

International Investment, Ownership and Risk in the City of London Office Market: An Analysis of Trends 1972-1997

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Abstract

Office returns in the City of London are more volatile than in other UK markets. This volatility may reflect fluctuations in capital flows associated with changing patterns of ownership and the growing linkage between real estate and financial markets in the City. Using current and historical data, patterns of ownership in the City are investigated. They reveal that overseas ownership has grown markedly since 1985, that owners are predominantly FIRE sector firms and that there are strong links between ownership and occupation. This raises concerns about future volatility and systemic risk.

1. Introduction

In this paper, ownership trends in the City of London office market are examined. The Corporation of London (1997) estimate that the total office floorspace in the City in 1996 to be 77 million square feet. Commercial agents, using differing geographical definitions, provide similar estimates. For example Richard Ellis (1998) produce a stock figure of 84 million square feet. This represents around 40% of all central London office space by floor area. Using conservative estimates of rent and yield, this office stock must have a minimum capital value of £20-25 billion¹. At the end of 1996, City offices on the Investment Property Databank had a capital value of £4.6 billion, nearly a quarter of the total institutional office portfolio (IPD, 1997). The City, thus, is highly significant within the UK commercial real estate market both in terms of size and in terms of value.

There is evidence that the investment performance of offices in the City of London (and in Central London in general) has been more volatile than that of offices in other markets. Analysis of the Investment Property Databank shows that the standard deviation of nominal returns over the period 1981-1997, at 13.9%, was higher than that for all offices (12.0%) and all commercial property (9.8%). This higher volatility, allied to indifferent returns in the early 1990s, results in inferior risk-adjusted performance, measured, for example, by the coefficient of variation. These differences are more stark when taken over the recent property cycle, 1986-1996. City offices, with a mean return of 8.4% and a standard deviation of 17.3% have a coefficient of variation of 2.07 compared to all property's 1.17 (12.1% / 10.3%). A simple regression of annual City office market returns on all property performance produces a beta of 1.25.²

The reasons underlying this cyclical volatility are complex. It may result from lower capitalisation rates (such that a small shift in yield may produce large swings in capital value), or from the greater liquidity of the prime City office market, facilitating fluctuations in investment activity. The generally large lot size may contribute to pricing uncertainty and

¹ Say 80 million square feet at £25 per square foot, capitalised at an initial yield of 8% gives £25 billion. While some of the stock may be secondary, other buildings will be large prime offices. At the end of 1997, top rents were around £45 p.s.f. and yields under 6%.

² Given the small sample size, this is not statistically different from 1.0; it is thus no more than indicative of higher volatility.

uneven capital flows. However, the City is regarded as a truly international centre. Would not this factor serve to reduce volatility? This clearly depends on the activities of international business in the City market. Is there significant office ownership by non-UK firms? If so, is this driven by the need to occupy space or is it for investment purposes?

It might be assumed that overseas real estate acquisitions for investment purposes would serve to dampen cyclical movement in the office market. Overseas capital flows are determined by many more complex drivers than domestic flows. These may include anticipated exchange rate movements, local liquidity, the expected performance of local property and equity markets, relative tax rates and strategic and operational reasons. These might result in counter-cyclical acquisitions, offsetting domestic capital flight. Alternatively, aggressive acquisition and lending strategies, allied to lack of local market knowledge, may increase the possibility of short-run mispricing, exacerbating boom-bust cycles.

Owner-occupation by non-UK firms will have a different impact on the City office market. The growing linkage of ownership and occupation, allied to increasing functional specialisation in the City serves to lock City office performance into the international financial market cycle. Foreign acquisitions for operational purposes reinforce this trend. Underlying the research is a concern that the interlinkage of development, investment and occupational markets in the City is producing an undiversified economy, vulnerable to downturns in global financial markets. The feedback effects between real estate and financial markets may increase the amplitude of cyclical variation and lead to the possibility of *systemic* risk.

The issue of ownership of office space has largely been neglected in the office literature. This paper, based on a broader research project on City ownership (Baum *et al.*, 1998), begins with a discussion of the changing functional structure of the City of London and the impact that this change has had on the office market in the City. Next, the research methodology is described and data issues aired. Section four presents empirical results, detailing ownership trends in the City. Has there been a significant increase in non-UK office ownership? If so, is it for owner-occupation or investment? Has the nature of firms owning real estate in the City changed? How are ownership and occupation linked? Finally, we draw conclusions and raise some hypotheses about future trends in the City of London office market.

2. Global Finance, Risk and the Restructuring of the City of London Office Market

2.1 Globalisation and Functional Specialisation

Wider economic, political, technological and social forces determine the context in which changes in occupation and ownership in the City of London office market take place. These determine the future trajectory of the City and hence the patterns of supply and demand in the real estate market. Although the forces and trends are closely interrelated, four broad themes may be identified:

- *Globalisation of business and financial services;*
- *Developments in information and communications technology;*
- *Changing working practices and business organisation;*
- *Regional economic integration.*

In this paper, the focus is on globalisation and the simultaneous functional specialisation and internationalisation of the City. Although the extent of “globalisation” has been challenged³, it seems clear that the last three decades have seen intensification of global trading and cross-border activities. This is particularly true in financial services, where deregulation and financial liberalisation, allied to improvements in information technology have created a global market place for equities, bonds, currency and derivative products based on those financial assets. The implications for property markets of this “*new international financial system*” have been discussed in Coakley (1994), Lizieri (1991, 1995) and Pryke (1991, 1994).

One consequence of the new financial system has been growing concentration of international financial activity in a relatively small number of “world cities”. London, New York and Tokyo are considered to be the three principal world cities. In order to resist competition from rival centres, these global financial centres need to exploit agglomeration economies through depth and breadth of markets. This entails a growing specialisation of activity.

International competition within financial sectors has led to consolidation and merger and acquisition activity. Much of this M&A activity is cross-border. In the mid-1980s, associated with Big Bang, many UK broking operations were acquired by overseas banks and institutions. UK City-based firms such as Barings, BZW, Kleinworts, Mercury, Morgan Grenfell, Smith New Court and Warburgs passed into Dutch, French, German, Swiss and US ownership. Pension fund portfolios and life insurance firms have been acquired by non-UK firms (CIN by La Salle, Pearl by AMP for example). Currently, a new round of mergers and acquisitions seems to be occurring, exemplified by the UBS and Swiss Bank merger.

2.2 Changing Ownership and the City Office Market

The forces leading to globalisation of financial activity are likely to lead to a growth in overseas ownership of real estate assets in world cities. However, there is little literature to confirm such trends. Edward Erdman’s 1989 review of the overseas influence on the London office market does not mention ownership, concentrating exclusively on occupational demand. Similarly, Pryke (1994), in his discussion of changes in City office markets, does not identify overseas ownership as a significant factor. By the 1990s, the trend for overseas acquisitions had become clear. Thus, LPAC (1995) discuss how institutional disinvestment from the central London office market could be seen as an opportunistic response to increasing demand from a wide range of overseas investors⁴ and commercial agents were documenting the extent of overseas purchases.

Motivations for overseas investors acquiring City office space will vary greatly and so, hence, will the impact of that ownership. Much of the space is likely to be owner-occupied. Why would a firm own rather than rent space? A number of possible reasons may be advanced. These include:

- *the space is seen simultaneously as an operational base and as a financial asset;*
- *ownership signals commitment to local clients;*

³ See, for example, Weiss (1997); Hirst & Thompson (1996) for contrary views.

⁴ This is an interesting inversion from the more commonly expressed view that overseas investors snapped up bargains resulting from institutional withdrawal and the difficulties experienced by a number of property companies in the early 1990s.

- *ownership of space brings control of space.*

The first two reasons would suggest that overseas ownership may signal commitment to the City as a location implying some form of stability. However, the inflexibility of the standard UK lease may be too great for firms unsure as to their position in the City. As a result, ownership would imply *less*, not more, commitment. Overseas *investment* ownership is presumably motivated by risk and return considerations. While fears are expressed over capital flight, there is no intrinsic reason why overseas investment ownership should be more volatile than ownership by a UK institution or property company.

In parallel with the growth of overseas ownership in the City office market, there may have been changes in the types of organisation owning property. Traditional landlords may have declined in significance relative to more entrepreneurial real estate companies and financial firms. This has two potential consequences. First, financing and funding techniques have changed greatly (Pryke, *op. cit.*, Lizieri, 1995). Second, the combination of speculative activity and new types of occupier led to a territorial expansion of the City's functional boundaries, a '*spatial deregulation*' breaking down tradition and inertia

2.3 Ownership, Real Estate and Stability in the City

One consequence of the more varied and complex forms of funding is that real estate markets are more closely integrated with the other capital markets and, hence, are exposed to their volatility. The growing functional specialisation of the City is more than a concentration on financial and business services - it is a concentration on high order *international* services. As LPAC (1995, iv) note: '*for businesses primarily serving UK based customers, downsizing and upgrading frequently results in decentralisation from central London. In contrast, organisations serving international markets show greater resilience in maintaining or increasing their presence in London*'. Even within large organisations, non-core administrative and back-office functions may be moved outside the City. Thus the forces that drive occupational demand are both singular and international in nature. Demand is linked to the international financial services business cycle.

We further hypothesise that *ownership* of the City office stock is dominated by the FIRE sectors - the same financially-oriented firms that occupy the space. This will be as true of investment property as the owner-occupied stock. Property companies do own a significant proportion of the tenanted City stock. However, the character of property companies involved in the central London markets changed over the 1980s, driven by the increasing size of prime office buildings. Only larger companies (whether property investment companies or trader-developers), able to tap the capital markets, could participate in the restructuring of the City.

Methods used to fund and finance property also changed over the 1980s and 1990s. The conventional short-term bank-led project finance followed by institutional take out or long term mortgage funding has been augmented (and, largely, replaced) by more complex arrangements that mix debt and equity and spread risk through syndication and securitisation. The same financial services firms that occupy and own the space provide this funding and carry the default risk. Thus, changes in ownership and in financing of office property have served to tie together the occupational, investment and development markets. This must lead to the possibility of *systemic* risk.

Systemic risk exists where failure in one part of the (financial) system has spillover effects in other parts, threatening the stability of the system as a whole. Systemic risk has been a subject of growing concern since the ability of regulatory authorities to control and manage crises has diminished. With power and assets concentrated in fewer institutions and markets, the threat of a cascade through the system is real. Heinman and Alexander (1997, p82) suggest that the *'rapid changes occurring in the international financial system have resulted in new sources of, and transmission mechanisms for, systemic shocks'*. Similarly, Phillips (1993, p6) notes that *'the expansion of market linkages which cut across national boundaries and embrace a wide range of financial and non-financial firms raises concerns about the ability of central banks to contain systemic difficulties, should they emerge'*.

It should be noted that the international financial system has proved robust in dealing with major failures in recent years. However, the localised effects of internationally induced crises are considerable. The linkage of real estate to financial markets has led to concern amongst regulatory bodies (see, for example, Bank for International Settlements, 1993; Renaud, 1994; Folkerts-Landau & Ito, 1995; Goldstein & Folkerts-Landau, 1993). The expansion of lending into real estate, fuelled by rapid asset price inflation and deregulation (giving access to new sources of funds) created problems for Japanese, Nordic, UK and US banks in the aftermath of the world recession. Cyclical decline was associated with major falls in property values. The losses incurred by banks were sufficiently large to force curtailment of portfolio growth to meet regulatory capital requirements such as the capital adequacy and solvency requirements of the Basle Accord. This created the so-called "credit crunch" where reduced (and more costly) lending hampered business expansion and prolonged the recession. Ghosh *et al.* (1994) discuss the impact of the Canary Wharf failure on bank profitability around the world.

The functional specialisation of the City, the concentration of ownership and the linkage of investment, occupational and development markets thus pose a potential threat to stability. Demand is driven by the international financial business cycle. In downturns, reduced occupational demand depresses rents and hence capital values leading to deterioration of the quality of loan books. This depresses the asset base of the financial sector. The converse is true in an upturn, with strong asset values underpinning expansion. Thus linkages between the office market and the other financial markets serve to deepen the amplitude of cyclical movements. As Lizieri & Finlay (1995) note, since the economic forces that drive these cycles are international in nature, property-financial crises tend to be co-ordinated around the world in major financial services cities, frustrating risk diversification strategies (see also Goetzmann & Wachter, 1995; Ball *et al.*, 1996).

Functional specialisation is thus a two edged sword. The concentration of international financial and business activity in the City contributes to the depth of markets, permits specialisation and creates the agglomeration economies that are critical to the City's competitive position. At the same time, an undiversified economic structure and interlocking markets create dangers of downward spirals and spillover effects whenever the international financial system is subject to shocks. The City of London office market, with its tightly-linked ownership, occupational and financial structures, may contribute to that danger. The research presented here seeks to shed light on these issues by investigating the nature of ownership in the City of London office market. A broad ownership base serves to reduce risk, while concentration increases risk. We examine overseas ownership, attempt to distinguish owner-occupation from investment ownership, investigate change in type of owner and investigate linkage between ownership and occupation.

3. Methodology and Data

The research, conducted in 1997, consisted of a series of stages involving literature reviews; analysis of current and historic office market data; and a series of interviews and seminars. It quickly became apparent that there were no publicly available definitive databases on ownership. Most commercial agents and data suppliers concentrate upon occupier details since this provides the bulk of their income. Investment deals are brought to brokers; properties remaining in ownership are of less interest. Individual deals are recorded on the Land Registry and available at a fee but only record the named purchaser.

The office database compiled by Chesterton for Estates Gazette interactive (EGi) was used to analyse the current situation. This has good coverage of the City core (with around 75% of records having ownership details) but less comprehensive data on the fringe. There is information on around 92% of the City floorspace. A series of special tabulations were run examining nationality of ownership, the type of organisation owning, the business of occupier and the type of ownership.

As with all secondary data, analysis is dependant upon the definitions employed. Ownership is defined as freehold (fee simple) ownership or long leasehold (lease of 30 years or more). Even with the lengthy UK lease, 30 years is an exceptional letting; depreciation and functional obsolescence implies an intention to expend capital. Nonetheless, the freeholder retains the reversionary capital value (over 50% of the value of City offices is land) and more modern long leases have ground rents with escalation clauses. Type of organisation was defined according to standard industrial clarification. Unfortunately this means that there was no category for pension funds although insurance companies were separately identified.

Nationality of ownership presents further problems. A firm may be UK incorporated, but largely or wholly owned by an overseas parent. Is St Martin's a UK or a Kuwaiti company, for example? For listed companies, traded on the stock market, a considerable proportion of shares may be owned overseas - 17% of UK listed ordinary shares are owned overseas. However, the issue here is one of control: only majority or significant shareholding will have a direct impact on decision-making. Clearly, dividend income (derived from rental income) is flowing out of the country. Finally, for a truly multinational firm, it is not clear where the locus of operation lies. In such cases, the firm's formal head office was used as the basis for designation in the historical analysis. These are, in many instances, judgement calls.

The Chesterton/EGi database, then, provides valuable information as a snapshot of the City market. However, it was not possible to trace the history of the ownership. No source was found that would permit such an analysis. Accordingly, a sample database of City offices was assembled and agents' records, on-line sources, deals gazettes and direct interviews used to complete a historic record from 1972 to 1997. The final database contained 126 buildings for which complete data existed. The floorspace of the properties on the database, at 10.2 million square feet, represents around 17.5% of the core Chesterton database. The database is broadly representative of the core City market. Data on type of organisation and nationality of current and past owners were collected, together with the dates of transactions. This enables a time series view of ownership patterns in the City. Data definitions conformed to those used by Chesterton although pension funds were separately identified. The database recorded multiple ownership (and the proportions owned by each party) and distinguished commercial from traditional ground rent/long leasehold arrangements.

The empirical data collected provided the basis for analysis. More qualitative information was obtained from a series of semi-structured interviews with agents, investors and funders in the City and from a seminar/focus group of senior players in the market.

4. Ownership And Occupation: Empirical Results

4.1 The Current Situation

Analysis of the Chesterton/EGi database suggest that offices in the City are owned by firms from thirty-three countries and six continents. In the core of the City, around a fifth of space is owned by overseas firms, with significant proportions held by German (3.4 million square feet), Japanese (2.8 million square feet) and US (1.8 million square feet) companies. In the fringe area, where data coverage is more patchy, around 14% of office space is recorded as being in overseas ownership (Exhibits 1 & 2). Combining the two samples produces total overseas ownership of 19% which, applied to the corporation of London's stock estimate produces a figure at 14.4 million square feet with a capital value of estimated in the range £3.6bn - £4.5bn. (\$5.8 - \$7.5bn).

Around 27% of the core office stock is owner-occupied. Owner-occupation is much higher for overseas firms at around 49%. Owner occupation varies by nationality with Swiss, Old Commonwealth and many European countries almost exclusively owner-occupiers (Exhibit 3). As a result of the greater extent of owned operational property (particularly in financial services sectors), nearly a third of owner occupied stock is overseas owned. As a corollary, UK firms own 86% of tenanted, investment space, with only German and, to a lesser extent, Japanese investors holding substantial amounts of space as landlords (Exhibit 4).

Much of the literature on the history of the City of London emphasises the growing financial specialisation of the City as a focus for international financial service activity. As Exhibit 5 shows, 75% of City employment is in financial and related business services. The growing dominance of finance-based activity conceals a further trend: financial activity in the City is becoming more international in nature, as domestic-oriented firms and administrative and back office functions have decentralised. As a result, it has been argued that the City economy has been 'decoupled' from the UK economy as a whole.

Earlier, it was hypothesised that functional specialisation was accompanied by concentration of ownership, and that the same type of firms occupy and own space. We thus expect ownership to be dominated by the finance, insurance and real estate (FIRE) firms. In the core, these sectors own 80% of space (Exhibit 6). This is not a function of owner occupation: 81% of tenanted property is FIRE-owned. In the fringe, 71% of space is owned by FIRE firms; however, industrial firms and business and professional firms (particularly legal firms) have larger holdings (Exhibit 7). Almost all overseas owners were financial, insurance or real estate companies.

Over a third of office space in the core is occupied by overseas firms led by American (6.5%), German (4.6%) companies. By organisational type, FIRE sectors account for 61% of space, with business and professional services firms accounting for a further 27%. It should be stressed that the majority of these service providers - international law firms, research and information providers, accountants - are linked to the international financial activity of the City. Less than a tenth of the stock is in other business use.

As Exhibit 8 shows, 53% of office space is simultaneously owned and occupied by FIRE firms. Adding business and professional services firms increases the proportion to 74%. It is well known that the City has become increasingly functionally specialised. This evidence of a combination of specialisation of function and concentration of ownership is new. However, combined ownership and occupation by financial and insurance companies (that is, excluding the mediating role of property companies and separating out service suppliers) is only 29%.

Analysis of the current situation in the City of London office market has shown the importance of overseas ownership and the dominance of both occupation and ownership by finance, insurance and real estate sectors. The growing interlinkage between ownership and occupation may be a cause for concern, should financial recession and a property slump coincide. Next, we turn to the historic development of these patterns.

4.2 The Recent History of the City of London

The historic office database created for the project provides information on ownership patterns for a significant sample of City of London offices. The database shows 22% of core space to be in overseas ownership. The database can be used to trace changes in the pattern of ownership over the twenty five year period between 1972 and 1997. Here, analysis of the nationality and business type of owners is reported.

The most striking trend is the rapid rise in overseas ownership from the mid 1980s. As Exhibit 9 shows, overseas ownership was stable across the 1970s and early 1980s. 1985 represents a watershed. Thereafter, the combination of financial deregulation, easing of barriers to capital flows and the onset of the boom phase of the City office cycle created conditions favouring transfer of ownership. The initial increase in foreign ownership came from Japanese and Western European acquisitions. In the early 1990s, transfer of ownership reached a plateau, with UK ownership stable at around 85% between 1990-1994. In the last three years, the level of overseas ownership increased once again, with major purchases by German and US funds.

The figures here are consistent with national statistics on overseas direct investment in real estate (see Exhibit 10) Investment at the national level remained low until the late 1980s, peaked in 1989/90, fell in 1991/2 and recovered in the mid 1990s. (DTZ, 1997). The correspondence between UK and City figures is unsurprising since DTZ report that a third of all overseas investment between 1998 and 1995 was in the City and that 78% of investment was in the office sector.

More detailed analysis reveals that there have been a number of sales between overseas owners of differing nationalities and transfers between foreign firms of the same nationality. Thus not all overseas acquisition activity involves a transfer from UK ownership. Examples of cross trading include the 1996 acquisition by DIFA of the Royal Bank of Canada Centre from RBC and Markborough and Trizec's purchase of a 50% share of Advanta's developments. As DTZ (1998) note, the growth in sales by overseas firms "*is a natural consequence of their increasingly established presence within the UK*".

The historic database, then, indicates that substantial overseas ownership of City office buildings is a comparatively new phenomenon. As recently as 1987, barely 10% of floorspace was owned by non-UK firms. The growth of international ownership seems to be related to financial deregulation and “Big Bang”. First, overseas firms set up operations in the City, acquiring owner-occupied space. Secondly, reductions in barriers to capital flows made it easier for investors to acquire space. Finally, the impact of the financial markets on real estate produced conditions that encouraged waves of overseas investment. These same forces would be expected to influence the type of organisation owning space.

Changes in the composition of ownership by the type of business are less clear cut (Exhibit 11). Public and charitable ownership has declined over the period, from 36% in 1972 to 26% in 1997, much of the change occurring after 1985. The decline reflects sales of property by the traditional land owners (the Livery Companies and guilds) but also transfer from public to private ownership, such as the development of former railway lands as office and mixed use sites. Institutional ownership fluctuates over the period.

Property company ownership fell from 23% in 1972 to 17% in 1985 then rose to 29% by 1997. There might have been a change in the nature of property company ownership over the period, traditional property investment companies being supplemented by newer entrepreneurial developers accessing capital market sources of funding. FIRE ownership rises from under 60% in 1973 to nearly 70% in 1997 with, once again, the bulk of the increase occurring after Big Bang (Exhibit 12). That 10% increase is equivalent to an additional 7.7 million square feet of office space in the City.

The current pattern of ownership is a recent phenomenon. Overseas ownership rose rapidly from the mid 1980s, encouraged by financial deregulation. There have been waves of overseas ownership, associated with economic, fiscal and regulatory conditions and the state of the City market. Functional specialisation in the City has been paralleled by growing specialisation and concentration of ownership. The period of analysis has seen a transfer of ownership from the public sector and traditional landlords to more financially-oriented firms. All these trends serve to integrate real estate and financial markets more closely together.

5. Conclusions

Analysis of ownership trends in the City of London office market reveals rapid growth in overseas ownership paralleling internationalisation of business in the City. Some 20% of office floorspace is in overseas ownership, a total of over 14 million square feet with a capital value of around £4billion (\$6.7bn). The growth of overseas ownership dates largely from the mid-1980s and is associated with financial deregulation and Big Bang. While half the overseas offices are in owner-occupation, foreign firms directly hold significant amounts of investment real estate in the City.

The growing importance of overseas ownership coincides with a second trend: increasing concentration of ownership by financial, insurance and real estate firms. The FIRE sectors now own 70% of office space in the City of London. This rise has been at the expense of traditional landowners like the livery companies and guilds, the public sector and the corporate sector. The City’s role as a location for corporate headquarters has largely ended. The changing character of ownership has permitted an extension of the City’s boundaries into fringe areas traditionally considered unsuitable for development.

This concentration of ownership binds together ownership, investment and occupational markets. The employment structure of the City is dominated by international financial activity with ancillary business and professional services. As a result, the characteristics of owners are near identical to occupiers: 74% of office space is *simultaneously* owned and occupied by finance or finance-related firms. This increases the City's vulnerability to downturns in world markets. The functional specialisation necessary to exploit agglomeration economies and resist competition from rival centres results in a highly undiversified economic structure. A financial downturn would suppress occupational demand, reduce asset values and worsen portfolio performance in the financial sector. The complex nature of funding and financing of large schemes in the City would tend to exacerbate these negative feedback effects.

While these risks are real, they should not be exaggerated. At the peak of bank lending to UK real estate in 1991, the £56 billion outstanding to property companies and construction firms represented less than 12% of UK-based banks' loan book (Davis, 1993). Following a long period of disinvestment, the proportion of UK institutional assets directly invested in real estate is around 7% (ONS, 1997). City offices make up around 10% of the capital value of the IPD index. Thus less than 1% of insurance and pension fund assets are directly owned City offices. This, however, understates institutional involvement: they will be significant owners of property company shares and may have financial interests through bonds and other debt instruments. To this must be added their owner-occupied operational property. Furthermore, ownership of City offices is probably confined to a handful of larger funds, given lot sizes. For foreign owners, and for UK owners with international portfolios, exposure to real estate in other international financial centres needs to be factored in. The impact of a major downturn in the City office market would thus be major but not necessarily catastrophic.

To conclude, we offer five hypotheses about the future trajectory of the City of London office market. These hypotheses are implied in, but not confirmed by, our empirical research. They also derive from a series of interviews and seminars with leading players in the London market.

1. Overseas ownership of City offices will continue to increase.

The City is an international financial and business centre: further functional concentration is likely to occur. Financial trends, including cross-border mergers and acquisitions, corporate restructuring, development of specialised niche markets and innovation in products and trading mechanisms all emphasise that global character. The new large multi-national corporations are likely to locate headquarters or major operational offices in and around the City. Thus overseas owner-occupation is likely to increase.

Global business activity is accompanied by global investment. European monetary union is likely to accelerate this process by removing currency risk within the Euro zone and facilitating cross-border trading. While the state of the London market will determine inward direct investment, international portfolio diversification, the development of privatised pension schemes in much of mainland Europe and the development of new ownership vehicles will permit a further round of overseas acquisitions. 17% of UK ordinary equities and 20% of UK government securities are in foreign ownership (ONS, 1997), so the 20% share of ownership is not greatly out of line with other asset markets and not high for the 'one true world city'.

2. London will continue to have higher foreign property ownership than other major financial centres and cities

London has higher levels of international financial and business activity than other major financial centres and this is reflected in ownership patterns. Other world cities are likely to exhibit far lower levels of overseas ownership. Tentative estimates for Frankfurt and Paris by Henderson Investors confirm this view. In Frankfurt, owner-occupation is the norm. Where investment property does exist, the majority of landlords are German, led by the open-ended funds. Foreign ownership is probably between 1%-5%. In Paris, foreign ownership levels have increased in recent years, with overseas investment accounting for some 90% of major office purchases in 1996 and 1997. Even if this trend continued, the aggregate share of space in foreign ownership would only rise to around 5% by the turn of the century.

3. New forms of ownership will encourage further overseas property ownership

4. New forms of property ownership may increase volatility but reduce mispricing

Direct overseas investment in real estate is constrained by the characteristics of property as an asset including large lot size, illiquidity, high management and monitoring costs. The development of more liquid investment vehicles that permit investors to gain market exposure without facing these disadvantages must encourage further investment. Current vehicles, such as limited partnerships, are likely to be complemented by real estate OEICs, equivalent vehicles to Real Estate Investment Trusts and other securitised vehicles. The successful development of these vehicles will make direct real estate more expensive to hold and increasingly unattractive to investing institutions.

Such vehicles, often traded on secondary markets, emphasise liquidity. Evidence from indirect real estate vehicles in other markets suggest that they have levels of volatility closer to those found in stock markets than conventionally reported in direct property markets. In part, this reflects the requirement for liquidity - which permits more rapid inflows and outflows of capital. It is possible that a market where a significant proportion of the assets are owned through liquid vehicles is vulnerable to capital flight. Furthermore, real estate may function less effectively as a risk diversifier. However, the closer integration of real estate and other capital markets may lead to more efficient pricing of property assets reducing the possibility of speculative boom and bust. Changes in the pattern of office ownership in this form do, nonetheless, further increase the linkage between real estate and the investment and finance markets.

5. Changing office ownership patterns will extend the boundaries of the City

The declining significance of traditional landlords and traditional sources of funding, allied to changes in the nature of firms occupying space, led to a greater willingness to develop and occupy space on the fringes of the traditional City. This spatial extension was driven, in part, by planning constraints, conservation measures, land costs and the difficulties of site assembly within the traditional City office market. However, it also represented a change in attitude on the part of occupiers, developers and investors. With further changes in the nature of ownership and funding of office development predicted, it is likely that the functional boundary of the City will continue to extend. The spread of the City may produce a flatter rent gradient (product becoming more important than micro-location) and shifts in the rental centre of gravity.

In competing with other financial centres, the City of London will become still further specialised as a provider of global financial and business services, continuing a long-established trend. This internationalisation of activity will be accompanied by increased levels of foreign ownership of assets. For the real estate sector, this ownership will be both for operational reasons (to control and occupy space) and for portfolio investment purposes. Overseas investment flows into real estate will be encouraged by the development of more liquid, traded vehicles offering exposure to the City office market. Such developments are likely to increase the volatility of real estate markets and reduce some of property's diversification benefits as office returns are linked more closely to the fortunes of the international financial services markets. Allied to the growing interlinkage of ownership and occupation, this brings greater risk of instability in times of recession. This is not a function of overseas ownership (which, indeed, may imply commitment and stability) but of the changing financial nature of real estate markets. The connection between office ownership and the operation of financial markets, and the particular concentration of these forces in the City of London, imply greater market volatility and more extreme cyclical behaviour. These forces are largely outside the control of domestic regulation; but that is the price of London being a true world city.

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Exhibit 1: Ownership in the City of London By Country of Origin

Column % Country	Core		City Fringe		Combined	
	Total	O/Occ Total	Total	O/Occ Total	Total	O/Occ Total
UK	80.3%	64.0%	85.8%	85.8%	81.3%	68.2%
France	1.3%	2.4%	0.0%	0.0%	1.0%	2.0%
Germany	5.8%	4.8%	3.8%	0.3%	5.5%	4.0%
Japan	4.8%	11.2%	0.6%	0.0%	4.0%	9.0%
Netherlands	0.9%	2.3%	0.0%	0.0%	0.8%	1.8%
Switzerland	1.1%	3.8%	0.0%	0.0%	0.9%	3.1%
USA	3.2%	6.8%	3.2%	9.7%	3.2%	7.3%
Rest W Europe	0.6%	1.8%	5.9%	3.4%	1.5%	2.1%
India, China, Far East	0.8%	0.7%	0.2%	0.1%	0.7%	0.6%
Middle East	0.7%	0.7%	0.1%	0.3%	0.6%	0.6%
Old Commonwealth	0.4%	1.2%	0.6%	0.5%	0.4%	1.1%
Others / Unknown	0.2%	0.3%	0.0%	0.0%	0.2%	0.2%

Exhibit 2: Overseas Office Owners, City Core

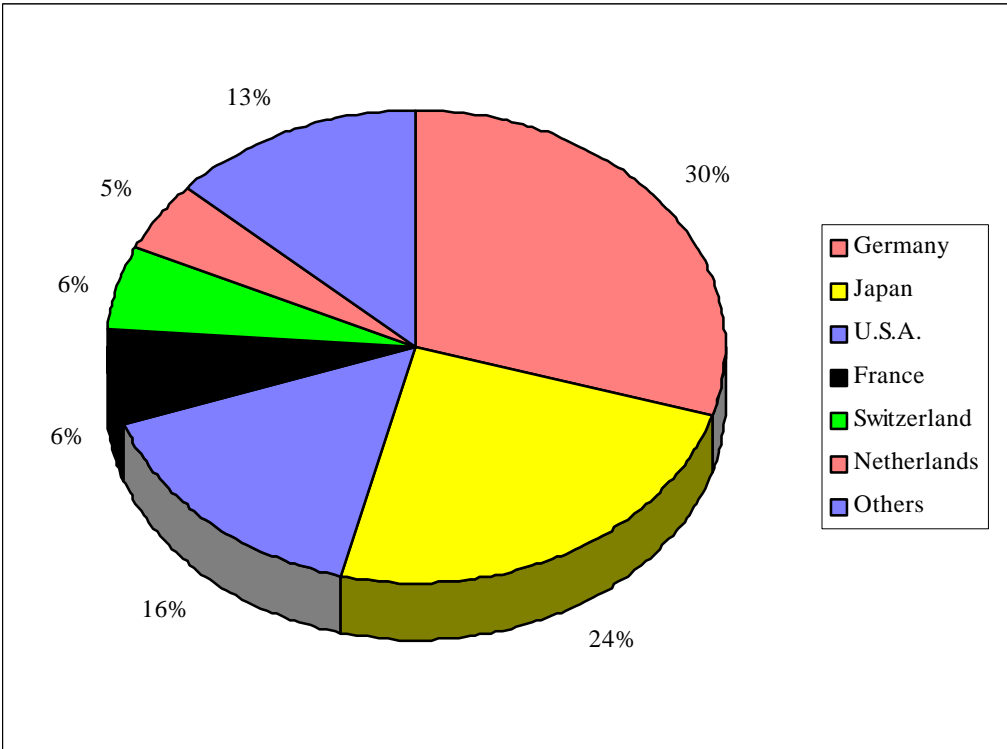


Exhibit 3: Office Owner-Occupation by Country, City Core

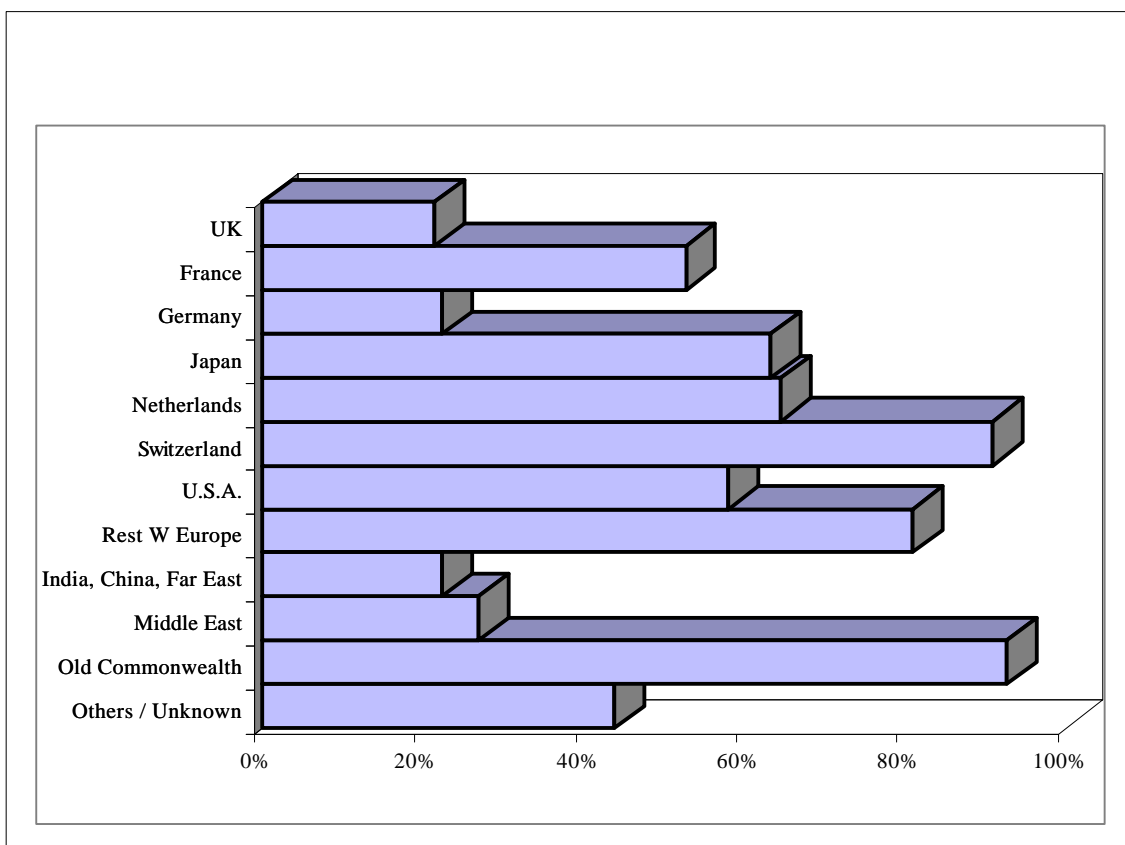


Exhibit 4: Ownership of Office Investment Property, City of London

Country	Space Sq M	Percent
UK	4,106,995	86.2%
France	32,012	0.7%
Germany	287,470	6.0%
Japan	101,892	2.1%
Netherlands	18,182	0.4%
Switzerland	5,435	0.1%
USA	74,029	1.6%
Rest W Europe	62,543	1.3%
India, China, Far East	35,887	0.8%
Middle East	26,012	0.5%
Old Commonwealth	6,869	0.1%
Others / Unknown	5,649	0.1%
TOTAL	4,762,981	
Non-UK	655,986	13.8%

Exhibit 5: The percentage distribution of City of London office employment, 1961-91

Sector	1961	1971	1981	1991
Insurance, banking & finance	31.1	43.1 *	41.9	51.0
- Banking	N/A	19.1	22.7	28.5
- Insurance	N/A	13.3	13.1	13.3
- Other financial services	N/A	7.1	6.1	9.2
Business services	8.2 **	9.9 **	12.3	23.4
Printing and publishing	11.1	10.4	9.2	1.5
Other	49.7	36.6	36.5	24.1
Total	100.0	100.0	100.0	100.0

** 'Professional and scientific services'

Source: Baum *et al.* (1998)

Exhibit 6: Ownership By Type of Business, City Core

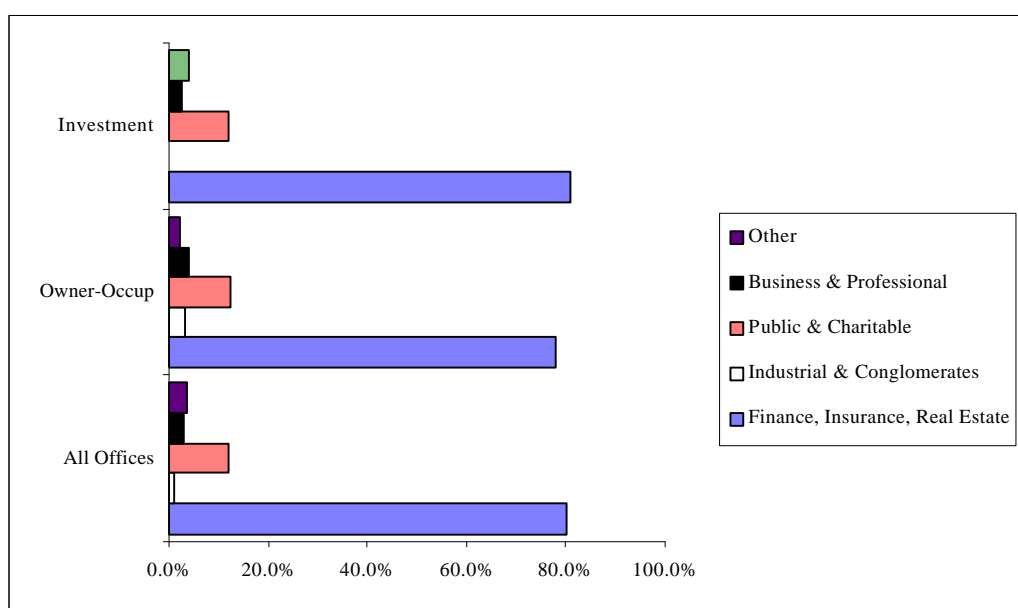


Exhibit 7: Office Ownership By Type of Business, City Fringe

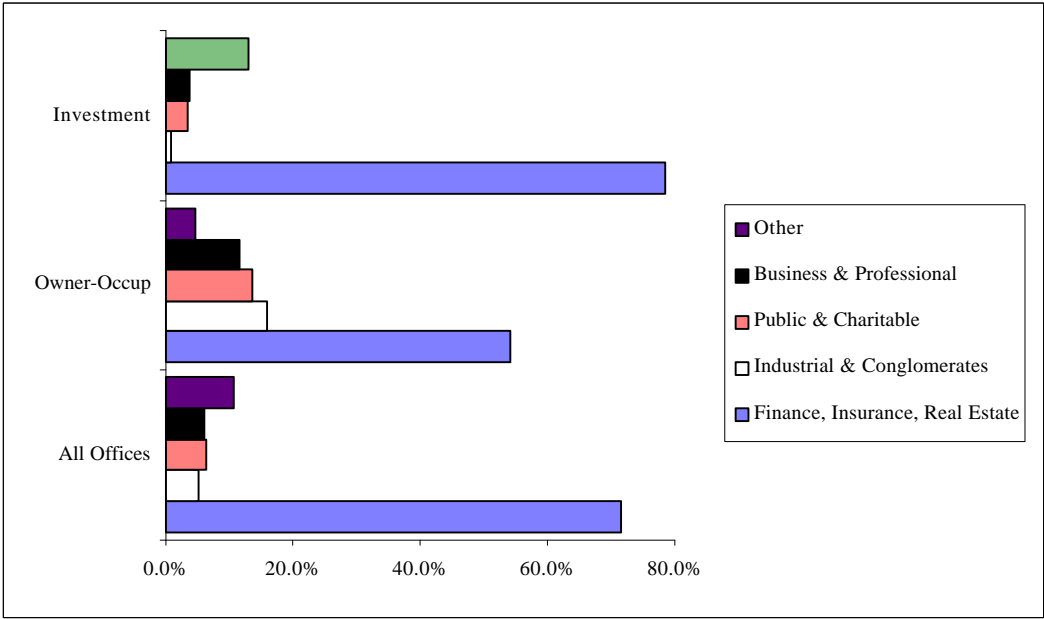
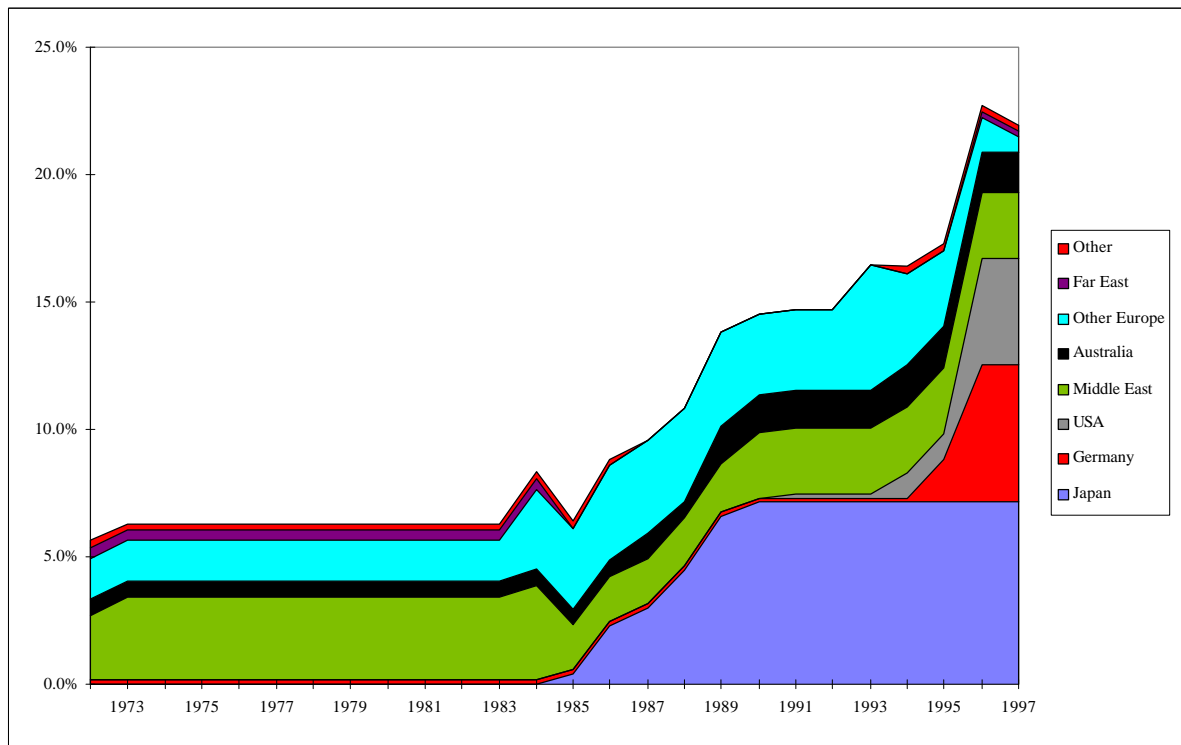


Exhibit 8: Ownership & Occupation in the City Core

Owner:	Occupier:	Financial Services	Insurance	Property & Construction	Bus & Prof Services	Public and Charitable	Other	TOTAL OWNED
Financial Services		20.2%	2.4%	0.2%	3.4%	0.4%	1.0%	27.5%
Insurance		5.3%	1.6%	0.3%	4.8%	0.2%	1.6%	13.8%
Property & Construction		19.2%	3.2%	0.5%	10.4%	1.0%	3.2%	37.7%
Bus & Prof Services		0.1%	0.2%	0.0%	2.4%	0.0%	0.3%	3.0%
Public and Charitable		3.7%	0.8%	0.2%	4.5%	2.2%	1.2%	12.7%
Other		1.4%	1.1%	0.0%	1.4%	0.0%	1.3%	5.2%
TOTAL OCCUPIERS		49.9%	9.4%	1.3%	26.9%	3.8%	8.6%	100.0%

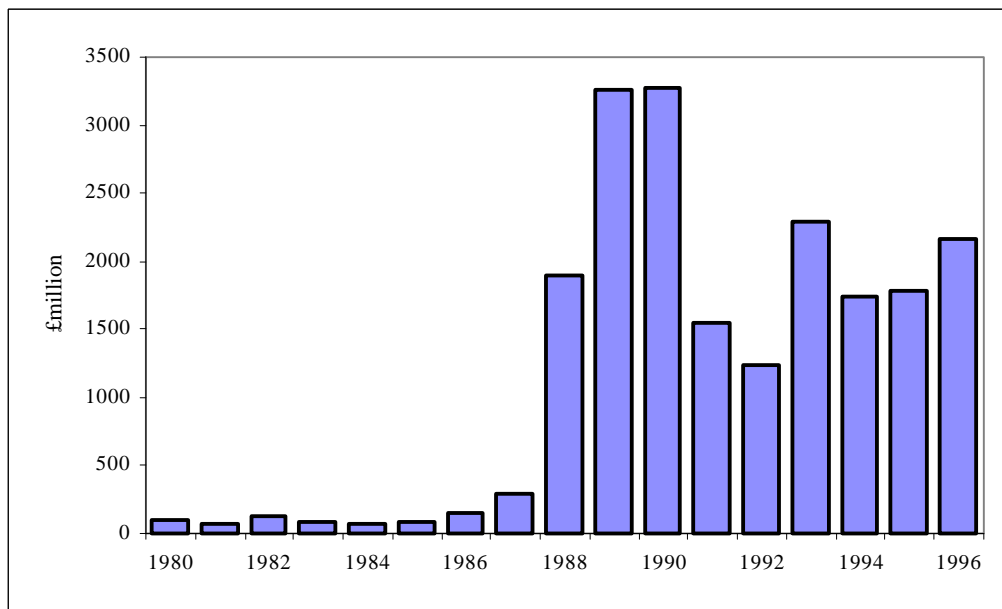
Note: total percentages by floorspace

Exhibit 9: Overseas Ownership of Offices in the City of London 1972-1997



Note: proportion of floorspace in overseas ownership.

Exhibit 10: Overseas Investment in UK Commercial Property



Source: DTZ (1997)

Exhibit 11: City Office Ownership By Firm Type 1972-1997

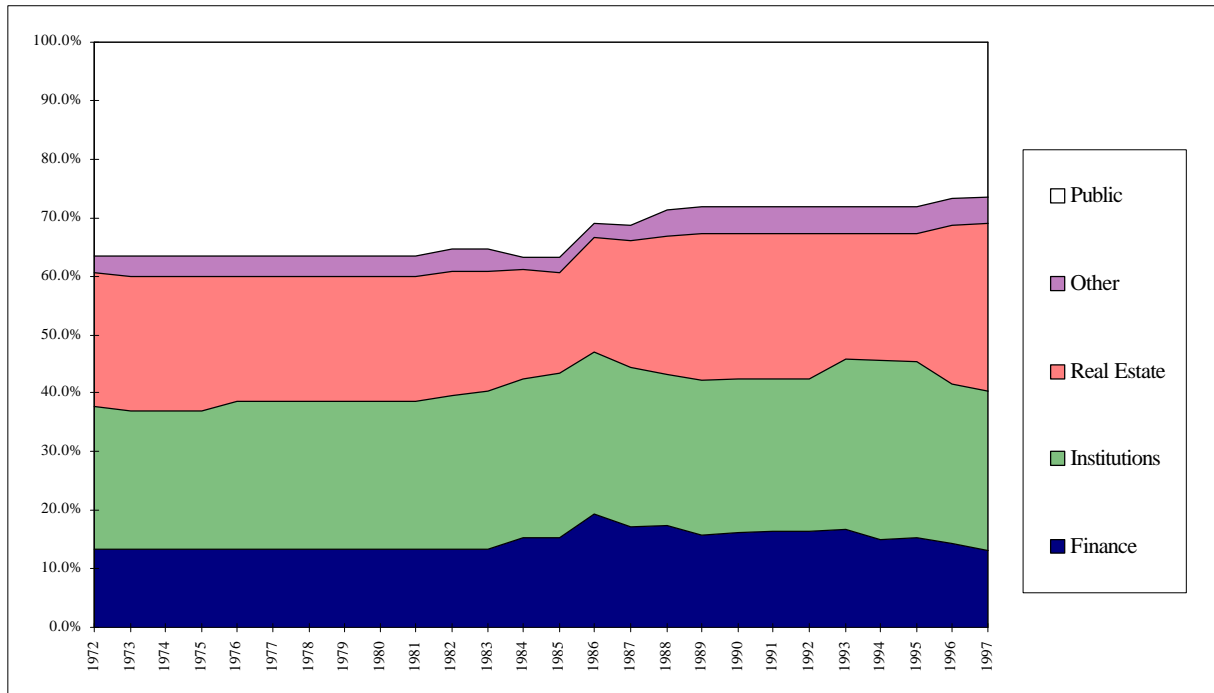


Exhibit 12: Proportion of Space Owned By FIRE Sector 1972-1997

