbes Cost of Living Extremely Well Index. In the three decades to 2006, general prices rose by a little over 250%. Over the same period, luxury prices rose by 630%. On average, luxury prices have been rising every year by an additional 2.6% compared to general prices.

The same trend is found in property. Comparing the mainstream UK market with the prime central London residential market (Figure 04), we see that prices of prime property have risen by 680% compared to 490% for mainstream UK property over the past 23 years. In London, the demand imbalance and its impact on prices has intensified in recent years.

Property, the ultimate Giffen good

As the plutonomy model develops, luxury products and services continue to rise in value. These are Giffen goods: goods that become more desirable the more expensive they are.

One key beneficiary of this trend has been prime residential property. For many, property is the ultimate Giffen good. It is limited in supply and has a low price elasticity, meaning that supply does not rise and demand does not fall significantly in reaction to higher prices. The ability of the wealthy to spend more money on property is being acted on, and it has coincided with a desire to secure more properties in the form of additional second homes or investments.

While the supply of properties has increased slightly over time and new prime markets have emerged, demand growth is vastly outpacing the expansion of supply. Prime property is unlikely to lose its status as the ultimate Giffen good.
Figure 05  Influences on primary residence location: how important were the following in influencing the choice of location for your current primary residence?  

<table>
<thead>
<tr>
<th>Factor</th>
<th>Least Important</th>
<th>Neutral</th>
<th>Most Important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unique property related factors</td>
<td>93%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Development or improvement</td>
<td>59%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long term investment</td>
<td>72%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Short term investment</td>
<td>57%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax status</td>
<td>39%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Access to work</td>
<td>62%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Family or historic associations</td>
<td>52%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lifestyle opportunity</td>
<td>75%</td>
<td></td>
<td></td>
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</tbody>
</table>

Figure 06  Risk factors: with regard to your primary residence location, do you think the following will become more or less important over the coming five years?  

<table>
<thead>
<tr>
<th>Factor</th>
<th>Less important</th>
<th>Neutral</th>
<th>More important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Climate risk</td>
<td>47%</td>
<td>58%</td>
<td></td>
</tr>
<tr>
<td>Congestion</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ease of access</td>
<td></td>
<td>57%</td>
<td></td>
</tr>
<tr>
<td>Tax</td>
<td></td>
<td>54%</td>
<td></td>
</tr>
<tr>
<td>Crime</td>
<td></td>
<td>57%</td>
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</tbody>
</table>

Figure 07  Future outlook: do you feel confident about the outlook for your primary residence location?  

<table>
<thead>
<tr>
<th>Factor</th>
<th>Not at all confident</th>
<th>Neutral</th>
<th>Very confident</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social and economic environment</td>
<td></td>
<td>89%</td>
<td></td>
</tr>
<tr>
<td>Crime and security</td>
<td></td>
<td>70%</td>
<td></td>
</tr>
<tr>
<td>Taxation</td>
<td></td>
<td>46%</td>
<td></td>
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</tbody>
</table>
Attitude survey: primary residence

The 2007 attitude survey

Between January and February 2007, Knight Frank Residential Research undertook detailed interviews with a sample of HNWIs based in the UK. The results have been analysed to reveal the current ownership of prime residential property as well as future investment and ownership intentions. Our survey highlighted areas of risk and opportunity identified in relation to HNWI property portfolios.

What are the key factors influencing prime residence location?

Of all the property choices facing HNWIs, the location of their prime residence is perhaps least flexible. The most prevalent factors influencing the selection of prime residence locations are the criteria of individuality and uniqueness. One survey participant spoke of their search for a houseboat; while another, of their desire for a period property in an unspoilt historic location. The next most important factor influencing property selection is lifestyle. This is a requirement that applies to city centres and rural locations.

Together with long term investment potential through capital gains, these factors are higher priorities than practical considerations such as access to work for HNWIs.

Our survey was limited to UK residents. For domiciled HNWIs, UK tax status is unsurprisingly low on their list of current location decision-making issues. For resident but non-domiciled individuals included in our survey, their tax status in the UK was of very high significance. For both HNWI groups, the impact of tax is probably the single most important feature concerning the future outlook for the location of primary residence.

Which issues affecting prime residences will become more significant in the future?

Taxation is an issue that will become increasingly significant over future years. There is a note of unease about the increasing complexity of UK tax affairs and the upswing in tough talk from the UK government regarding offshore tax arrangements. Talks of changes to taxation are being closely watched.

Despite the level of interest in the media and elsewhere regarding climate change, this issue did not rate highly for HNWIs in terms of choices regarding principal residence locations. Their view is that the UK is likely to have a relatively benign outlook; there is some limited concern about future flood risk in London, but this was not significant enough to be a defining issue. Later in this report we look at other areas of activity which suggest that green issues will begin to feature much more significantly.

Most are generally relaxed about the outlook for the UK as a primary residence location. The most significant concerns for the medium term are growing congestion and increasing difficulty in accessing property. This is especially marked among London and south-east England residents.

How confident are HNWIs regarding their primary residence location?

HNWI residents in the UK are confident about the future of their home country. There is a noticeable belief in the future of London as an economic centre. HNWIs assume that the current shift in activity from New York to the UK will at worst stabilise but more than likely increase. The flow of talent into the UK, London in particular, is felt to be a hugely positive benefit for the future.

Interestingly, the most significant area to give confidence to HNWIs is future security and crime issues. References were made to the UK’s apparent vulnerability to terror attacks and London’s position as a primary target. There was a general feeling that this was such a difficult area to second guess that it was effectively discounted.

As we commented earlier, taxation is the single issue where confidence is far lower. There is a concern that after a long period of stability, we are moving to a position where any tax changes could become significant.
### Figure 08 Influences on second home location: how important were the following in influencing your choice of location for your second home locations?

<table>
<thead>
<tr>
<th>Factor</th>
<th>Least important</th>
<th>Neutral</th>
<th>Most important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unique property related factors</td>
<td></td>
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<tr>
<td>Short term investment</td>
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<tr>
<td>Tax status</td>
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<tr>
<td>Access to work</td>
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<tr>
<td>Family or historic associations</td>
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<td></td>
</tr>
<tr>
<td>Lifestyle opportunity</td>
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</tr>
</tbody>
</table>

Source: Knight Frank Residential Research

### Figure 09 Risk factors: with regard to your second home locations, do you think the following will become more or less important over the coming five years?

<table>
<thead>
<tr>
<th>Factor</th>
<th>Less important</th>
<th>Neutral</th>
<th>More important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Climate risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Congestion</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Ease of access</td>
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<td></td>
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<tr>
<td>Tax</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Crime</td>
<td></td>
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</tbody>
</table>

Source: Knight Frank Residential Research

### Figure 10 Future outlook: do you feel confident about the outlook for your second home locations?

<table>
<thead>
<tr>
<th>Factor</th>
<th>Not at all confident</th>
<th>Neutral</th>
<th>Very confident</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social and economic environment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Crime and security</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Taxation</td>
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</tbody>
</table>

Source: Knight Frank Residential Research
What are the key factors influencing secondary residence location?

Unique property features dominates the list of influences on the HNWI second home search. Finding a property with sufficient hillside to permit the development of a semi-commercial olive grove in Italy was one specification. The desire for a property to pursue fishing and sporting interests was another.

Unsurprisingly, desired lifestyle was the next most important factor in selecting a secondary residence. Second homes offer more scope for individuality and to differentiate portfolios.

The potential for development or improvement was a significant factor influencing the selection of second home location. A second home is commonly chosen for its medium to long term investment (more than 7 to 10 years).

While access to work is low on HNWI requirements, it is an issue that could become far more significant in the future, as more work is undertaken away from business and prime residence locations.

The tax status of the second home location is not felt to be of great significance. The ease of accessing and exiting the market is regarded as being important to very important, in particular taking profits from eventual sales of properties.

Of those surveyed, 60% have a second home in the UK. Half of those surveyed have an international second home, with three-quarters of these being located in Europe. European second home locations were split equally between sunbelt locations (primarily for winter sun, holiday and weekend use) and Alpine ski properties.

With regard to second home locations, which factors will become more important over the next five years?

The potential impact of congestion was of most concern to HNWIs, in particular the spread of travel and associated noise and disturbance. We are now seeing an increasing push to remote and new unexplored locations (mostly within Europe and to some extent within the UK) for second homes. Congestion is an issue for primary residences as well, but is largely accepted due to the accepted trade-off between proximity to work and convenience of location.

Climate risk was identified as the next most important factor. Concerns were expressed about whether Mediterranean and other sunbelt locations would become increasingly uncomfortable in summer months. Likewise, Alpine resorts have experienced recent problems with snow reliability and the attractiveness of lower altitude resorts was raised.

Ease of access and the realisation that newer, more remote locations will require an increasing degree of complicated travel was also noted.

Tax and crime were identified as issues likely to become more significant over the next five years, but less than the previous items. Taxation is mainly a concern for those considering the future of the location of their primary residence. Crime is an issue that can be avoided and protected against.

Confidence in second home locations

HNWIs have a sophisticated attitude to the risks associated with overseas second home locations. There is reported trade-off between lifestyle opportunities and risk. There is some concern regarding the future of second home locations, especially the time implications of long haul as opposed to short haul.

Taxation is again an area of increasing concern regarding second home locations and the rules surrounding capital gains and inheritance taxation issues.

Overall, there is confidence about the location of second homes, especially those in Europe.
Objectives and attitudes surrounding investment properties

More than half of HNWIs surveyed hold residential investment properties in a personal capacity. The most important aim for HNWI investment properties is the achievement of a strong capital return. Target rates of capital growth are variously ascribed to a range between 8% and 15% per annum. Rental return is far less significant for most HNWI investors. The main objective is that rents will allow investments to cover costs.

Of more importance to the HNWI investor than rental return is portfolio liquidity, the ability to access gains at a time of their choosing. Ease of access to properties for inspection and review is important. Development and improvement potential for residential properties within investment portfolios is a key area for more than three-quarters of HNWIs.

The overwhelming majority of properties owned for investment purposes by UK resident HNWIs are located in the UK (more than 90%). This location reflects a desire to invest in locations personally known to the investor, where the market has been fully researched. The level of reported investigation contrasts to our experience with non-HNWI investors.

In terms of markets and properties, there is a significant bias towards established prime to super-prime markets, especially central London and prime south-east locations.

Attitudes to investment risk varies considerably – there is no typical HNWI in this respect. Approximately 30% to 40% could be described as having aggressive investment strategies. Their objective is to maintain very thin strips of equity and to achieve highly leveraged returns from residential property, especially prime property.

At the other end of the scale, a solid 30% of HNWIs do not currently hold and do not expect to buy investment properties in the near future. Risk aversion is one reason. Another is the clear belief that direct property ownership is a more active investment and that the time demands of investment property are too great.

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**Figure 11 Investment objectives: in terms of your investment properties, how important are the following to you?**

<table>
<thead>
<tr>
<th>Objective</th>
<th>Least important</th>
<th>Neutral</th>
<th>Most important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td></td>
<td></td>
<td>58%</td>
</tr>
<tr>
<td>Tax status</td>
<td></td>
<td>70%</td>
<td></td>
</tr>
<tr>
<td>Ease of access</td>
<td></td>
<td>70%</td>
<td></td>
</tr>
<tr>
<td>Capital return</td>
<td></td>
<td></td>
<td>87%</td>
</tr>
<tr>
<td>Rental return</td>
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<td>64%</td>
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</table>

Source: Knight Frank Residential Research
Monaco is the world's wealthiest nation per person and the most densely populated. Its cosmopolitan residents, attracted by the principality's generous tax regime, have helped push prime residential prices 13% higher in one year, to stand at €35,000 per sq m.
As the country’s leading financial and business centre, Shanghai is the powerhouse of China’s economic growth. A potent combination of huge demand and limited supply for prime residential property continues to push values upwards.
HNWI investment portfolio analysis

Property accounts for 42% of HNWI asset allocation. If we drill down into the property element of the portfolio, 23% of total asset value is held in the primary residence, 7.6% in secondary residence(s), 4.2% in residential investment properties, 2.6% in direct commercial and other property and 4.6% in indirect property investments.

HNWIs believe in the potential returns offered by residential property. They have the desire to increase their portfolio weighting in this sector from 42% to 45% on average. The increased weighting would take the form of additional investment properties for about 50% of HNWIs, and additional second homes for approximately 40% of HNWIs.

The biggest area of potential growth in property assets is indirect investments. The desire to gain exposure to commercial and residential property markets in locations such as Russia, Brazil, China and other key emerging markets is vast. For the HNWI the time involved in understanding the taxation and legal implications of direct ownership pushes them to consider the indirect route. We would expect to see the indirect property investment share of the HNWI portfolio grow from 4.6% to above 5% in the next 12 months.

In terms of their residential property portfolio, the ratio of debt to equity including the primary residence was 68% equity to 32% debt. There was an acceptance of higher debt to equity ratios on investment properties and second properties as compared to primary residences, which in 30% of cases were owned with 100% equity.

Property has always been a key part of the HNWI portfolio. In Europe, Ireland and UK, there is an enthusiasm for property. We would expect to see a very different portfolio if we looked at HNWIs from other countries.
Overview

Readers familiar with the UK, US, Irish or Australian residential markets will be surprised to hear that not all countries share a fascination, or an obsession even in the case of the UK, with property prices. Even in Europe with its mature property markets, gathering residential market data is hard, but is even more difficult for prime market data.

By comparing similar properties across all localities, the Knight Frank Prime International Residential Index provides a like-for-like analysis of capital values, rents and investment yields. Our analysis of the prime global housing market covers 70 locations distributed across Europe, the Caribbean, the Americas, Africa and Asia.

Our definition of prime markets is divided into four key location types, presented here with examples:

- **Cities:** Paris, London, Moscow
- **Sunbelt locations:** Cote d’Azur, Forte dei Marmi
- **Winter sport locations:** Courchevel, Verbier
- **Low tax jurisdictions:** Monaco, Andorra, Jersey

The global context

Reinforcing our theory that it is prime property that has outperformed in recent years, prices for the most expensive global property rose on average by more than 14%* in 2006 compared to a 9%** rise in the mainstream market.

Prime market price growth was led by city locations in Russia, China and India, where growth above 40% has not been unusual. These areas have seen high growth on the back of rapid economic development, together with the creation of new wealthy sections of society. This is leading to intense competition for the best apartments and villas in secure prime neighbourhoods.

The more mature markets tended to underperform average market growth. New York was hit by the wider US market slowdown, registering only limited growth during 2006 for prime property. Many of the slowest country and rural markets were also concentrated in established markets such as France and Italy. Such underperformance points to increasing supply in these markets. Value constraints have been hit after several years of very strong growth.

Despite a struggling US market, Caribbean property saw healthy capital price growth with prices on some islands rising by upwards of 20% in a year. The strength of the non-US markets in the Americas was also seen in Brazil, with Sao Paulo demonstrating a similar trend with capital prices in the best residential location growing by up to 12% during the year.

* Knight Frank Prime International Residential Index
** Knight Frank Global House Price Index
The demand for prime residential property in Moscow, Europe’s most populous city, pushed values up by an astonishing 75% in 2006.
London and Monaco fight for the top spot

Which is the most expensive city in the world? London, New York, Hong Kong or Tokyo? All claim the title. The difficulty is in the comparison. The Knight Frank Prime International Index attempts to solve this problem by using a property benchmark allowing for a fairer comparison location by location.

The result is that London has the title of most expensive city – by a whisker – just above Monaco at €35,000 per sq m. The list is crowned by the international markets. These are locations where international buyers make up a minimum of 20% of all purchases and 40% of the most expensive purchases. This domination by global locations reinforces our earlier contention that it is footloose HNWIs who are controlling the fortunes of the top of the market across the globe.

You need to travel to the middle of the list before you find markets that are not frequented by these globetrotting elites.

New contenders

In terms of price growth, the crucial players to watch are St Petersburg and Moscow (Russia) and Delhi and Mumbai (India). Together with Guangzhou and Beijing (China), we are in the presence of the future key prime cities.

We forecast that within 10 years, Moscow will vie with London for the most expensive city in the world. While the prime area of the city will be much smaller, the prices achievable for new build prime developments will be comparable. There is huge demand for prime property in Moscow owing to little existing stock and a very small potential pipeline of additional prime property.

Our future forecast also sees New York sliding from its number three position to number four, below Hong Kong. This reflects our belief that the Hong Kong market will recover from its current cyclical trough and see an improvement in demand and pricing after several years of underperformance.

Figure 17 Prime city values: price of prime property in urban locations

Source: Knight Frank Residential Research
Prime country property

Best country

With Monaco controversially defined as a city, the field is now open for St Jean Cap Ferrat (France) to be crowned the most expensive country or town prime market (£30,300 per sq m). While St Jean sits comfortably ahead of the field, some of the locations listed might have the non-jet set scratching their heads and asking - where?

Sunbelt and winter sport locations vie for top of table, with Courchevel (France) standing out in the Alps at €21,000 per sq m. The top 14 are all international second home locations, dominated by HNWIs who have the energy for skiing or yachting, while recuperating away from the office.

At 15 and 16 in the table we see the entry of the UK commuter locations, in this case locations in Surrey and Oxfordshire. These are the UK country equivalents of Belgravia and Knightsbridge.

Growth and decline

Some commuter locations in the UK have made it into the top of the prime market table. These locations have risen on the back of domestic and international demand, albeit following quite low growth in 2004 to 2005. There will be more growth in prime country locations in the UK in 2007 and 2008 (probably double digit growth) as more equity is taken out of the London market.

Flat price growth and the odd price fall have been seen in some markets, especially in France and Italy. These are areas where demand has matured and where growth has slowed, just as supply has been growing strongly. In both countries, we expect to see a revival of price growth over the next year to 18 months as demand growth begins to recover.

Forecast

We believe that the quest for exclusivity will see increasing purchase activity in locations much further afield. Brazil is a newly emerging location, which has seen a sharply higher profile in Europe and North America in recent years.

We would suggest that over the next two to three years several areas in eastern Europe will join the accepted range of prime European locations. Croatia will be one of the first markets to offer prime country locations and prices in some areas are already beginning to compete with France or Spain.

Figure 18 Prime country values: price of prime property in rural and smaller town locations

![Prime country values: price of prime property in rural and smaller town locations](source: Knight Frank Residential Research)
Italy’s Lake Como continues to attract wealthy second home owners, with prices now close to €6,000 per sq m.
Tax havens and domicile status

Tax is critical

Our survey revealed the importance that HNWIs place on taxation issues. The global nature of wealth creation and its mobility means that tax status has a crucial influence on choice of location for prime residence.

Non-domicile residency in the UK has become much more significant over recent years. The UK offers a very positive environment for foreign HNWIs and this is a significant factor that has underpinned the rise in residential prices at the top of the London market.

The non-domicile residents in the UK have a hugely positive view of the UK, especially central London and what we might term the London halo, the southern England prime country house market. London is seen as offering a good lifestyle, a friendly tax regime, open society and a can-do attitude similar to the US but different from the business environment perceived to exist in continental Europe.

Alternatives

The influence of tax status impacts significantly on residential market performance as in other markets, particularly the Offshore Financial Centres (OFC) in Europe and the Caribbean. Monaco is perhaps the most famous example. Many of its 33,000 residents are attracted by the very appealing tax status offered. Demand for residency and thus property has grown extraordinarily in recent years. With wealth in the financial sectors set to expand further, we expect prices to rise higher still.

A smaller and more affordable alternative to Monaco, Andorra has seen demand growth for Passive Residency Permits and again for property. Demand has pushed prices higher at a rate of 10% per annum for several years. While not explosive, this growth is healthy.

The Channel Islands offer additional alternatives for HNWIs looking to arrange their tax status. Demand is so strong that in Jersey long term residency is carefully controlled. With few exceptions, consent for residency is given to those who own a property on the island. The purchase of property is subject to consent, which is only given in a limited number of cases.

There are many other OFCs offering tax benefits to HNWIs. The impact on the residential market is fairly consistent. A friendly HWINI tax system means property prices will be higher than they ordinarily would be. The really big change is that price inflation in almost all OFCs has become more significant in recent years. We believe it will continue at a much higher rate than that seen in non-OFCs over the short and medium term.
Growth in wealth will underpin significant additional demand for prime residential property

Barring a significant economic shock, the growth of serious wealth will continue apace in the UK and in the global economy. The plutonomy economic model in the UK will be reinforced over the next few years. The growth of wealth will see increased demand for prime residential property across the board in primary and secondary homes and investments.

Prime property will outperform

Prime property prices in the UK will rise noticeably faster than the mainstream residential market in 2007. We expect to see a 12% increase in prime central London compared with 6% for the rest of the UK. The outlook for 2008 to 2010 is less certain, due to the high price level we are now seeing.

Prices in central London have risen by 38% in 18 months. If our forecast for 2007 is correct, they will have risen by 55% in three years. Prime country property in the UK will outperform the mainstream market from 2007 to 2009, as the London boom releases more equity for country bound homeowners.

Prime property globally will significantly outperform mainstream markets during 2007. Demand in prime markets will be underpinned by a growth in the wealthy population, the trend to more secondary homes and a greater willingness to treat residential property as an integral part of an asset class basket.

Price forecasts in the global market can be a foolhardy occupation. We venture to say that the prime market will see growth in 2007 at double the rate seen in the mainstream market – 10% compared to 5% would be a realistic guessimate. Growth rates in China, India, Russia and notably London will be half the rate seen in 2006.

Could it all go wrong?

Yes is the answer. It is always easy to feel confident when the market is strong. Property market commentators can fairly be accused of having very short memories. Such amnesia is not helped by the monthly release of sharply divergent market movement trackers. It is sobering to remember that it was only two years ago that the London market was still in the doldrums and a market meltdown for the UK, Australia and the US was being predicted.

The reversal in the fortunes of the mainstream and the prime markets is directly related to the strength of the world economy and the ongoing growth witnessed globally.

What would it take to knock the prime global residential market off track and see prices fall significantly?

The most obvious risks are economic recession, geo-political instability and terror attacks. The last two are so difficult, if not impossible, to predict that we can set them to one side as unknowns.

Economic recession prompted by higher inflation and higher interest rates, is probably the most significant and most likely of all the risks to the prime markets. The higher interest rate environment would place huge pressure on asset prices at all levels.

Inflationary led interest rate rises would unravel the basis for current asset values; the acceptability of current property yields is linked to the cost of money. If this rises, the value of property will fall. HNWIs are to some extent already insuring themselves against this eventuality, as their portfolios include significant use of hedging instruments.

What makes us confident about the prime market?

We have discussed at length the positive combination of world economic growth, the plutonomy model underpinning wealth expansion and concentration, and the increasing acceptance of residential property as an investment asset class. These are the key reasons for our confidence.

The availability of prime residential property is relatively fixed in comparison to demand. Such properties are assets for aspirational lifestyles. Their value is driven by an inequity in the market between the number of properties available in the locations where HNWIs want to buy.
Mass affluence will drive the HNWI to search harder for exclusivity

The same trends seen in luxury retailing are mirrored in the property market. Exclusive resorts and locations cease to be exclusive when the mass affluent begin to buy into them. Such mass affluence is viewed with concern, given the potential impact of congestion and over-popularity of locations. This is most evident in country locations (sunbelt and winter sport locations) where the desire for exclusivity is strong.

Views about prime city locations tend to be more egalitarian, at least on the surface. HNWIs describe London, New York and Paris as places to enjoy work and leisure. The social and work mix of these cities is described as offering ‘invigorating’ and ‘creative’ opportunities. This said, there is still a noticeable tendency to find locations that are unique, elite and different.

The desire to escape mass affluence will grow as this sector expands. The number of second homes in Europe has seen double digit growth every year for nine years. We expect the same rate of growth over the next decade.

Exclusivity will drive the demand for locations only served by private jet. Island locations will become ever more desirable. Formerly off-pitch locations will find new appeal, especially alternatives to the very popular sunbelt option. Northern Europe will see more interest, especially Ireland and Scandinavia.

Of UK households, 3% plan to buy a home abroad. There could well be a quadrupling of overseas second home ownership within the next 10 to 15 years. This is a huge increase. Add to this the impact of new Russian and Eastern European buyers, many of whom are only beginning to invest in these markets, and the growth could be higher. Assuming there is no significant backlash in the form of green taxes or regulations, this market is set to expand massively.

Unique property experiences

The importance of exclusivity has been a feature of the HNWI market for a long time. In a desire for experimental or unique experiences, the desire for traditional shooting and fishing estates is now being exceeded by more eclectic activities attached to either primary or secondary homes.

An example of individual exclusivity is the growing interest in properties with olive groves. An entire industry has grown to provide services to repair, prune and re-establish olive groves, allowing the owner to create bespoke unfiltered extra virgin olive oil. For many HNWIs, this is a more realistic and less time-intensive option, compared to the Herculean task of establishing a small vineyard.

The rise of the uber-development

In London, New York and Moscow developers have been pushing the envelope in terms of specification and construction quality. New projects in central city areas have seen an arms race by developers to up-spec their developments and keep ahead of the competition. A new market has been created, with record prices achieved, as clients find needs they never thought they had being provided for.

Tax havens to grow in popularity

There is aggressive positioning by governments against tax havens. Tax lawyers and accountants remain convinced that the ability of legislators in Europe and the US to stop tax havens from operating in the manner in which they do is limited.

We expect demand for property in tax havens to grow exponentially over the short to medium term. Demand coming out of the UK for property in Monaco and the Channel Islands will expand steadily and will underpin prices. These locations will outperform steadily in the future.

No end in sight

Without a catastrophic economic or geo-political event, there will be no halt to the large-scale wealth creation we have seen in recent decades. The positive impact of HNWIs on prime residential property is undeniable and our data strongly indicates that these markets will continue to outperform.

The rise of plutonomies and the class of HNWIs they have created means that an increasing number of investors and institutional funds will have no option but to ‘follow the money’. This mantra is too true to be ignored.