WHO OWNS THE CITY 2001?
An Examination of Office Ownership in the City Of London

A RESEARCH PROJECT FUNDED BY DEVELOPMENT SECURITIES

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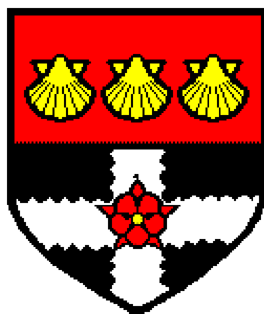
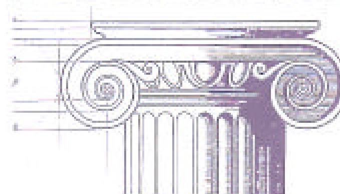




Executive Summary

- *This report examines ownership and occupation patterns in the City of London office market, updating the 1998 study "*Who Owns the City?*" The University of Reading's City offices database has been updated and new analyses of the EGi London Office database commissioned.*

- *The period 1998-2001 was characterised by economic uncertainty in the City and global financial markets. Despite this, the City office market performed strongly with relatively low supply increases leading to rising rents. Demand was more volatile but overall, the vacancy rate declined.*

- *Property investment activity was similarly volatile. Between 1998 and 2000 City office acquisitions totalled £8billion with 30% of that sum coming from non-UK sources even excluding portfolio transactions. The market itself changed with considerable use of new investment vehicles, many offshore, and the growth of an asset-backed securitisation market.*

- *The existence of new investment vehicles, the growth of securitisation and the creation of new forms of occupation and delivery of office services demonstrates that the City office market is robust and flexible in dealing with a changing business environment. Sustained levels of investment suggest that the market was able to absorb the Stamp Duty shock, for example.*

- *Market changes make it much harder to define the nationality of ownership of properties In 2000, over a fifth of all investment took place through international (pooled) vehicles and offshore special purpose vehicles. New vehicles permit division of ownership between different nationalities and between private and institutional investors.*

- *There has been a major increase in foreign ownership since the previous study. The 1998 report suggested that a quarter of the City's offices had non-UK owners. The Reading database now suggests that over a third of offices in the City have overseas owners or are held in international vehicles. The trend of rapid growth in foreign ownership, observed from the early 1990s, has continued.*

- *The volume of transactions has increased sharply in the 1998-2991 period. Part if the increase is attributable to market restructuring (e.g. break up of the portfolios of listed property companies taken private) but, overall, the increase reflects increasing depth and liquidity in the City office market.*

- *Ownership by Finance, Insurance and Real Estate (FIRE) companies has increased markedly since the last report, largely at the expense of traditional owners. Between 80% and 90% of office space is owned by the FIRE sector. This has been accompanied by a fall in owner occupation as firms seek to shed corporate real estate.*

- *FIRE firms occupied 70% of the space in the core City, with a further 24% occupied by associated business, professional and information services. 47% of fringe space is occupied by the FIRE sector, 39% by business services companies. This continues the trend towards functional specification in the City, non-finance related firms continuing to move away. 43% of space in the City core was occupied by overseas firms – who also occupied some 3million square feet of space in Canary Wharf.*

- *The 2001 findings confirm many of the hypotheses of the 1998 report:*

  - *there has been a further increase in international ownership and occupation;*
  - *new investment vehicles have encouraged further foreign investment in the City office market;*
  - *market changes and new ownership patterns have contributed to volatility in both occupation and investment markets;*
  - *information technology has changed the use of space without damaging the advantages of the City as a business location;*
  - *new forms of occupation and leasing have emerged that enhance the flexibility of the City office market.*

- *The findings raise three key issues:*

  - *enhanced by the strength of the market and by new vehicles, the volume of transactions and rapid turnover have provided greater market **liquidity**. The is important in encouraging investment due to the ease of market entry and exit. The high level of transactions improve market transparency by ensuring a flow of deal information;*
  - ***globalisation** has continued in both ownership and occupation. The flow of international capital is a signal of confidence in the City's continuing status and assists in maintaining the quality of the office stock;*
  - *the strength of the City lies in the depth and strength of its financial markets promoting agglomeration and information economies. However, the growing functional specialisation is a source of **risk** as well as a strength. The intertwining of occupation, ownership and finance of real estate in the City ties the market to the global financial cyclic and creates the danger of a downward spiral in the event of a sustained international financial markets recession.*

Contents

Executive Summary i

Contents iii

1. Introduction 1

2. The City Market 1998-2001-09-06 3

3. Ownership Change 1998-2001 7
    3.1 Data and Methods 7
    3.2 Evidence from the University of Reading Database 8
    3.3 Change on the London Office Database 14

4. Implications of the Changes 21
    4.1 Changes since *Who Owns the City* 21
    4.2 Globalisation, Liquidity and Risk in the Market 24

5. Conclusions 28

Bibliography 33

Acknowledgements 35

1. Introduction

This report updates the 1998 study of office ownership "*Who Owns the City*" (Baum *et al.* 1998; Lizieri, Baum & Scott, 2000). Research funding from Development Securities has enabled us to investigate changes in the City Market over the last three years. The University of Reading database has been updated and improved; a series of special tabulations have been created from the London Office database, now maintained by Estates Gazette interactive (EGi); and we have analysed market data and reports over the period. The research draws additional insights from Reading research on the City, including the model of the City office market (Blake *et al.* 2000) and a study for the Corporation of London on innovations in real estate finance (Lizieri *et al.* 2001).

The Who Owns the City report for Development Securities highlighted the growing internationalisation of the City office market both in terms of owners and occupiers. At the end of 1997, around 20% of office space in the City of London was owned by non-UK firms, with German, Japanese and American investors between them owning over 15% of the City's floorspace. At the same time, around a third of City space was occupied by non-UK firms. The report showed that foreign ownership increased rapidly after the financial deregulation of the mid-1980s, levelled in the early 1990s in the aftermath of the property crash but then accelerated again after 1995. These figures emphasise the global nature of the City.

The previous report also highlighted the increasing functional specialisation of the City of London. Finance, Insurance and Real Estate (FIRE) companies owned over 80% of the office space in the traditional City core and over 70% of the space in the fringe areas of the City. This specialisation is mirrored in the occupational market with 61% of space occupied by FIRE sector firms and a further 27% by business and professional service firms that, typically, service the City's financial industry. Over half the office space in the core City was shown to be simultaneously occupied and owned by FIRE companies. This undiversified structure, while resulting from the major benefits and attractions of London as a location for investment and for international financial activity, represents a potential source of risk in adverse market conditions.

Anecdotal evidence suggests that this pattern of internationalisation has continued, albeit unevenly, over the 1998-2001 period. Some countries, driven by domestic difficulties (for example Japan and other Asian economies) or changing investment priorities and concerns about the sustainability of sterling levels (Germany perhaps) may have reduced their holdings; others have become more active (Irish and Middle East investors). However, a more significant change may be a change in the characteristics of investment.

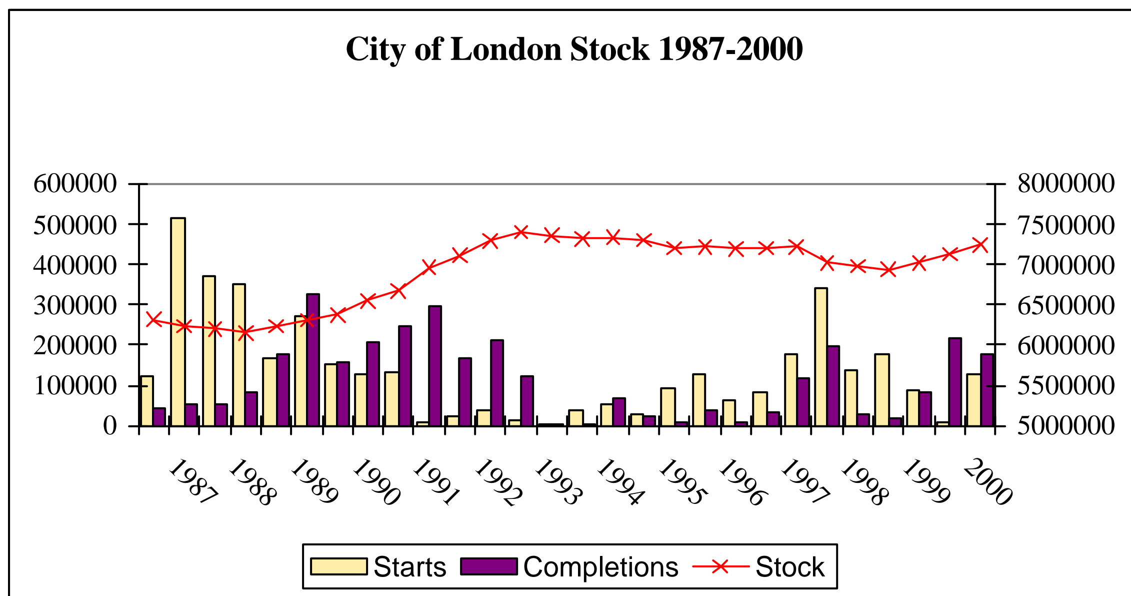
The period saw a number of property companies withdraw from the stock market and, in some instances, liquidate their holdings. The range of property vehicles changed, too. In particular, far greater use was made of Limited Partnerships and trust structures, including a number that were offshore vehicles. It is this that has lead to an increase in non-UK ownership. Major asset-backed securitisations took place – notably British Land's £1.54billion securitisation of rents from the Broadgate development in the City. In the financial markets, the period has been marked by uncertainty. At the start, there were fears of "financial meltdown" with the Asian currency and Russian debt crises; by the end concerns that the American economic slowdown might trigger a global recession. It is within this context that we investigate office ownership in the City.

In the next section, we examine evidence of change in the City of London office market over the period, relating that change to the performance of the financial markets. Next we provide empirical evidence of the change in ownership between 1998 and 2001, drawing on analysis of Reading's sample City office ownership database and the EGi London office database. We then examine some implications of the changes discovered for the strength and stability of the City office market. Finally, we draw some broad conclusions about the City and its future.

2. The City Market 1998-2001

For much of the period, the City of London office market performed strongly, with limited new construction and sustained demand pushing real rents back towards their pre-crash levels. Over the period, a modest property cycle can be observed. However, consistent with Barras's model of the London office market, the memories of the 1990 crash have dampened the cycle. Caution on the part of lenders and developers limited the amount of speculative construction; thus the impact of new supply relates largely to space released by firms moving to new accommodation. Contractual and logistic arrangements means that this space is released more gradually into the market, easing adjustment problems.

Figure 2.1 Office Stock Change 1987-2000



Source: Adapted from Corporation of London data

Demand for space has been sustained but more volatile. Financial services demand for space in the City core continued throughout the period, with mergers and acquisitions activity producing changes to requirements. However, demand has been affected by market sentiment – initially fears surrounding the Russian debt crisis and the turmoil in Asian markets (the results of which proved more transitory and less deep than feared at the time) and, more recently, over the slowdown in the US economy, continuing problems in Japan and, hence, concerns over a global recession. In the fringes of the City, much demand came from new economy stocks – particularly information technology and media companies. This absorbed much of the available smaller and secondary space (including space vacated by financial services firms consolidating operations or moving to purpose-built offices). However, the bursting of the dot.com bubble dampened demand from this source. This strong but unstable demand affected both rents and market sentiment, which, in turn, had an impact on investment yields.

It should be noted that delays in reporting official employment statistics make it difficult to present a definitive picture of aggregate demand in the City. For example, recent revisions to 1998 data suggest that employment growth was far stronger than market reports suggested at the time.

Figure 2.2 Take Up, Availability, Vacancy and Rental Rates

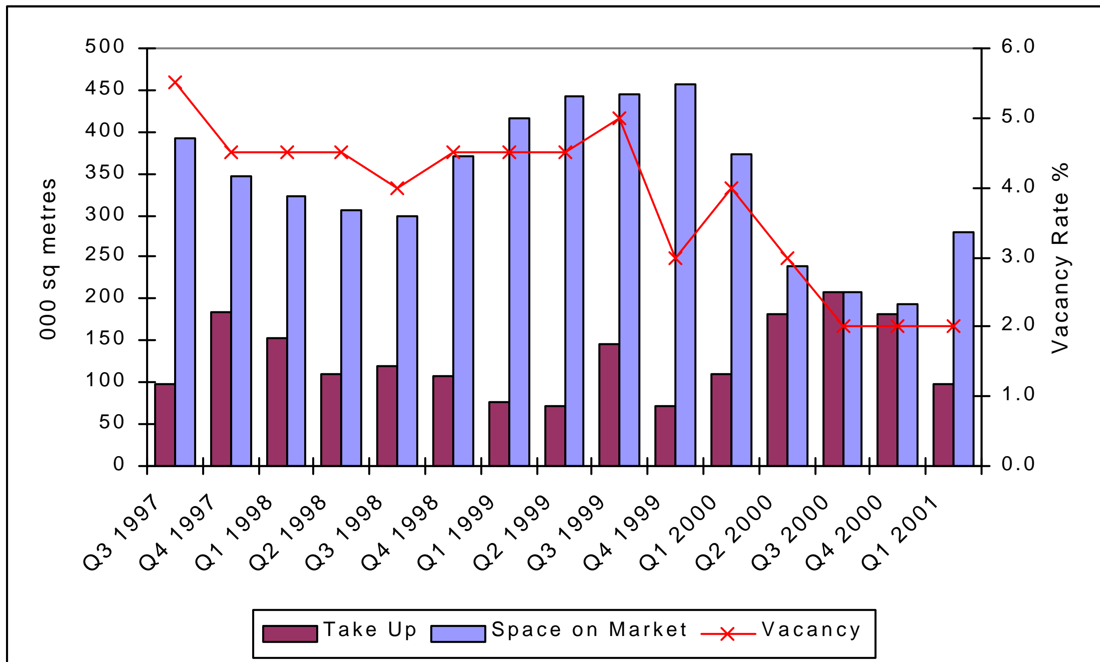
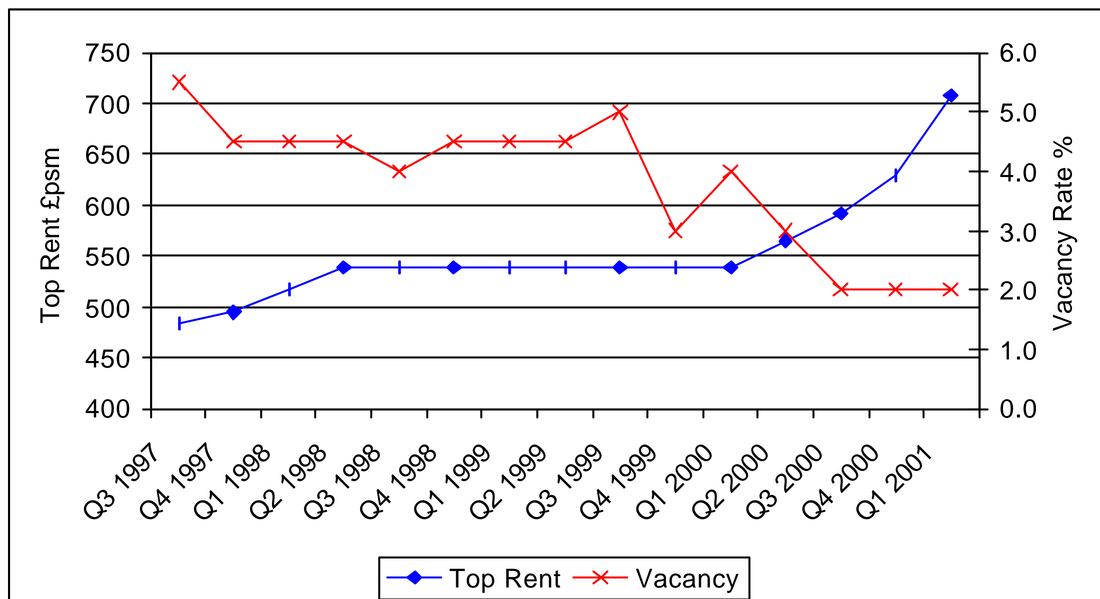


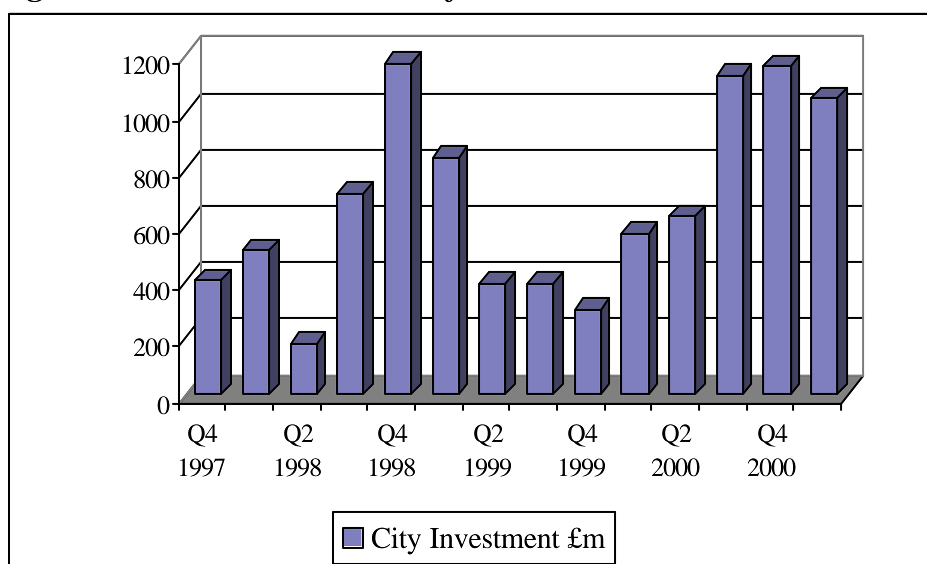
Figure 2.3 Rents and Vacancy Rates, City of London



Source: Adapted from Insignia Richard Ellis / CB Hillier Parker data by authors

The general uncertainty that characterises the period can be seen in the very volatile pattern of investment (see Figure 2.4) in the City office market over the period which, by quarter, varied between a low of £182million (Q2 1998) and highs of nearly £1.2billion (Q4 1998 and Q4 2000). Of the approximately £8billion office acquisitions in the City between 1998 and 2000 approximately 31% was from non-UK sources. This figure excludes portfolio acquisitions (for example Leconport's acquisition of the MEPC portfolio and the disposal of the Wates City of London office portfolio by Pillar) but also contains sales from foreign owners to other nationalities.

Figure 2.4 Investment in the City Office Market 1997-2001

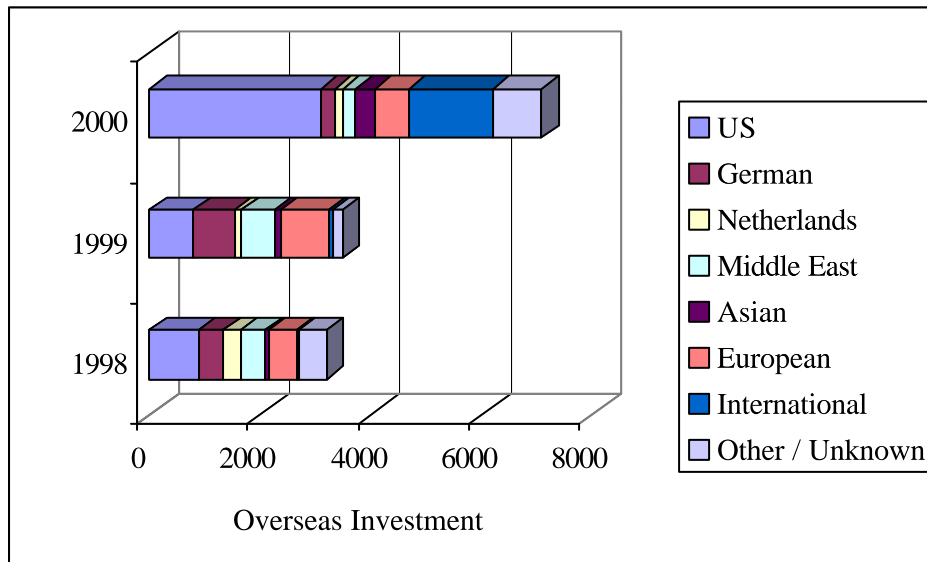


Source: adapted from DTZ/IRE data

Changes in the structure of the market since 1998 make investment figures much harder to interpret than in the past. In that period, investors (including many non-UK investors) took controlling interests in listed property companies and acquired portfolios from property companies that were liquidating assets or going private in the face of persistent and large discounts to net asset value. At the same time, growing use was made of Limited Partnership arrangements to spread investment across different owners and to produce a (relatively) tax-efficient vehicle for so doing. It has been suggested that there are now over 100 limited partnerships with investment in excess of £12billion (OPC/University of Reading 2001). Offshore vehicles have appeared, including offshore property unit trusts (such as the transfer of the Wates City portfolio to the offshore CLOUT) and similar special purpose vehicles. This can be seen in Figure 2.5, showing overseas investment in UK property. There was a dramatic jump between 1998 and 2000 from £3.2billion (historically well above average) to over £7billion. Part of this jump can be attributed to GE Capital and Westfield's shared in the Leconport vehicle to acquire the MEPC portfolio (some of this portfolio has now been sold on).

However, over a fifth of international investment in commercial property in 2000 was through international vehicles - £1.5billion compared to just £99million the previous year. Such vehicles make it much harder to identify who are the beneficial owners of a property. DTZ's figures suggest that City offices were still the most popular sector/location for investment after accounting for portfolio acquisitions.

Figure 2.5 Overseas Investment in UK Commercial Property



Source: DTZ (various)

It should be noted that these investment figures only account for acquisitions. The £13.8billion of non-UK purchases between 1998 and 2001 must be offset by the £6.7billion of sales in the period. A number of countries were net sellers in 2000: notably the German funds (£245million purchases, £370million sales) but also the Japanese and Swedes. Nearly a quarter of all sales were to other foreign nationals, a feature very evident in the City market.

While the very high level of overseas investment activity in 2000 can be seen as an aberration or blip, reflecting the move to take a number of listed property companies private, the amount of overseas investment in 1998 and 1999 (high by historic standards) at a time of dampened investment sentiment and uncertainty in global capital markets indicates sustained interest in the UK property market in general and the City office market in particular. The volume of deals (and the number of transactions) implies a deep market, a market with considerable liquidity.

3. Ownership Change 1998-2001

3.1 Data and Methods

As with the previous study, analyses were run using two sources: the University of Reading sample database of City offices and the EGi London Office database. The London Office database is now maintained exclusively by Estates Gazette interactive, with Chesterton no longer involved. There appear to be some discontinuities between the 1997 and 2001 results that cannot be fully explained by market changes. As a result, the two analyses cannot be considered to be completely compatible. The total space recorded on the database, some 9,500,000[1] square metres, is 40% higher than at the end of 1998. The bulk of this increase is in the City fringe. Over the same period, the total office stock of the City of London has increased by less than 5%. This expanded coverage may result in compositional changes (for example, it may indicate an expansion of the information held on smaller buildings, which may exhibit different patterns of ownership). Other results suggest that the way information is collected and recorded may have changed. They argue that the current figures are a more accurate reflection of the market than in 1998, thanks to improved and more comprehensive coverage. EGi estimate that their coverage is around 88% in the core of the City and around 41% in the Fringe. They note that they have great difficulty in obtaining ownership details for small fringe properties.

As in 1998, ownership and occupation figures for 2001 were analysed separately for the City Core and City Fringe. Information was collected on the country of origin of the owner, the type of business of the owner and the country and business of occupiers, where available. In the new analysis, data on owner-occupied and investment properties is not completely compatible (since occupier and ownership data are held on separate tables). However, it was possible to cross-tabulate aggregate ownership and occupation data.

While we can utilise the EGi data collection methods and definitions for aggregate analysis, the update of the University of Reading database allows more control over the definition of variables. Our analysis of the period since the publication of *Who Owns the City* raised a number of issues. The first concerns ownership interests. As in 1998, we sought to define beneficial ownership where a freeholder had granted a long lease – defined, at thirty years or more, as longer than a conventional institutional lease. However, it is clear that many of the ground leases granted in the City provide a profit interest for the freeholder – either in the form of a market-linked rent review or a contractual profit share. We were able to investigate this in more detail than in the previous analysis and sought to apportion ownership in line with the interests in the rental cashflow.

[1] 102million square feet. Corporation of London figures suggest that the Square Mile has a total stock of around 77million square feet, around the same as the LOD Core City figure.

This means that the results from the earlier study are not completely compatible with those presented here. We did not have the resources to backdate this analysis fully beyond 1997.

Given the focus of the research, the issue of nationality of ownership is vital. We attempted to reflect the changing nature of ownership (discussed above) in the database. In particular, we sought to identify the effective ownership of firms, rather than simply rely on the nominal place of registration. This has important implications given the large number of mergers and acquisitions in the financial service industry and the changing nature of property companies. In the latter case, where a property company had been taken private or an overseas firm had clearly acquired a controlling stake, we redefined nationality.

In addition, we created a new nationality category -"international" – to accommodate the growth in special purpose vehicles that collect capital from disparate national sources to invest directly in real estate. Offshore vehicles (for example Jersey property trusts) were clearly international in nature. For UK limited partnerships and joint ventures, we split ownership between participants where the structure was simple but defined them as international where there were many partners of differing nationalities and levels of participation. We suspect that the London Office Database figures may considerably understate the extent of non-UK ownership by failing to account for such new investment vehicles and for the portfolio acquisition of property companies by foreign investors individually or in consortia. EGi classify international vehicles as "other" or "unknown" or as UK where there are a large number of domestic investors in the vehicle.

We are unable to deal with the additional complexities posed by securitisation of assets. If asset backed securitisations are treated as simply a way of raising debt capital, then there is no transfer of ownership. However, the complex structures of deals such as the securitisation of Broadgate offices by British Land (involving a web of subsidiary companies, trustees holding mortgages in the interests of bond and note holders and guarantors) raise questions about beneficial ownership, control of assets and corporate structure. While this is outwith the scope of the present project, it illustrates the changing terrain of commercial property market investment.

3.2 Evidence from the University of Reading Database

The University of Reading sample database on office ownership in the City of London consists of 128 properties with a total floor area of around 10.3 million square feet (960,000 square metres). This represents around 14% of the stock in the core City market. The size of the individual properties in the database ranges from just 2,500 square feet to 810,000 square feet (23 to 75,250 square metres).

The range of building types, their micro location and the overall size of the sample relative to total floorstock gives some measure of confidence that the results obtained should be representative of the City office market as a whole.

For each property, data was collected on size, age and ownership, with owners being classified by nationality and type of business. Initial data was collected from on-line sources including EGi and Focus. This provided information on current ownership and on recent transactions. Additional information was collected based on interviews, examination of the records of a number of commercial agents, consultants and fund managers and, where necessary, telephone calls to owners and occupiers. Wherever feasible, the data was cross-checked from multiple sources. Care was taken to check information which appeared contradictory. The historic database is thus based on detailed research which produces more accurate data than aggregate sources such as the London office database and permits analysis of change over time. Data has been collected back to 1972, although information from the earlier years is somewhat less reliable that that from 1980 onwards.

A series of working definitions are required in compiling the database. First, ownership is defined as freehold (fee simple) ownership except where there existed a long leasehold interest (30 years or more) with a ground rent that was either small as a proportion of the rack rent or unrelated to market rents. A number of properties (and sites) remain in the freehold of their historic owner (for example a worshipful company) but are let on long leases to developers or investors: in these cases, beneficial ownership has been defined as resting with the long leaseholder. This task has become more complex with the growth in use of development leases that incorporate some profit sharing element. Where we had sufficient details, we apportioned ownership in such cases. It became evident that there were some anomalies in the London Office Database, for example where ownership was shown as being held by a long leaseholder where there was only a minimal beneficial interest or, alternatively, where the freeholder had retained a profit interest but was not given ownership status. Where a property had multiple owners, an attempt was made to ascertain the proportion held by each party. Where this information was unobtainable, equal weighting by floorspace was assumed. This shows the advantage of the detailed sample-based approach in complex situations.

Firms were classified as non-UK where they were incorporated in another country or where they were wholly or in the majority owned and controlled by overseas interests. In this latter case, detailed research and consultation with market actors was necessary. For listed companies, it is possible that a majority of shares may be held in overseas ownership - some 20% of UK listed shares are foreign-owned. However, there were insufficient resources to check on major shareholders of all the listed companies owning property.

As noted above, large shareholdings do not necessarily give rise to control of decision-making. Where a property company was taken private, we examined the ownership patterns of the acquiring vehicle. Where a special purpose vehicle had been created (such as a limited partnership) we apportioned ownership between the parties according to capital inputs where these were available. In the financial and institutional investor sectors, merger and acquisition activity can result in a transfer of the nationality of ownership. Such changes were recorded on the database. One major change over the previous analysis was the creation of a generic "international" category. This was necessary because of the growth of off-shore special purpose vehicles and pooled vehicles drawing in funds from disparate sources and nationalities and more complex joint venture and limited partnership arrangements and the existence of firms that are truly multi-national in nature with no single head office or home base. These changes reflect the growing globalisation of business and are discussed further below.

The type of organisation owning the property was also recorded, using a categorisation compatible with that used by Chesterton/EGi but including a separate category for pension funds. As with nationality, the classification is not simple to implement with many firms having a core business but many peripheral interests. In particular, the distinction between sub-sectors of the financial services industry is increasingly blurred through consolidation, mergers and acquisitions, with retail and investment banks acquiring insurance companies and pension funds – and vice versa. In general, we classified according to core business. One key decision concerns the classification of the German open ended funds. These are financial institutions and yet their activities in London are dominated by real estate acquisition. In view of this, and consistent with the definitions employed in the previous study, we have classified them as property-related. Given the importance of the German open ended funds in the City office investment market in the 1990s, this should be borne in mind in examining sub-sectors within the wide FIRE classification.

Figure 3.1 shows our estimates of the nationality of ownership of City offices on the database at the end of 1997, the end of 2000 and as at June 2001. The 1997 figure has been re-estimated, compared to the previous report and suggests a higher percentage of non-UK ownership. This relates largely to more detailed evidence on the balance of interests between freeholders and long leaseholders and on further investigation of the ownership of UK-registered companies. We include the 2000 and 2001 figures to illustrate an important trend: the increasingly rapid turnover of offices in the City market. Thus the 2000 figures show a dramatic fall in UK ownership, largely through the sale of property company portfolios to special purpose vehicles with international ownership. The subsequent sale of elements of those properties – often to UK institutions or UK –registered investment funds – has then led to an increase in UK ownership.

Nonetheless, the figures from the Reading database suggest that over a third of City offices are effectively owned and controlled by non-UK firms and individuals compared to the 25% figure in the earlier report.

Figure 3.1: Nationality of Ownership: Change 1997:2001

	2001	2000	1997
UK	62.0%	53.4%	65.0%
Japan	5.8%	10.9%	11.3%
Germany	2.7%	2.7%	2.7%
USA	1.9%	2.0%	3.2%
Middle East	3.0%	3.0%	2.9%
Australia	2.1%	0.4%	1.3%
Other Europe	5.2%	4.9%	3.4%
Far East	0.0%	0.4%	0.2%
International	9.1%	14.1%	3.1%
Other	8.3%	8.3%	7.0%
Total	100.0%	100.0%	100.0%

The longer term change in nationality of ownership is shown in Figure 3.2, which resembles the contours of a Tour de France mountain stage. After a long period of stability across the 1970s and 1980s (where foreign ownership was largely confined to owner occupation), non-UK investors increase their holdings after financial deregulation in the second half of the 1980s. Growth is more gradual in the immediate aftermath of the property crash but accelerates rapidly in the late 1990s. As can be seen, the major source of growth from 1997 is international special purpose vehicles rather than individual national ownership, the rise in German investment having stabilised as the open ended funds face competition for savings in their domestic markets.

Figure 3.2 Historic Change in Nationality of Ownerships

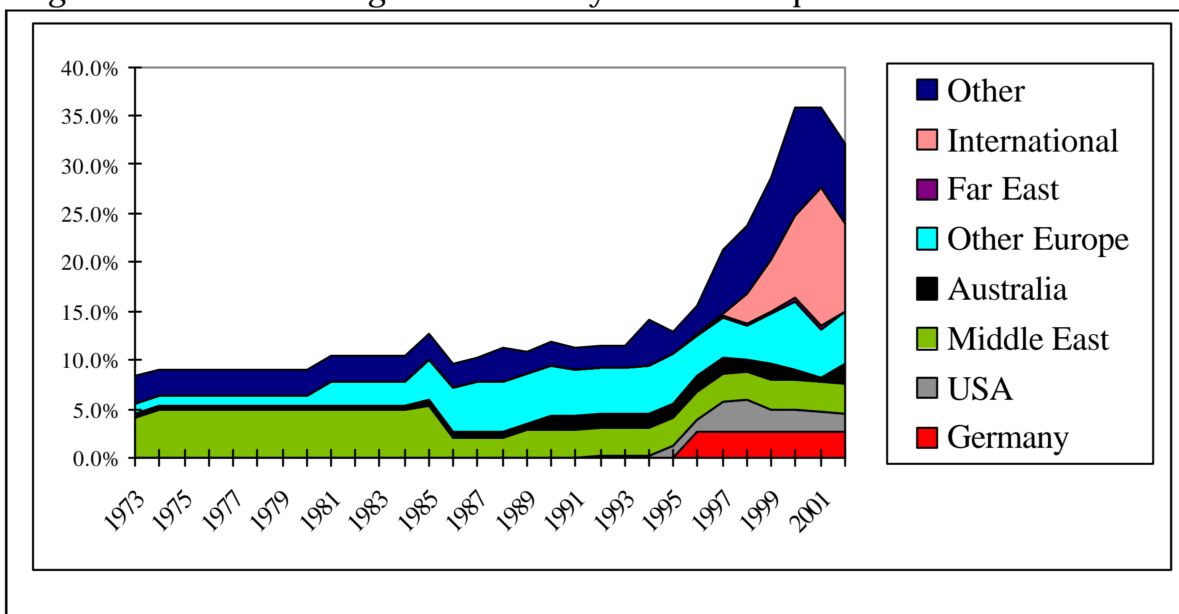


Figure 3.3: City Office Market Transactions 1980-2000

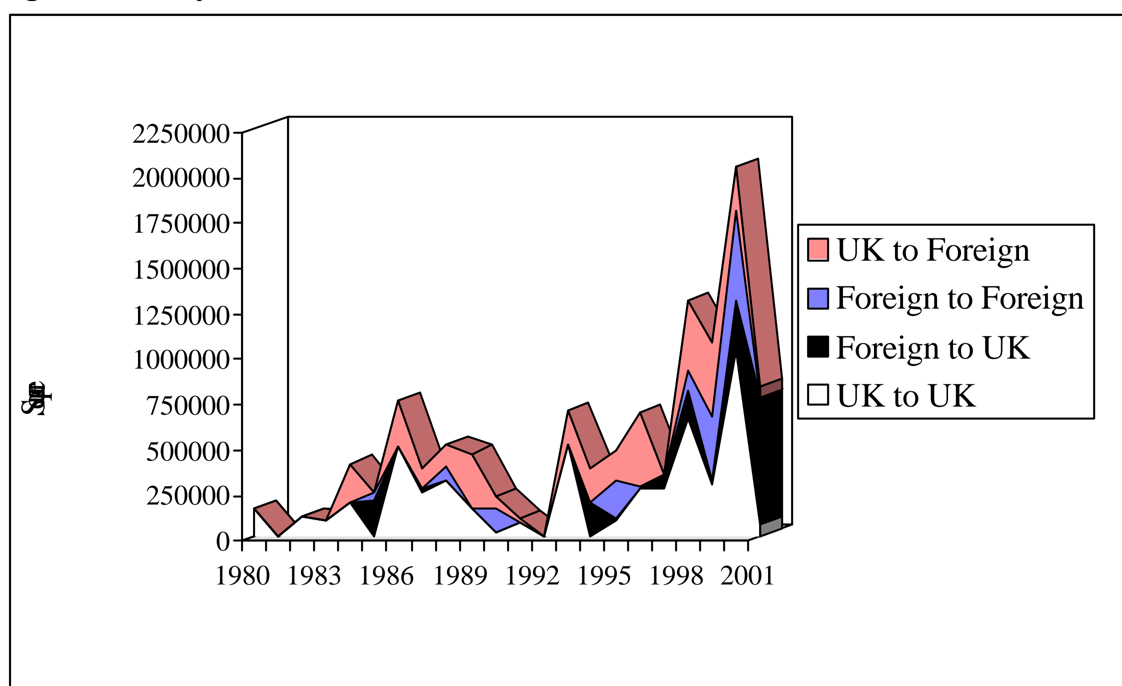


Figure 3.3 provides further evidence of the increase in turnover in the market. Turnover in the database increased from an average of 1.1million square feet in the 1980s to 2.1million square feet in the 1990s (some 20% of the database changing hands in any one year) to 5.4million square feet in 2000 and a comparable amount in 2001. Some buildings changed hands three times in a year. To some extent this can be explained as a structural shift in ownership in the City (away from traditional listed property investment companies) with international funds facilitating the change. However, the upward trend both emphasises the liquidity of the City market and indicates that owners have shorter holding periods and are managing their property portfolios in a much more active manner than in the traditional model.

It is noticeable from Figure 3.3 (confirming the earlier market commentary) that there are many cross-sales from one foreign owner to another, and that UK owners acquire property from foreign owners and vice-versa. Thus, foreign acquisition activity is a poor indicator of the change in non-UK ownership of City offices. It is important to focus on the *net* investment and account for disposals as well as purchases. This is particularly important as turnover rates increase and portfolio acquisitions are broken up and sold on.

In the very early years of the database, foreign owners tended, on average, to hold larger buildings than UK owners – as there were just a small number of buildings in overseas ownership. This reversed as the proportion of non-UK owners increased across the 1980s and 1990s; by the mid 1990s, the average foreign office was around 75% of the floor area of the average UK-owned property. This position has now reversed: since the late 1990s, the average size of foreign-owned offices has been larger than that of UK firms.

This reflects both greater international activity and the development of investment vehicles which, by allowing tax-efficient co-ownership, permit investors to acquire large lot size property without incurring high levels of property-specific risk. This demonstrates the City's ability both to handle large transactions and to meet foreign space requirements.

Figure 3.4: Size of Buildings Owned By Non-UK Firms

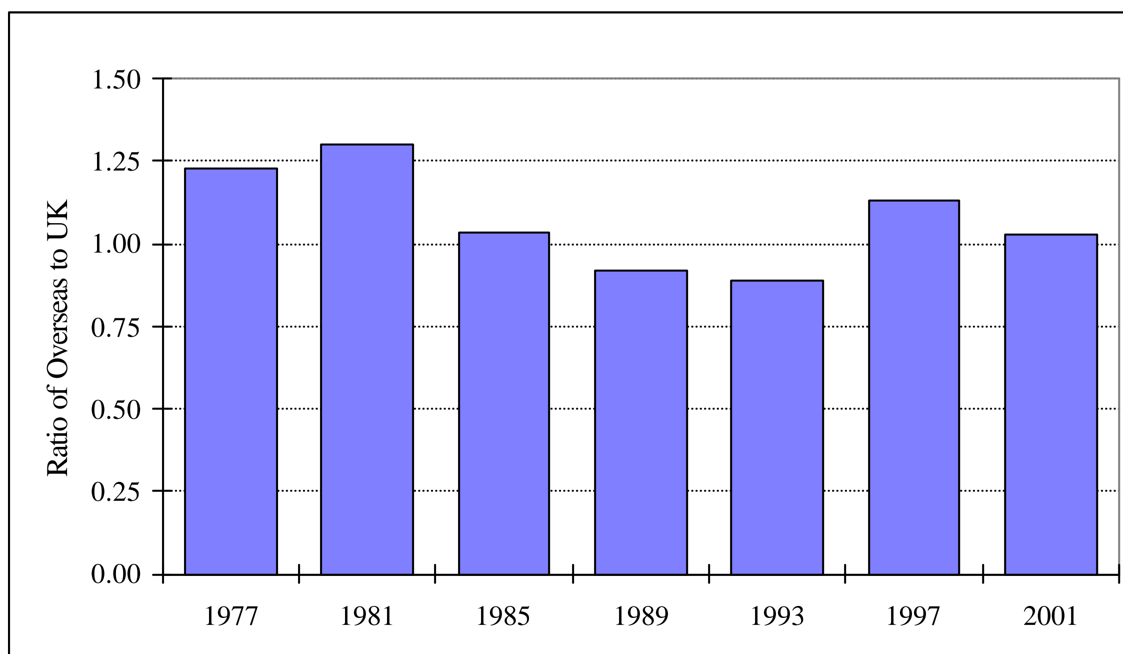


Figure 3.5: Ownership By Business Sector, 1997-2001

Sector:	1997	1998	1999	2000	2001
Insurance	24.0%	27.6%	25.5%	29.9%	31.5%
Pension Fund	3.0%	10.0%	9.8%	4.6%	4.7%
Property/Constr	28.8%	35.2%	38.9%	39.4%	36.0%
Finance	13.2%	18.1%	18.4%	19.9%	20.3%
Bus & Prof Services	0.4%	0.3%	0.3%	0.3%	0.3%
Conglom/Indust	2.8%	4.1%	3.7%	3.7%	4.0%
Other	1.2%	0.0%	0.0%	0.0%	0.4%
Public & Charitable	26.5%	4.7%	3.5%	2.2%	2.8%
All FIRE	69.0%	90.9%	92.6%	93.8%	92.5%

The sample database reveals a sharp increase in FIRE ownership in the City office market since 1997, largely at the expense of the "public and charitable" group which includes, in addition to the Corporation and other governmental owners, the Worshipful Companies and City guilds. This change is only part explained by a reclassification of ownership following more detailed analysis of long leasehold interests (which has led to a higher figure of FIRE ownership than shown on the EGi London database).

It represents a broader trend towards concentration of ownership in the City with financial, insurance and real estate sectors dominating ownership to the exclusion of all other sectors. As noted in *Who Owns the City,* this is a comparatively recent trend, with the City no longer accommodating non-financial headquarters functions or owner-occupied buildings from other industrial sectors. The Reading sample database shows little increase in ownership by business and professional service companies, despite their importance in occupational take-up, particularly in the City fringes. As noted below, the London Office Database presents a similar picture for the Core, although it shows an owner-occupied presence by new economy firms in the Fringe area - the total amount of space this represents is comparatively small.

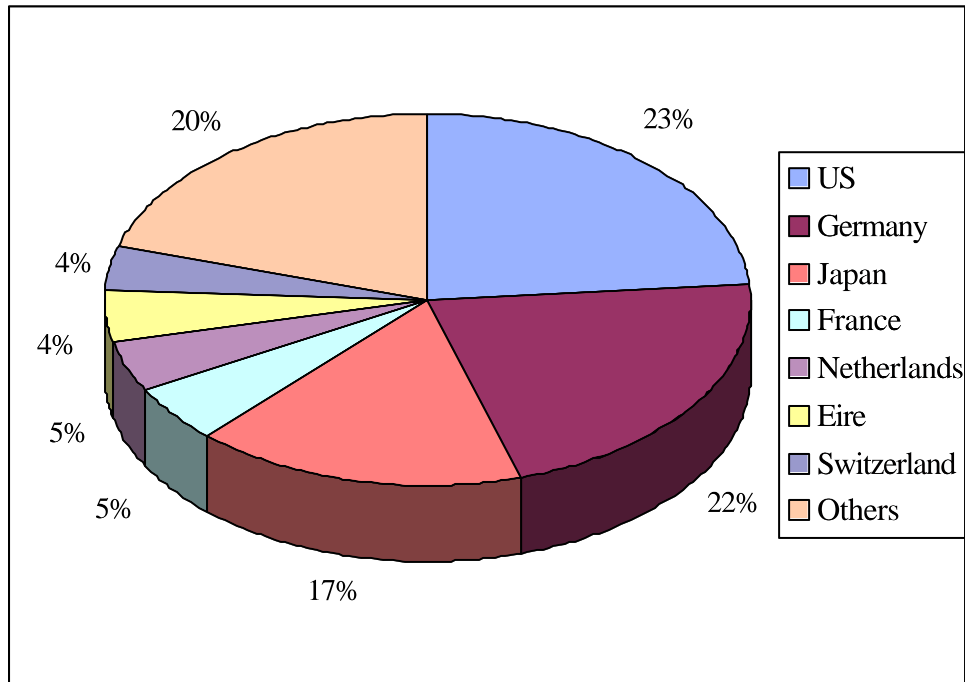
3.3 Ownership and Occupation Change on the London Office Database

The EGi London Office database figures suggest that around 20% of office space is owned by non-UK firms and individuals. This represents around 1.8million square metres (19.4million square feet) of office space, including 1.4million square metres in the City core. Applying the proportion of foreign ownership to the Corporation of London's estimate of City stock and using very conservative assumptions, these figures suggest that non-UK firms own City offices with a value of at least £6billion These figures, in contrast to the findings of the Reading database, suggest that there has been no substantial increase in foreign ownership in the City between 1997 and 2001. The combined figure is identical to that found in the 1998 study. This result is counter-intuitive given evidence of continued non-UK investment in the City over the period. It is possible to explain part of the discrepancy in terms of cross-selling (foreign owners selling to other foreign owners) and in terms of rationalisation amongst non-UK owner-occupiers perhaps following mergers in the financial service sector. However, a more plausible explanation might be that the London Office Database does not fully account for the changing nature of ownership and, in particular, the growth of international investment vehicles. As noted above, ownership issues are complex: the more detailed research at individual property level that is possible using the sample database has advantages over the broader brush aggregate approach adopted (of necessity) by EGi.

Figure 3.6 displays the non-UK ownership of core City offices. As in the Reading sample database, three countries dominate: the United States, Germany and Japan. These figures suggest a decline in Japanese ownership and a sharp rise in US ownership since the previous study. In other respects, the results are very similar to those of 1997, other than the appearance of Irish investors. In part, this may relate to a broadening of the London Office Database coverage to include smaller office buildings, in part it reflects at outflow of capital from the rapidly growing, and possibly overheating Irish economy.

Non-UK ownership in the Fringe is dominated by Germany (39% of the foreign total) with US (17% of non-UK), French (11%) and Swedish (7%) owners having the only other significant presence. In the earlier analysis, German owners held less than a quarter of the non-UK Fringe stock.

Figure 3.6: Overseas Ownership, City Core, 2001



Source: EGi London Office Database: special tabulations, authors' calculations

Figure 3.7 shows nationality of occupiers in the City. Occupation is more international in nature, with some 40% of space occupied by non-UK firms, with US-based firms having by far the largest share of non-British occupation. By contrast to the ownership figures, foreign occupation is more strongly concentrated in traditional core City locations. The share of non-UK occupation in the core appears to have risen sharply between 1997 and 2001, mostly accounted for by growth in US occupiers. Some of this change may relate to composition changes on the database, but much will be linked to mergers and acquisition activity over the period, confirming the international nature of the City. There has been a very slight increase in the proportion of occupiers letting properties from an owner with another nationality but nearly two thirds of occupiers have owners from the same nation state.

Figure 3.7: Nationality of Occupiers (where known), City of London 2001

	UK	US	German	Other Europe	Japan	Other
Core	57.4%	20.2%	6.9%	6.1%	3.7%	5.7%
Fringe	78.5%	16.8%	0.3%	2.0%	0.4%	2.0%
Combined	61.6%	19.5%	5.6%	5.3%	3.1%	4.9%

Source: EGi London Office Database: special tabulations, authors' calculations

Figure 3.8, Ownership by Business Sector, 2001

SECTOR	CORE	FRINGE	COMBINED
Property Development / Investment	47.5%	54.2%	49.2%
Financial Service	19.5%	14.3%	18.3%
Insurance	12.8%	7.5%	11.5%
Pension Fund	0.8%	0.1%	0.6%
Public Sector and Charitable	12.1%	6.9%	10.9%
Business & Professional Services etc.	2.8%	5.7%	3.5%
ITCM	0.0%	2.8%	0.7%
Other / Unknown	4.4%	8.5%	5.4%
Primary/Manufacturing/Oils	0.4%	1.6%	0.7%

Source: EGi London Office Database: special tabulations, authors' calculations

Figure 3.8 indicates that nearly half the office space in the City is owned by specialist property investors, with 29% owned by financial institutions. Financial ownership is higher in the core, as might be expected. These figures have changed only marginally from the 1998 analysis. On this basis, there appears to have been an increase in property company ownership (the figures, though, include German open ended funds and other specialist property investment vehicles) and a slight decline in ownership by financial firms. Again, this may result from compositional changes in the database. The Reading database shows a higher proportion of institutional (insurance and pension fund) ownership than EGi[2] and lower levels of public and charitable ownership. We would suggest that this results from the more detailed analysis of beneficial interests in long leasehold arrangements that the sample framework enables. New economy firms – identified separately – do not seem to have moved into ownership, despite being a significant force in take up, particularly in the fringe.

The EGi data suggests 81% of offices in the Core City are owned by Finance, Insurance and Real Estate (FIRE) firms – a share just slightly higher than the 1997 figure and around 10% lower than the figure derived from the Reading database. In the fringe, the proportion of space owned by FIRE firms has increased from 71% to 77%, largely at the expense of industrial firms and conglomerates. EGi figures suggest that the increase in FIRE ownership in the Fringe is almost entirely growth in specialist property company ownership (which, as noted above, includes special purpose property vehicles that might be classed as "financial"). Whether this change results from further outmigration of non-financial headquarters functions from the City or from spin-offs and outsourcing of corporate real estate, the net effect is a further concentration of financial ownership of office space.

[2] The Reading figure seems more consistent with market perceptions about ownership structures.

Figure 3.9 Ownership by Sector, Core City 2001

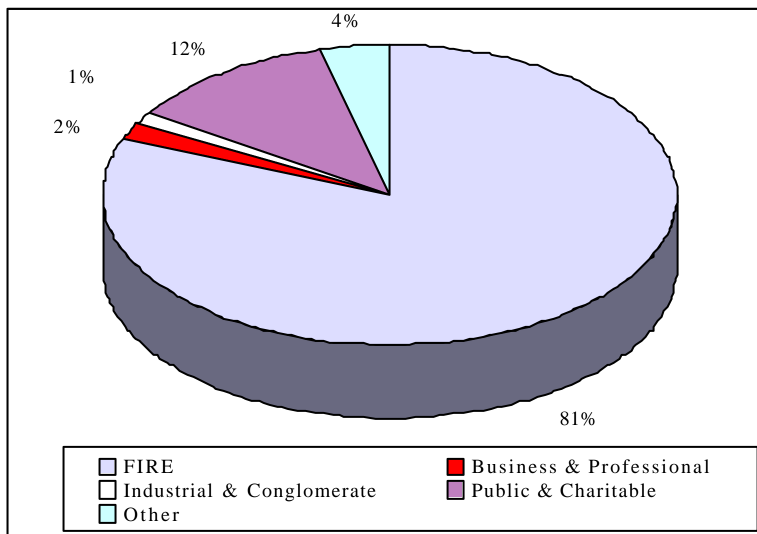


Figure 3.10 Ownership by Sector, Fringe City 2001

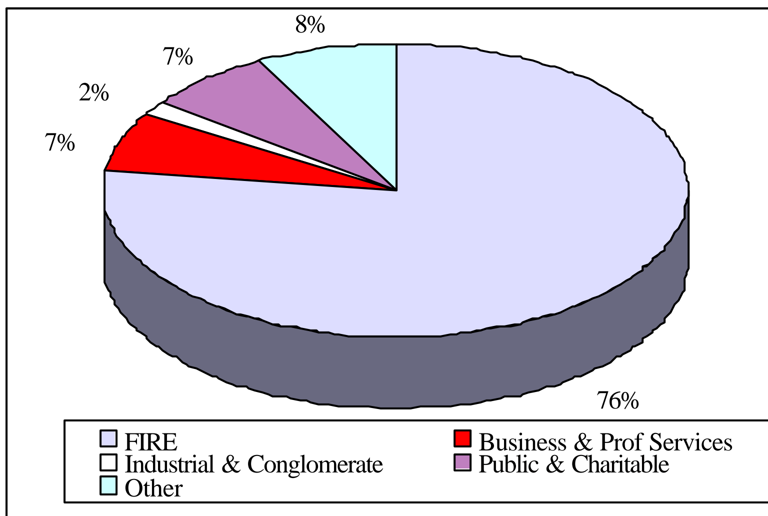
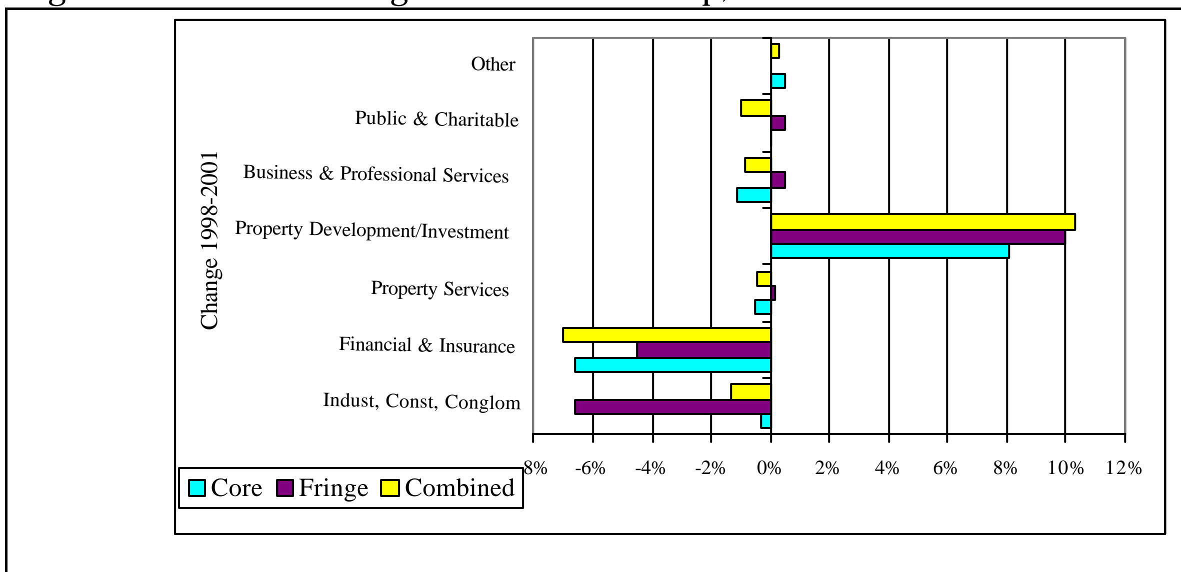


Figure 3.11: Sectoral Change in Office Ownership, 1997-2001



In the 1998 study, 27% of Core stock was recorded as owner-occupied. The current London office database records of owner-occupation make up just 12% of the Core stock and 14% of fringe space. We assume that this reflects changes in data recording rather than a major shift in ownership patterns, although there is a trend for firms to shed their corporate real estate, the change is too dramatic to be explained in this manner. As in the previous report, levels of foreign ownership are far higher amongst owner-occupiers. In the Core, 54% of owner-occupied space is foreign, with high levels recorded for US, German, Swiss and Japanese firms. In the fringe, the proportion of non-UK owner-occupiers, at 20%, is closer to the proportion for all properties.

Figure 3.12: Owner Occupiers in the Core City: Nationality

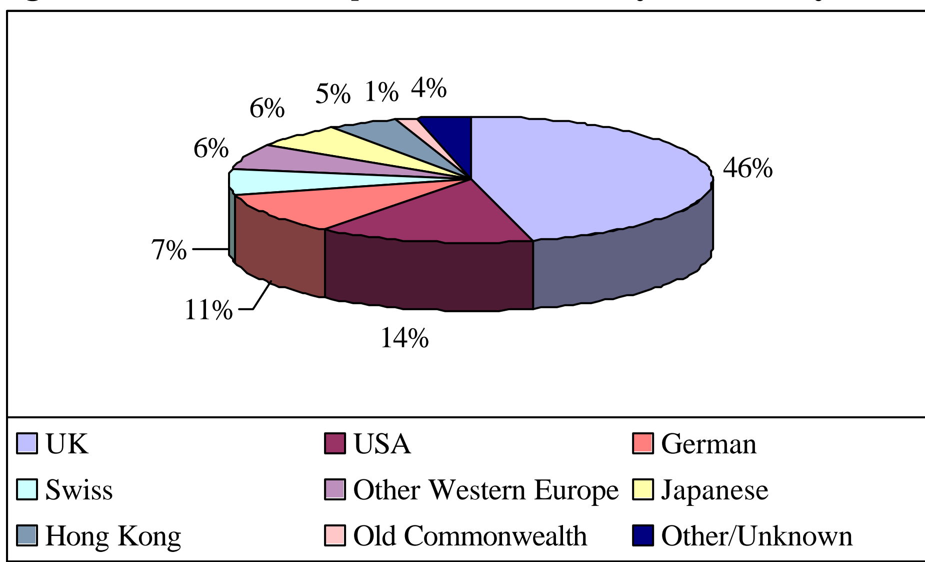
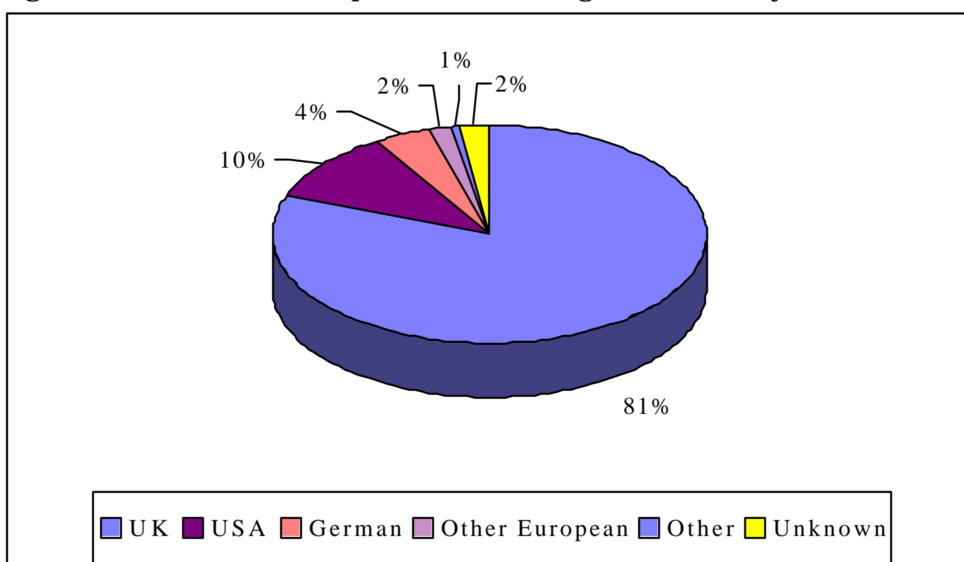


Figure 3.13: Owner Occupiers in the Fringe: Nationality



As would be expected, FIRE sectors dominate owner-occupation in the Core, with only 18% of the owned-space occupied by other sectors. The results are slightly curious in that no pension funds are shown as owner occupiers while 10% of owner-occupiers are classed as property-related firms[3]. Ownership patterns in the Fringe are more diverse, with only 45% of owner-occupiers operating in the FIRE sectors. Business and professional services and new-economy firms (IT, media, communications) make up a quarter of the owner-occupied space and there are higher proportions of non-finance related firms, including industrial, conglomerate and retail services headquarters. In both the Core and the fringe there is a significant public and charitable presence amongst owner-occupiers.

Figure 3.14 Owner-Occupiers: Business Sector

	Core	Fringe
Financial Services	58.8%	28.8%
Insurance & Pensions	13.1%	3.7%
Property-Related	10.3%	10.0%
Business & Professional Services	1.5%	10.5%
New Economy	0.2%	14.6%
Public and Charitable	14.8%	13.8%
Other and Unknown	1.2%	18.6%

Figure 3.15 Occupation of City Office Buildings, 2001

OCCUPATION:	CORE	Fringe
Industrial/Manufacturing/Oils	0.6%	3.1%
Construction	0.1%	1.0%
Financial Service	51.3%	34.7%
Pension Fund	0.2%	0.0%
Insurance	11.8%	6.9%
Property Services	0.2%	0.5%
Prop Development, Investment	6.7%	4.8%
Business & Professional Services	18.9%	19.2%
New Economy Services	5.1%	19.6%
Conglomerates	0.2%	0.4%
Public Sector	2.2%	2.7%
Charitable	0.4%	2.4%
Other Services	0.2%	2.3%
Other / Unknown	2.0%	2.5%

Figure 3.15 examines occupation in the City of London. In the core City, FIRE activities take up 70% of all space with a further 24% consisting of business, professional, IT and media services, much of which will be serving the City's financial industry.

[3] This includes 1% of space owned by serviced office operators: if, *qua* Regus, these are considered as service providers rather than landlords, this would not be unreasonable.

The Fringe is slightly more diverse than the Core. Even here, 42% of space is occupied by financial firms, 47% by FIRE firms and 86% by FIRE and business services firms. The importance of new economy firms in the fringe is clear to see, despite the recent downturn in fortunes of the technology sector.

The picture of ever-increasing functional specialisation in the City is further emphasised by Figure 3.16, which tabulates ownership and occupation for the core of the City. 64% of space is simultaneously owned and occupied by FIRE firms: 89% by FIRE and business service firms. This highly undiversified structure, the product of the attraction of the City as a financial centre, does create potential threats to stability.

Figure 3.16 Ownership and Occupation – Business Sector

CORE	Fin Serv	Insurance	PropCon	BusProf	PubChar	Other	TOTAL
Fin Serv	13.6%	2.4%	1.0%	3.5%	0.3%	0.6%	21.5%
Insurance	4.9%	3.4%	0.6%	3.3%	0.3%	0.3%	12.9%
PropCon	28.8%	4.7%	4.4%	14.1%	1.1%	1.7%	54.8%
BusProf	0.7%	0.0%	0.5%	0.3%	0.0%	0.0%	1.6%
PubChar	1.8%	0.5%	0.3%	1.6%	0.9%	0.2%	5.3%
Other	1.6%	0.7%	0.2%	1.2%	0.0%	0.2%	3.9%
TOTAL	51.5%	11.8%	7.1%	24.1%	2.6%	3.0%	100.0%

The EGi database suggests that there has been a major increase in the proportion of Core City space occupied by non-UK firms. The 1997 figures showed 64% of all space occupied by UK companies. This had fallen dramatically to 49% by 2001. Much of this change relates to recording practices (the "unknown" category has risen from 6% to 15% of the total), but even comparing only the known space, the foreign share has risen from 30% to 43%. US occupiers have exhibited the largest increase in market share, in part due to mergers and acquisition activity. Similar trends can be seen in the Fringe area with the overseas occupiers' share increasing from 21% to 34%. Overall, then at least 40% of City office space is occupied by non-UK companies.

This growing internationalisation of occupation has occurred, despite the increased availability of space in Docklands and in Canary Wharf in particular. At the end of 2000, 5.7million square feet of space was occupied in Canary Wharf. We estimate that some 56% of that space (over three million square feet) was let to non-UK firms. Over a million square feet of the space let to foreign firms was let in 1999 or 2000. That overseas occupiers' share of City space increased sharply in the face of this major increase in supply is a testimony to the attractions of the City for global financial firms.

4. Implications of the Changes

4.1 Change Since Who Owns The City

In this section, we consider the office market implications of the change in ownership patterns in the City of London. In the 1998 study, it was noted that the rise in international ownership was a comparatively recent phenomenon but that the growing functional specialisation of the City as a global financial centre represented a continuation of historic trends. Who Owns the City concluded:

- that the traditional model of finance and funding of real estate would increasingly be replaced by a more diverse model which helped integrate property and other capital markets;
- that new procurement, funding, financing and investment vehicles tend to increase the volatility of the market with the real estate asset being "worked" more intensively rather than being held passively in a portfolio.
- that continued investment in the City of London office market by non-UK firms (whether as owner-occupiers or as landlords) was a marker of commitment to the strength of the market although did increase the risk of "capital flight" should the market deteriorate significantly;
- that the trend in the expansion of the City's boundaries is likely to continue as the pull of the traditional Square Mile is eroded;
- that the growing concentration of both ownership and occupation of City offices by FIRE sector firms – and, in particular by globally-oriented financial service firms – was a source of systemic risk. Any sharp downturn in global capital markets could initiate a downward spiral in the City's office market.

The report concluded with eight hypotheses:

1. *Overseas ownership of City offices will continue to increase;*
2. *London will continue to have higher foreign ownership than other major financial centres and cities;*
3. *New forms of ownership will encourage further overseas property ownership;*
4. *New forms of property ownership may increase volatility in real estate markets, particularly those dominated by financial services;*
5. *Changing office ownership patterns will extend the boundaries of the City;*
6. *Infomatics innovation strengthens the City's position but changes the usage of space;*
7. *Leasing arrangements will need to change to meet more varied demand for space*
8. *Similar ownership trends will be found in other property sectors.*

With this update of the City office analysis, we can examine these hypotheses, test their validity and suggest new or revised hypotheses. We go on to examine three critical issues on the City market: liquidity, systemic risk and globalisation.

[H1/H2] In the period since *Who Owns the City,* non-UK firms have continued to be net investors in the City office market. While the EGi London Office Database suggests at best a marginal increase in foreign ownership, the more detailed analysis of the Reading database suggests that as much as 35% of City offices may be owned overseas once portfolio acquisitions, international vehicles and beneficial interests in joint ventures are considered. Taken together with the occupation figures, this study confirms the truly global character of the City of London. It is outside the scope of this report to discuss foreign office ownership in other cities. However, an earlier study[4], also funded by Development Securities, found that Frankfurt – London's supposed rival as principal European financial centre – was far less international in character.

[H3/H4] The hypothesis concerning new forms of ownership seems amply confirmed. The use of limited partnerships, offshore special purpose vehicles and other collective investment vehicles have allowed asset managers to pool capital from overseas and domestic investors and acquire individual buildings and portfolios of properties – for example the MEPC and Wates City disposals. In so doing they overcome some of the problems of large lot size (and hence over-exposure to single property risk) in the conventional directly-owned property market. Other implications of these vehicles are discussed further below. In addition, high profile asset backed securitisation issues (notably the £1.54billion issue for British Land backed by the rents from thirteen Broadgate offices) allow investors access to a property-market related debt instrument with a high credit rating. It is too early to discern volatility effects from the new vehicles: however the increased volume of transactions give support to the belief that enhanced liquidity and capital market price adjustments may produce more uneven short-run returns.

[H5] Evidence on the hypothesis that changing office ownership patterns will extend the boundaries of the City is mixed. This study shows that FIRE ownership has increased in the Fringe of the City – but this is almost entirely attributable to specialist property investors: financial service ownership is little changed and insurance ownership has declined slightly between 1997 and 2001.

[4] Add reference to Space Race.

Over the period, more financial service functions have relocated to Docklands (principally high volume activities such as settlement where cost control is important to profitability and business sectors that rely less on face-to-face contacts): with Paddington Basin coming on stream and the Kings Cross development to follow, it seems likely that City-type activities will become more widespread. However, statistical analysis by Blake *et al.* (2000) for the Corporation of London suggests that the City core still behaves as a distinct, segmented property market.

[H6] The impact of improvements in information and communications technologies on occupational requirements has been much debated. Certainly, ways of working have been transformed, as have the delivery mechanisms for retail financial services. There is no real evidence of a decline in floorspace per worker in the City (although reliable and detailed data on space and employment is hard to obtain). However, this might result from relocation of tasks where space intensification is possible out of the City and, hence, a still greater concentration of information-dependent and face-to-face business financial services in the core financial district. The rapid growth of new economy companies (many providing services for core financial business in the City) led to a growth in occupation of office space by this sub-sector in the fringe of the City. In turn, this performed a useful function in recycling secondary space released as firms moved into new pre-let space. However, the bursting of the dot.com bubble and the impact of the US economic slowdown on IT firms have led to a retrenchment in this sector.

[H7] The tight letting market has enabled landlords to recapture many of the terms of the institutional lease that were eroded in the aftermath of the property crash. It is worth noting that a number of the high-profile financial innovations are predicated on the existence of the long lease (for example, both the British Land / Broadgate and Canary Wharf issues rely on long leases to provide rental backing for long-maturity bonds, benefiting from the shape of the yield curve[5]). However, technical improvements in the evaluation of rental cashflows (repackaging income streams, use of option pricing and flexible income models, for example), allied to the greater presence of international players used to short leases have helped erode resistance to different forms of tenancy. Corporate real estate strategy has looked to find new models of space procurement following PFI deals (for example the Abbey National – Mapeley deal) and the serviced office sector has matured and become more firmly established, Regus's current woes notwithstanding.

[5] For a full discussion see Lizieri, Ward and Lee (2001).

[H8] We have no direct evidence for an increase in non-UK ownership in property sectors outside the office market. Information on investment patterns suggest that, while central London office purchases still dominate foreign direct real estate acquisition, other sectors and geographical areas have increased in importance. Portfolio acquisitions will increase international ownership where the portfolios are already diversified.

Certainly there is evidence of innovation in investment vehicles and financial arrangements in the retail sector: Sainsbury's "Project Redwing" a bond-backed innovative sale and leaseback, Peel's securitisation of the rental income from the Trafford Centre and the Lend-Lease retail limited partnership being examples of change in the sector.

4.2 Globalisation, Liquidity and Risk in the London Market

From the current research project, three key issues seem to emerge. The first concerns the impact of changes in the structure of ownership on the liquidity of the City market – and the impact of liquidity on investors' decisions. The second reflects the increased globalisation of the City market and the signalling effect of this. The third considers the impact of the changes described in the City of London on office market – and wider financial market - risk. We examine each in turn.

The high levels of transactions and rapid turnover experienced in the City between 1998 and 2001 emphasise the liquidity of the market. Since investors require a risk premium to account for illiquidity in property markets, any increase in liquidity reduces the required return and, hence, increases the value of assets in the market. Liquidity in the City market reflects three factors that are well established: sustained occupational demand, market transparency and the brokerage function; and one new factor, the creation of new investment vehicles that enhance liquidity.

Sustained demand for space (including both tenanted and owner-occupied space) underpins the market. Although demand for space is volatile, the breadth of the City market ensures that it is less affected by financial market downturns than smaller, more specialised markets, despite the very high concentration on international financial activity. Evidence suggests that major financial firms are fairly insensitive to property prices (are price inelastic) in that occupation costs are a relatively small proportion of total costs (particularly when compared to salary costs) and are outweighed by the agglomeration economies derived from a City location.

It is important to distinguish between different types of financial activities[6]. Retail financial services *are* cost-sensitive (and many functions have relocated from the City to lower cost locations); some high volume, low margin wholesale and business functions (settlement, clearing, some routine trading) are also price sensitive. However, low volume, high margin activities such as corporate finance, fund management, raising capital, mergers and acquisitions activity require information networks (between customers, competitors, suppliers and parallel businesses) and client contact. This leads to greater concentration, further fuelled by the need to obtain and retain highly-skilled staff. In turn, this maintains demand for high quality space in the central City. This demand sustains rents (supported by good covenant tenants) and, in turn, capital values, encouraging a high level of investment activity.

The market transparency and brokerage functions are closely related. The City of London is the most heavily researched office market in the UK. This produces time series data on rents, yields, supply, demand and take-up that supports investment decisions, reducing information costs and uncertainty. In turn, this generates more transactions which produce more evidence on trends in the market. The quantity and quality of information is sufficient to support exacting due diligence enquiries, which is important in sustaining overseas investment. In turn, the high levels of activity in both the occupational and investment markets supports brokerage services that seek to match buyers and sellers, landlords and tenants in a highly efficient and cost-effective manner, again reducing search costs and reducing uncertainty.

While these features are long established characteristics of the City (and wider central London) market, creation of innovative investment and financing vehicles have served to increase liquidity still further. The new model of limited partnership schemes and special purpose pooled investment vehicles have many advantages for investors. First, they allow pooling of capital across investors. This, in part, overcomes two key problems facing real estate investors – the large lot size problem (in that smaller investors are excluded from buying certain types of property, for example large prime City offices) and the diversification problem (the cost of property makes it hard for individual investors to build a portfolio of property leaving them exposed to the specific risk of one or two buildings). Second, properly structured, they allow investors comparative tax efficiency and, critically, ease of entry and exit, effectively reducing transaction costs. Research has shown that high transaction costs reduce trading and increase holding periods. This, then, contributes to illiquidity and also to investors holding sub-optimal portfolios. By reducing transaction costs, investment portfolios can be more actively managed and, as appropriate, holding periods may be reduced. Once again, this produces more transactions evidence, improving market transparency.

[6] See GHK (2000) for a fuller discussion.

Asset backed securitisation and repackaging of real estate income contributes to this enhanced liquidity. Securitisation helps in the management of debt exposure and enables owners of property (whether landlords or owner-occupiers) to raise capital backed by the assets and/or the income stream from the rents directly from the capital markets. In turn, this offsets the risk of large amounts of capital being sunk in single properties. At the same time, it creates a highly liquid asset which provides a measure of exposure to the property market (since the underlying security is the rental and capital value of the property, the market value of asset-backed paper will reflect the market's perceptions and expectations concerning the state of the property market since default risk changes even if the cashflow profile remains unchanged). While ABS and repackaging schemes could be applied to any property market, the City market offers ideal conditions for the promotion of such schemes, in terms of the size and quality of buildings, the covenant of tenants and the depth of research, which supports a favourable credit rating.

It seems clear that the City office market has become still more global in the period since the publication of *Who Owns the City*. Once international vehicles, and corporate/portfolio acquisitions are considered, around a third of the City's office space could be effectively owned by non-UK firms and investors. The growth of joint venture structures and pooled investment vehicles have served to encourage further investment including investment by smaller investors, previously excluded. As with the ABS schemes mentioned above, this helps sustain the flow of capital into the City, ensuring the supply of space appropriate to maintaining the City's status as Europe's premier financial centre. It is clear that investment in City offices now is more truly "international" in nature than before in that it is increasingly difficult to assign a single nationality to many buildings in the City at all, given complicated cross ownership structures.

The flow of international capital into the City office market is a signal of confidence in the City's continuing status. It might be argued that non-UK investors have less commitment to maintaining a presence in the City – the threat of capital flight increased by the existence of exit routes through the new property vehicles. However, there is no financial reason why UK investors should be any less likely to flee. Further, while liquidity has been enhanced, it is not a simple task to exit from City real estate ownership at a time of falling prices. Furthermore, where there are differences in market cycles, foreign capital can replace UK capital at times of domestic capital famine[7]. International investment may thus sustain the City in crashes acting as a stabilising force. The presence of international capital thus adds to UK capital in sustaining the importance and strength of the City.

[7] As with the activity of German open ended funds in the early to mid 1990s.

The final strand relates to risk. In *Who Owns the City* and subsequently (Lizieri, Baum & Scott, 2000), we argued that the growing concentration of ownership, occupation, finance and funding in the City, as well as reflecting the strength of the market, was a potential threat to stability. With occupation (particularly in the core of the City) so dominated by international financial services, ownership dominated by FIRE and the funding and financing of office space provided by the same financial firms that own and occupy the space, a sharp downturn in markets could trigger a downward spiral as dampened occupational demand pushes down rents, depressing investment values and threatening loan portfolios – the poor performance of real estate equity and debt further depressing financial markets.

The changes to market structure outlined above increase this potential systemic risk. The greater ease of exit is combined, in a number of the vehicles with capital market pricing that allows both swifter response to market changes and greater reaction to market sentiment. The effect of sentiment changes can be seen in the City office market around the time of the Asian currency and Russian debt crises, with investment activity dampened and expectations of rental growth marked down. The same impact is much harder to discern in traditional property market performance indicators with capital values and rental norms hardly changed. With vehicles priced in the capital markets, the impact of sentiment shifts would feed through into market values in a more direct and rapid fashion, increasing volatility and the risk of a vicious circle developing. We should emphasise that this threat must be set against the benefits of agglomeration and concentration that serve to emphasise the strengths of London as a business location.

5. Conclusions

In the original *Who Owns the City* study, we presented a Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis of the City of London office market. In concluding this report, we revisit that analysis in the light of change over the 1997-2001 period.

The major financial *Strengths* of London were seen as the combination of the breadth and depth of financial markets, the accumulation of specialist business expertise, the pragmatic regulatory and tax regime and the cultural attractions of London as a cosmopolitan, global city. Little has happened that has damaged the financial market strengths. London remains one of three true global financial centres, offering depth and diversity in markets – with major equity, bond, insurance, derivatives and currency markets and a leading position in fund management.

In terms of the property market, the scale and diversity of product, professional expertise in matching supply to demand and low transaction costs encouraging investment were seen as key strengths, particularly relative to Frankfurt[8]. The increase in stamp duty increased the relative cost of trading real estate in London. However, the creation of new tax-efficient vehicles demonstrates the flexibility of London's property markets in finding solutions to new problems; the volume of investment activity suggests that property market liquidity has not been adversely affected. Innovation in real estate markets can also be seen in the growth of asset-backed and mortgage-backed securitisation. Many of the largest issues have been linked to UK (and central London) real estate. Furthermore, the combined investment banking and property market expertise in London has meant that many mainland European and pan-European deals have been arranged and issued in the City.

Potential *weaknesses* identified included the UK's position outside the Eurozone; the overloading of the internal transport infrastructure; restricted opportunities and lack of space for development; and property market inefficiencies including the inflexibility of the institutional lease and the lack of a tax structure to deal with depreciation and obsolescence. In practice, the weakness of the Euro in relation to sterling and the US dollar has reduced the likelihood of any migration of financial activity to mainland Europe. The City's foreign exchange markets captured a third of all Euro trading within months of the January 1999 launch of the new currency and has captured a considerable share of the mergers and acquisitions activity that followed monetary union. Continued high levels of non-UK investment in offices, despite the strong pound and non-membership of the Euro suggests that the property market has not been adversely affected.

[8] The advantages and disadvantages of London and Frankfurt were considered in *Space Race* (Lizieri *et al.* 2000), another Development Securities funded project. The report concluded that "*London dominates Frankfurt by virtue of the scale and diversity of its markets*".

The transport infrastructure remains the Achilles heel of central London. Although the Jubilee Line extension has improved the linkage between Docklands and the City, there are already concerns that it is stretched to capacity. The Heathrow Express has improved access to the airport but there is no imminent start to the Crossrail project and any substantial investment in the public transit infrastructure seems lost in political wrangling over the advantages and disadvantages of public-private partnership. This makes it difficult for the City to absorb increases in employment. It also causes inertia, as existing firms are unwilling to relocate and disrupt the transport arrangements of staff. In the short term, this may limit relocation from the City to fringe locations but represents a long term inefficiency. As yet there is no clear evidence of an adverse impact on the property market[9].

Space in the City remains constrained although the Corporation of London has responded to demand pressures as far as it is able. There remains resistance to an increase in building heights despite support from both the Corporation and the Mayor for London's office, with opposition to a number of landmark schemes. This contrasts to the Frankfurt 2000 property-led development plan. Nonetheless, new building and redevelopment, particularly in the fringes of the City, has contributed to an upgrading of the stock. Additionally, there is now over 5.5million square feet of space in Canary Wharf alone, with further space in developments such as Paddington Basin adding to overall supply of prime office space in the central London market. Conventional long leases still dominate the rental market; the rise of serviced office provision and outsourcing deals have provided an alternative to long leases although they still represent a small fraction of the market. Lease length constraints are more likely to be a problem in fringe locations and property for smaller, dynamic firms, start ups and niche traders. Total occupancy costs of prime City offices are nearly double those of Frankfurt and 60% higher than in Paris (Insignia, 2001) – but it should be recalled that property costs are only a relatively small proportion of the total costs facing an international financial services firm and need to be set against fixed employment costs and labour market inflexibilities in other locations.

In terms of *Opportunities*, the previous report suggested that London might benefit from its agglomeration economies, product innovation and labour skills in capturing a greater share of global capital market activity; that planned transport improvements would link the City to other clusters, improving critical mass; and that the development of private pension fund activity (allied to general economic growth) in mainland Europe would boost fund management business. Finally, there was the possibility that the City's "offshore" position would be strengthened if the Euro proved to be a failure.

[9] It is possible that the compact nature of the City market – that makes it possible to *walk* around – enables the City to survive in the face of growing transport difficulties.

As this report is written, the overall financial climate is somewhat sombre, with fears of a US and global recession affecting the capital markets, technology stocks out of favour and the long stock market bull run ended. It is too early to judge the success or failure of European monetary union. As noted above, there is no clear evidence of an adverse affect on the City's financial activity but nor is there any persuasive evidence that London has gained from the UK's current stance. London's share of existing business has not increased markedly over the period but there is some evidence that the City is still the European leader in product innovation – London's key role in the development of mortgage and asset backed securities, discussed above, provides one such example. The amount of international investment in the City office market over the period shows that London is still a favoured location. The example of Irish investment in London's property market gives an indication of gain from overall European Union growth.

Threats to the City's position included competition from Frankfurt, Paris, the US markets, from stock market alliances and from the rise of electronic/internet remote trading; the isolation of London should the Euro prove a great success but the UK remain outside; and erosion of London's strengths in terms of taxation, regulation, transaction costs and market flexibility as a result of harmonisation within the European Union. To these one might add the dangers of over-specialisation in global financial activity (the systemic risk noted in Lizieri, Baum & Scott, 2000) and the progressive deterioration of the transport system should adequate infrastructure investment fail to materialise.

Between 1997 and 2000, London's share of the market capitalisation of equities fell slightly, from 9.2% to 8.4%. Almost all of that fall can be attributed to the growth of technology stocks on NASDAQ in the first part of the period: it is likely that London's market share will have risen by the end of 2001 as the prices of dot.com and speculative technology shares have continued to fall. The Deutsche Börse's share rose slightly from 3.8% to 4.1% but London's market capitalisation and market turnover is still more than double that of Frankfurt. Stock market mergers and alliances have had some impact[10] with the market capitalisation of Paris Euronext more than doubling between 1997 and 2001, to become the second largest exchange in Europe, surpassing Frankfurt. However, cross-listing on the Euronext exchanges makes the market capitalisation figures a less valuable indicator: London is 1.8 times as large as Paris by capitalisation but has 4.3 times the volume of trading[11]. London's share of bond market trading relative to Frankfurt has also increased over the period. The supposed threat posed by internet and remote trading to conventional financial centres has, to date, proved illusory with professional investors still dominating markets, despite added volatility.

[10] The London Stock Exchange and the Deutsche Börse were themselves in merger talks that failed at the last minute.
[11] All figures from International Federation of Stock Exchanges data, re-analysed by authors.

Thus, the 1997-2001 period has seen little erosion of the City of London's position as a global capital market force and as Europe's financial capital. This should not be a cause for complacency, as these potential competitive threats still apply. However, it seems likely that the City's financial activities will continue to generate sustained demand for quality office space in the future.

The threats posed to the City's position by the relationship between the UK and the European Union are harder to assess. The danger of the UK being isolated outside a successful Euro system have diminished somewhat both due to early Euro weakness and by a less sceptical government stance. In terms of harmonisation, no final agreement has been reached on withholding tax for Eurobonds, employment legislation is moving closer to mainland European norms and the increase on stamp duty on property has increased UK property transaction charges relative to Europe (although there still remain cost advantages over many other markets). As noted above, the property market's success in creating investment vehicles that diminish the adverse effects of the stamp duty increase demonstrate the City's ability to react to changing market environments through innovation and product development.

There remains the threat of systemic risk through the increasing specialisation of the core City in high level international financial services activity and the growth of business and professional service firms and information providers dependent upon that activity. This threat extends into the property market, with ownership, occupation and finance of office development interwoven. With 89% of core City offices simultaneously owned and occupied by FIRE and business service firms, there is a danger that a severe and sustained international financial market downturn could trigger a downward spiral in markets.

This risk, although real, needs to be set against the benefits of such specialisation. It is the concentration of activities in the City (and its linked office clusters) that creates the agglomeration and information economies, that generate exchange of ideas and encourage innovation. The quality of tenants creates a favourable investment environment, which contributes to the supply of capital to maintain and upgrade the quality of stock. Furthermore, the City has the expertise to generate financial products and vehicles that exploit the quality and liquidity of the central London office markets.

In summary, the period 1997-2001 saw a further growth in foreign involvement in the City of London office market as new international investment vehicles augmented and complemented traditional forms of institutional and private ownership. With a third of City offices in foreign ownership and 40% of space occupied by non-UK firms, the international character of the City is manifest.

High levels of office investment are an indicator of market confidence in the future of the City. There exist threats to the City's position and, hence, to the performance of its property markets: competition from other centres, systemic risk in the event of a sharp/sustained downturn in global markets, erosion of some of the regulatory and market advantages possessed by London. These need to be set against the advantages of the City both as a location for financial activity and as a real estate market.

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