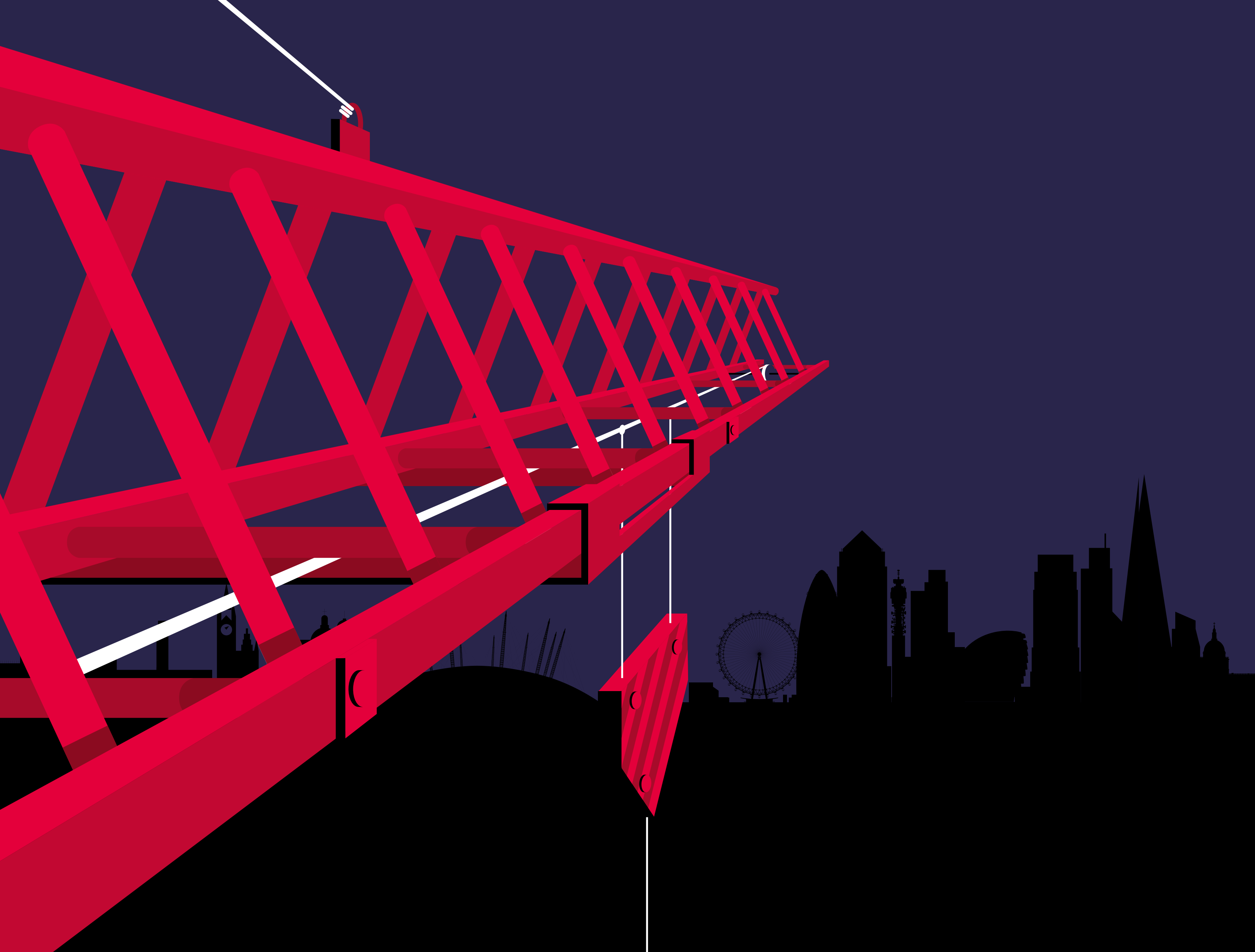
The London Report

2018



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Overview

London: The world's greatest city!

Stephen Clifton
Head of Central London Offices

Constantly evolving, London adapts to change like no other city. Its robust performance in the face of the Brexit spectre bodes very positively for the acceleration we are set to feel as Euro-political uncertainty subsides.

2018 will be both a pivotal and positive year. The Elizabeth line, a key accelerant to growth, will open and change how we move around the city. Add to that the world's top talent pool, the emergence of new technology and bioscience occupiers in an increasingly supply constrained environment, and we have a recipe for performance.

As the marketplace continues to shift, The London Report provides further context and guidance for those operating within it.

These are the five key takeaways:

01. **London's economy has been particularly resilient in the face of Brexit. Any job losses over the next two years as a result of the UK's exit from the EU will be off-set by new job creation.**

02. **Central London occupational supply peaked in 2017 and is now falling. This will increase demand for pre-lets.**

03. **The biotech sector has now joined technology, media & telecoms (TMT) in attracting unprecedented levels of investment, and will drive demand for office space in 2018.**

04. **Occupier decision-making has evolved. For occupiers, real estate has become a strategic device.**

05. **London's investment market saw transaction volumes rise 30% in 2017. New market entrants, favourable global pricing and a rotation towards risk will drive investor appetite in 2018.**

London's economy: Resilient and global

The capital's adaptable economy is successfully weathering the Brexit uncertainty, thanks to rising digital industries

James Roberts
Chief Economist

There is a perception held by some that London's economy must be suffering as a result of the move towards Brexit; but this is not in evidence in the statistics. Employment is rising and unemployment is falling in the capital, while inward investment continues. In the year to October 2017, 128,000 new jobs were created in London, according to ONS. UK GDP growth was sluggish for much of 2017, but we did not see the post-referendum recession many feared. In fact, the growth figures stayed safely in the black.

How do we explain this gap between perceptions that Brexit should be dampening the economy, and statistical proof of growth? There are three key points to consider, which explain why London's growth is holding up better than expected, and will continue to do so in 2018.

25%

Office take-up by TMT firms in 2017 exceeded the long-term average by a quarter

01. LONDON IS NOT SEEING LARGE NUMBERS OF JOBS LEAVE AS A RESULT OF THE VOTE TO LEAVE THE EU

Most major banks and insurers have announced plans to move a small number of jobs (usually in the low hundreds) to offices in the European Union in order to continue serving EU-based clients post-Brexit. The number of jobs has been much lower than previously expected.

A survey by Reuters of over 120 UK and international banks and insurers suggested 10,000 jobs could relocate as a result of Brexit. The office space occupied by 10,000 workers is the equivalent of 0.5% of total office stock in Central London – a manageable figure for the market to absorb. Experian Economics is forecasting 49,000 jobs will be created in office-based industries in London over the next two years – more than enough to compensate for the job losses predicted.

02. LONDON'S ECONOMY HAS NOT BEEN LED BY FINANCE FOR SOME TIME NOW

Government figures show the number of people in London employed in the technology, media and telecoms (TMT) sector overtook those working in finance and insurance in 2013, thanks to rapid expansion by major digital firms. The TMT sector has continued to recruit and expand in London since the referendum to leave the EU, because most tech firms operate in a borderless world that is less affected by Brexit. Take-up of office space by TMT firms in Central London was 25% above the long-term average level in 2017.

Tighter immigration rules will be a challenge for the TMT sector. However, we expect the government post-Brexit to look favourably on visa applications from highly skilled and well-paid tech workers.

03. THAT INTEREST RATES IN THE UK ARE RISING AGAIN IS REASON FOR CONFIDENCE IN THE OUTLOOK

The Bank of England Monetary Policy Committee (MPC) in November 2017 raised the UK base rate because it has confidence the economy can cope with the increase. Unlike the Eurozone, which is still pursuing Quantitative Easing, the UK is now in a position to move away from emergency measures brought in during the global financial crisis. The MPC has indicated that going forwards rates will rise very gradually, which should limit the impact on debtors.

In particular, the Bank of England views the tight conditions in the employment market as proof that the UK economy is strong enough to handle higher rates.

Our outlook is for London to remain a leading global business hub, but with TMT industries leading growth. Finance is adapting to new realities, but the job losses involved are manageable in number. London is the UK region best positioned to shrug off the Brexit uncertainty and benefit from the upturn currently underway in the global economy. This bodes well for demand for Central London offices in 2018.

> **"In the year to October 2017, 128,000 new jobs were created in London, according to ONS"**

Supply pipeline: The cycle continues

Patrick Scanlon
Head of Central
London Research

Abby Brown
Partner, Central
London Leasing

Supply has peaked, the development pipeline is weak and tenant demand is strengthening. We are now in the next property cycle

The Central London office market is cyclical. This adage has been the cornerstone of London office commentary and forecasts for more than thirty years, and it has been absolutely correct.

Property cycles are fluctuations in activity measured by peaks and troughs in performance, and in Central London they have historically been triggered by major global economic events.

The 1990's recession, the dot com crash, and the global financial crisis all sparked a fall in occupier demand, an increase in vacancy rates, and downward pressure on rents. However, the most recent increase in supply was not triggered by any particular economic event; it had already commenced before the EU referendum in mid-2016.

One of the key characteristics of the property cycles has been the relationship between peaks and troughs in office supply, and speculative construction activity. Speculative construction is counter-cyclical; as demand picks up, supply begins to fall, and developers commence schemes to fill the potential supply-demand gap due to their increased confidence.

Levels of supply of new and refurbished space began to fall rapidly in 2014, which prompted a reaction from developers. However, it was also the release of second-hand space to the market by occupiers moving into stock they had pre-let in the preceding years that contributed to supply's rise.

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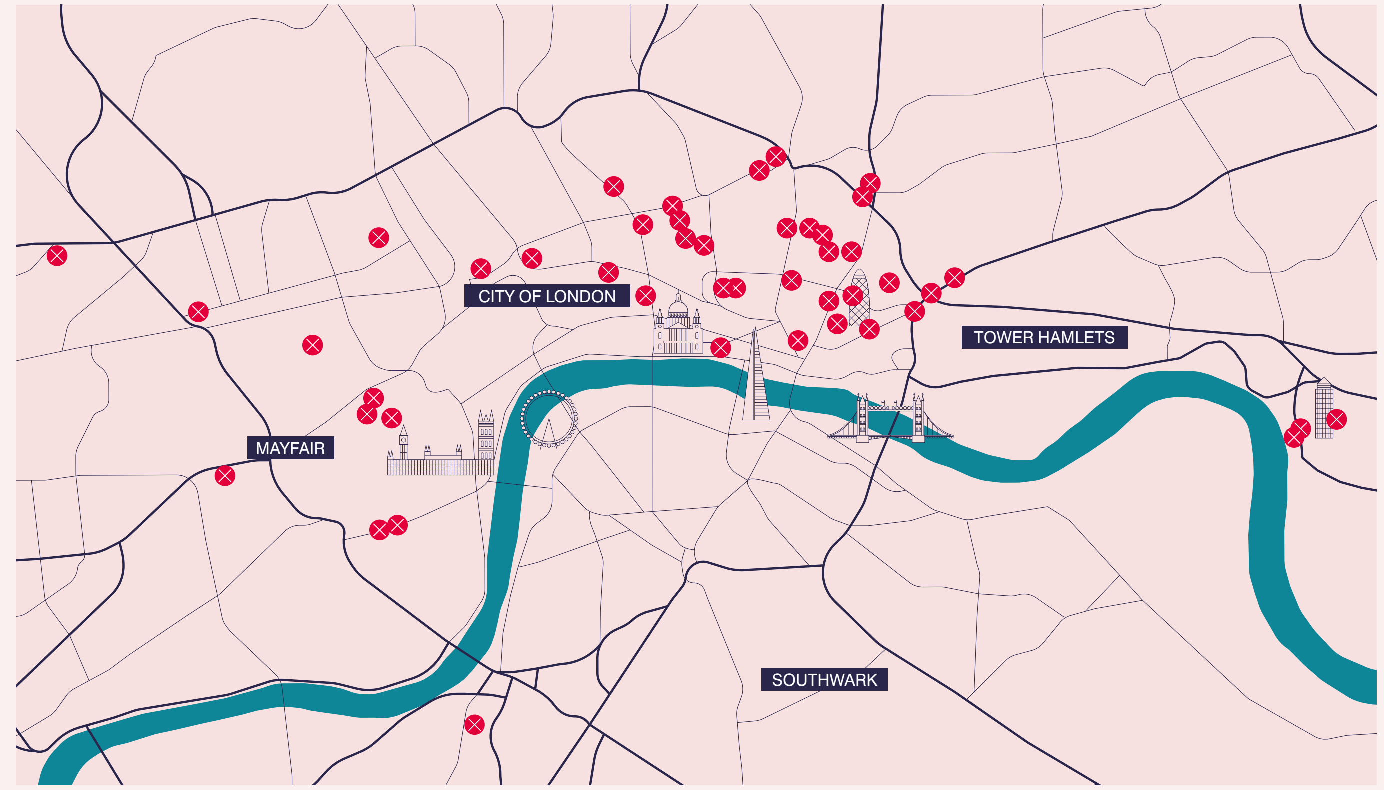
> “As the pipeline thins and employment remains high, London office supply will start to fall”

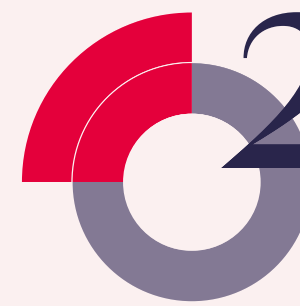
SPECULATIVE OFFICE SCHEMES UNDER CONSTRUCTION IN CENTRAL LONDON



Source: Knight Frank Research

Despite an abundance of development schemes across London, relatively few are commercial and fewer still are available to lease.

At the end of 2017 there was 7 m sq ft under construction speculatively



25% of schemes under construction speculatively will not be delivered until 2020

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WE NOW FIND OURSELVES IN THE NEXT PROPERTY CYCLE.

Although to an observer London may appear to be a sea of cranes, there is more going on beneath the surface that ought to be understood in any appraisal of the market. There are 259 development schemes under construction in Central London, however 187 of these are residential; only 72 can offer commercial space, and just two-thirds of these remain available to lease.

That being said, at the end of 2017 there was more than 6.9 m sq ft under construction speculatively, 20% above average levels. So what does this mean for the Central London office market?

In normal circumstances, the delivery of such a volume of stock to the market would be a cause for concern. However, more than a quarter of all office space currently under construction is not due to be completed until 2020 at the earliest, leaving around 4.9 m sq ft of new stock to be delivered to the market in 2018 and 2019. The development pipeline for this period will only be able to satisfy little more than half of tenant demand, assuming average levels of take-up of new and refurbished space of 9.0 m sq ft.

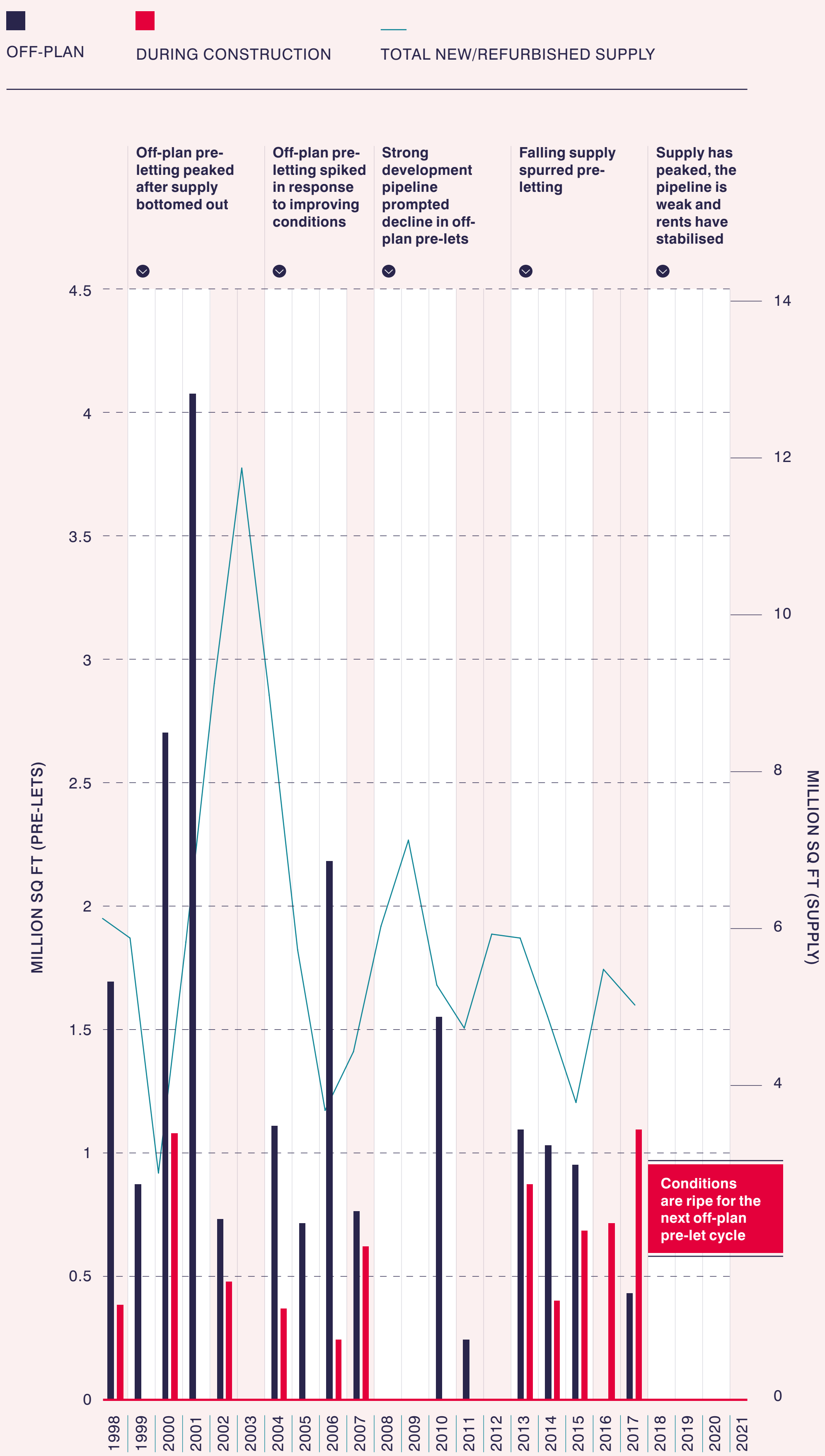
We believe that this lack of quality supply will trigger the next wave of large pre-lets in Central London.

An historic analysis of pre-letting shows that at times of falling supply and strengthening market conditions, the pre-let comes to the fore. Supply has peaked in Central London, which has already prompted an increase in pre-letting. An ongoing fall in supply will drive tenants to continue taking space out of the pipeline to ensure they secure their preferred options well in advance of their lease events. Large tenants cannot afford to assume that there will be speculative space available to satisfy their requirements.

As the pipeline thins and employment remains high, supply will fall.

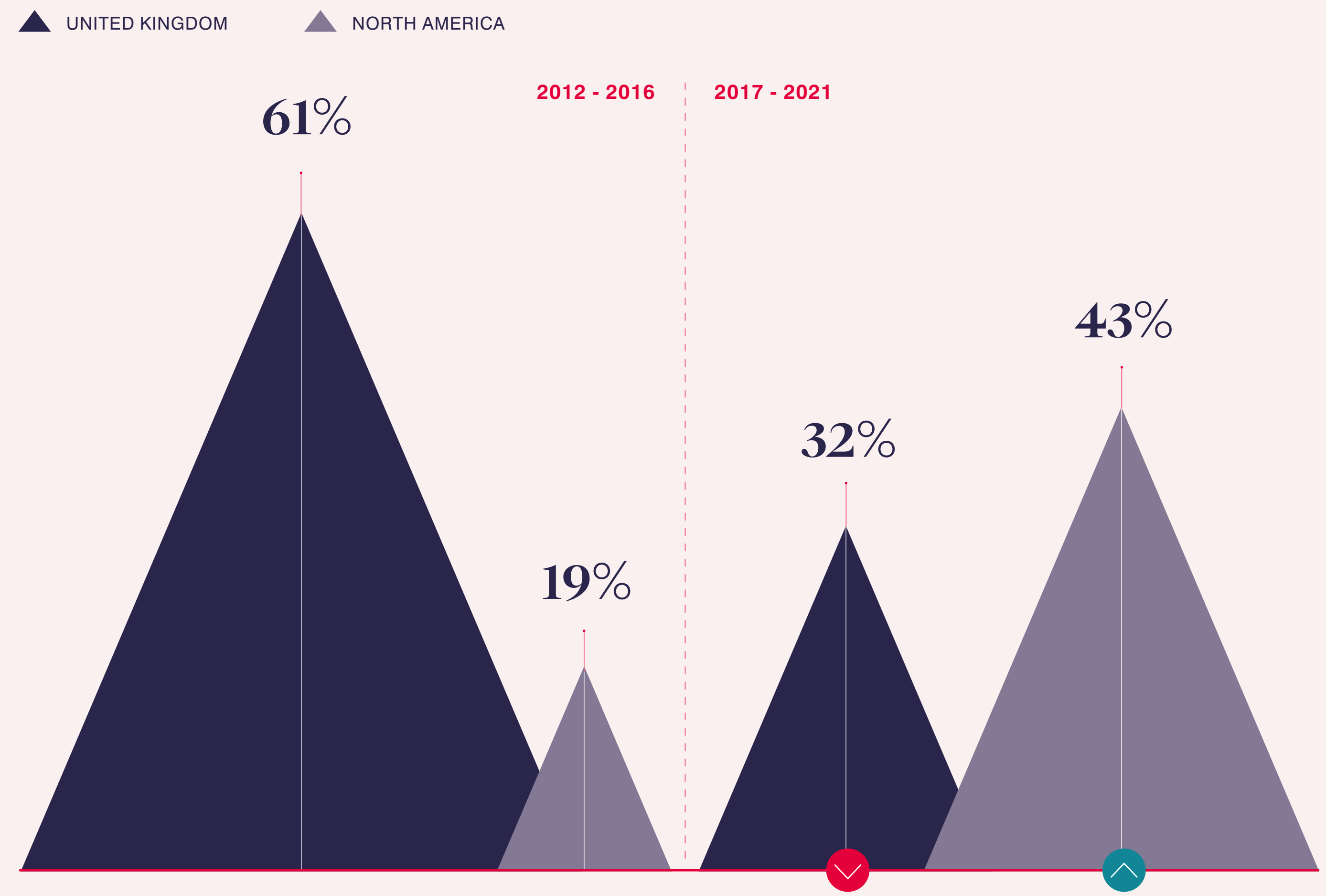
CENTRAL LONDON PRE-LETS, 200,000 SQ FT VS NEW/REFURBISHED SUPPLY

Historically, off-plan pre-lets are most prevalent at the extremes of the cycles



Source: Knight Frank Research

SOURCES OF CENTRAL LONDON DEVELOPMENT FUNDING



Source: Knight Frank Research

Data for 2017-2021 shows completed schemes and schemes under construction

WHO'S BUILDING LONDON?

London's commercial pipeline has historically been controlled by UK developers and funded by domestic capital. While overseas investors have dominated the market for built investment stock, there has been less appetite for involvement in development.

However, since the global financial crisis, bank funding for speculative development has been difficult to obtain, which has helped keep the pipeline under control. This has led to a significant shift in the type of money behind developments. Our analysis shows that the percentage of development over the next five years funded by UK money has fallen from more than 60% to around 32%, with a noticeable rise in the volume of space under the control of North American developers. This includes schemes yet to start on site.

One of the side effects of this rise in overseas money has been the lowering of returns for development projects in London; as ungeared returns of circa 10% become normal, London has become more aligned with other global markets.

Despite both this and Brexit, London has remained a relatively safe and attractive market, not least because of the currency advantage enjoyed by foreign investors.

In last November's budget, however, the Chancellor announced that from April 2019, most foreign investors will be liable to pay capital gains tax on UK property. From April 2020 they will also be subject to the recently introduced debt interest relief restrictions and loss relief restrictions, meaning that heavily indebted structures will be exposed to more UK tax. Importantly, this could be most keenly felt where an investor has already purchased secondary stock with a view to scaling up with a new scheme.

So what will be the effect on London's development pipeline?

Knight Frank believes that there will be differences on a case-by-case basis. Larger overseas developers planning to build out and sell will, in all likelihood, already face corporation tax and could be largely unaffected by these changes.

Smaller developers or private investors may well benefit from accelerating the development process to add as much value to their site as possible before the March 2019 date, thus reducing the gap between 'current' value and post-development profit.

In either case, although the changes could be significant, the advantages of owning and developing commercial real estate in London are likely to ultimately outweigh the negatives.

“A building is not just a place to be, but a way to be” – Frank Lloyd Wright

London's newest buildings: Paving the way


Patrick Scanlon
Head of Central London Research


Andrew Tyler
Head of Central London Office Development

American architect Frank Lloyd Wright believed that architecture was not just about buildings, but about nourishing the lives of those within them. This notion is more relevant to Central London now than ever before.

Historically, companies' focus tended towards maximising profit through reducing capital expenditure; real estate was often a key area in which it was perceived margins could be increased. A drive for large, efficient floorplates with high occupational densities drove commercial real estate design during the 1980s, 1990s and 2000s.

However, attention has turned to potential gains in productivity and staff satisfaction, which has impacted building design. In addition, as technological advances made moving back office functions to cheaper locations a possibility, the focus turned to attracting and retaining talent in front office functions.

A study by the British Council for Offices found that around 55% of underlying business costs are staff-related, with just 15% being directly related to real estate. By this logic, it makes good business sense for a company to limit the costs involved with staff turnover by creating a desirable, rather than simply efficient, workplace.

> **“Investment related to real estate, should reduce spend related to staff”**

Therefore, investment related to real estate, should reduce spend related to staff.

The following selection of schemes highlight where this new thinking has been incorporated - not just in the design of buildings, but in the amenity and public realm, to create the next wave of London's commercial real estate.

The WestWorks

White City Place, W12

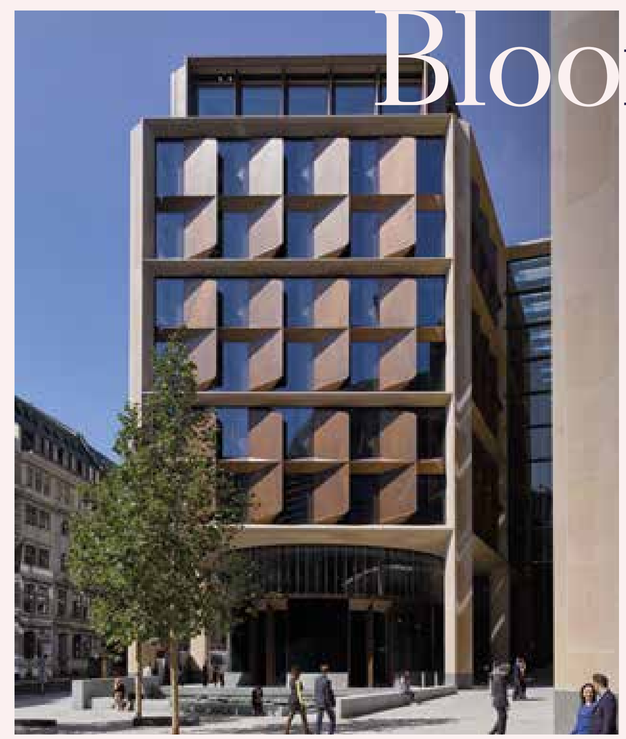
White City Place forms part of the redevelopment of the former BBC West London campus, providing almost 800,000 sq ft of office space amid re-modelled public realm.

The WestWorks, a comprehensive 290,000 sq ft refurbishment, encourages collaboration and innovation through its interactive design and unique offering. In addition to a 100-seater recording studio, the building provides a vibrant arrival experience with relaxed meeting areas, both to lend an air of informality to the building and to take the strain off occupiers' meeting rooms.

In addition, occupiers can access a communal 12,000 sq ft terrace and a pavilion, both of which are available to hire for private events.

Bloomberg

3 Queen Victoria Street, EC4



Sustainability and community are central to the design of Bloomberg's new bespoke European HQ, a 760,000 sq ft building on a 3.2 acre site between Bank and Cannon Street stations.

The building achieved the highest design-stage BREEAM score ever achieved by any major office development in the world, using natural ventilation, a smart airflow system, and combined heat and power generation.

Inside, the building design encourages collaboration. Upon entry, staff and visitors alike are directed to the sixth floor 'Pantry' area, offering a place to meet and greet with free coffee and food, located around a central 'triple helix' staircase with access to all floors.

The retail at ground floor level has been carefully chosen to encourage the staff within the building to socialise there at lunch and in the evening.

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International Quarter London

Stratford, E20

The International Quarter London forms part of the redevelopment of the Queen Elizabeth Olympic Park, Europe's largest urban development.

The mixed-use scheme has the capacity to provide 4 m sq ft of workspace alongside residential, retail and leisure accommodation.

Wellbeing forms a major part of the scheme's design; staff can access the Park's sporting facilities along with the open spaces, while the buildings themselves are adaptable and designed to accommodate more agile ways of working.

Connectivity will also be a major factor in the scheme's future. The area is currently served by the High Speed 1 rail line, the Docklands Light Railway, Overground services, the Jubilee and Central Lines, and from 2019, the Elizabeth Line.

Battersea Power Station

Battersea Power Station, SW11

The regeneration of the iconic Grade II* listed building and surrounding area will provide a minimum of 1.25 m sq ft of offices along with extensive residential, retail, leisure and public spaces.

Once complete, the regeneration of the 42-acre site will include: a 2,000 capacity event venue within the Power Station itself; 40 cafés and restaurants; 250 shops and food and beverage outlets; 18 acres of public space; and a new zone one tube station. In addition, the site will provide 4,364 new homes.

Apple has already committed to 500,000 sq ft in the Power Station; its new London campus is expected to be operational in 2021 and will initially house around 1,400 Apple employees from existing offices around London, with space for future headcount growth.

The northern section of Phase 3 designed by Foster & Partners has been pre-let to The Art Hotel, which will provide 163 rooms with the benefit of a rooftop pool.

Occupiers: Talkin' 'bout an evolution:


Dr Lee Elliott
Head of Commercial Research


Richard Proctor
Head of Central London Tenant Representation

London, the tech sector and a new approach to real estate

While recently researching for a project entitled 'Future Gazing', I was struck by the wisdom of a quote from Bill Gates. The Microsoft co-founder maintains that "we always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten." This is prescient when assessing the recent evolution of the London office market.

WHAT A DIFFERENCE TEN YEARS MAKE

Just think back over the last ten years; a period that commenced with the global financial crisis (GFC) and even greater trepidation in the market. At the time, I was constantly fielding the question 'when will the market return to normal?'. The hopeful inference therein was that huge market disruption emerging from the GFC would be short-lived. The answer, as it transpires, was that it would not be. What constituted 'normal' was steadily, and sometimes subtly, redefined over the remainder of the decade. The size and shape of the London market; the volume and nature of the physical space developed within it; the tenant mix occupying that space; and the terms on which that space is occupied have all been fundamentally altered. Rather than reverting to type, the market adapted.

The market had to adapt because its most essential component – the occupier – was itself needing to respond to a range of pressures. As the post-GFC operating environment became characterised by lower economic growth, the transformational impact of technology, a digital revolution which changed the route to market forever, and an associated shift in businesses' talent requirements, the role of real estate became redefined.

It is telling of the period that it was the emergent tech giants - Microsoft, Google, Apple, Amazon and Facebook - who led this process of redefinition. In the spirit of the Gates quote, it was an incremental but significant change. The giants gravitated towards cities and particularly towards London; they utilised technology to change work styles and working practices; transformed the layout and fit-out of the workplace to support those work styles and raise workplace satisfaction; and, critically, in so doing influenced and inspired the real estate strategies of occupiers drawn from across all other industry sectors.

THE FOUR KEY THEMES IN THE OCCUPATIONAL MARKET TODAY

This influence cannot be underestimated. As well as being the dominant source of occupational demand in London today, the new orthodoxies introduced by tech occupiers have been actively mirrored by lawyers, accountancy practices, media firms and banks – in fact by all businesses being reshaped by technological disruption. In this sense, London's occupational market has four key themes running through it today.

01. Real estate underpins strategy

Real estate is now firmly viewed as a strategic device. Rather than a simple factor of production, the right office supports operational and cultural transformation within a business. It contributes to talent management strategies, supporting headcount growth and staff retention. It facilitates and drives new working cultures. It increasingly embodies and promotes brand values. Yet this strategic role for real estate is not without problem. The inherent uncertainty, together with the sheer scale and speed of change within the operating environment, means that business planning horizons are becoming ever shorter. For many businesses, looking out two to three years from today is near impossible. This is problematic in a real estate market where, although reducing, average Central London lease lengths stand at over seven years. Little wonder therefore that occupiers today demand greater flexibility and optionality within leases. It used to be the case that the premium placed on lease flexibility was too great a cost for the occupier to bear. Today the true cost of not having such flexibility could well be terminal to a business. What is more the balanced nature of today's Central London market means that flexibility is available at lower cost to the occupier, as pragmatism shapes landlord behaviour.

02. An innovation imperative

Business success, if not business survival, is now entirely dependent upon adopting and applying new technologies to drive efficiency, productivity, open up new markets or create new product offerings. As a result, an innovation imperative is at work which is directly impacting on the function, use, design and even location of space. A key trend has been the emergence of innovation hubs across a range of industry sectors. These can be entirely ring-fenced within an organisation but are increasingly open, collaborative environments that seek to generate tie-ups between corporate occupiers and innovative start-ups or suppliers. No longer is the office about housing row upon row of staff administering email. Instead, it is about creating and innovating in collaboration.

03. Occupier mobility continues

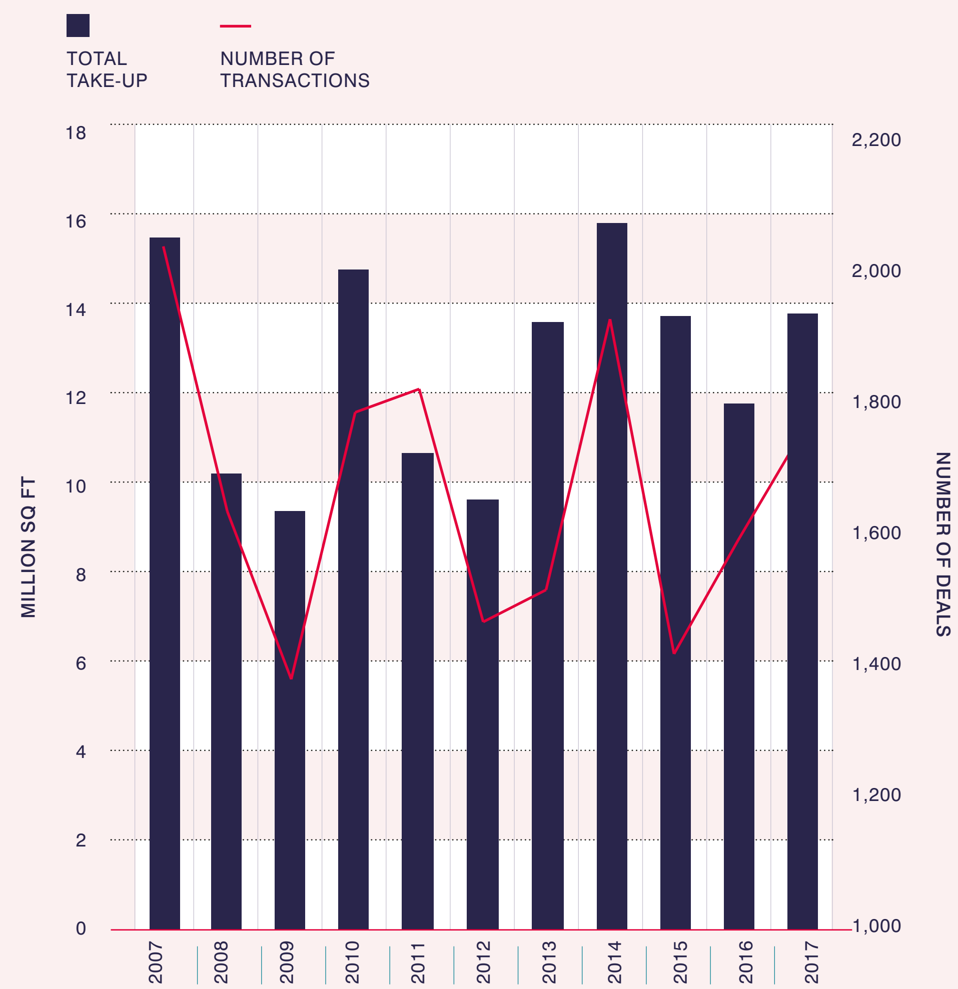
In seeking both strategic transformation and greater innovation, occupiers are showing increased levels of mobility across the London market. This is a trend we have highlighted over the last two years, but one that shows no sign of abating. There are a number of factors at work. Key is the need for occupiers to tap into talent pools that are capable of supporting business transformation. Unsurprisingly we have seen growing interest in locations that benefit from transport infrastructure improvements, and which therefore increase the catchment from which labour can be drawn – three of the five best-performing submarkets since 2007 are those surrounding Crossrail stations. Similarly, we now see occupiers proactively seeking locations that are supported by an innovative, academic infrastructure. While reduced new supply in the London market has influenced this mobility, the push for staff access is undoubtedly the principal driver.

04. Coworking expands and evolves

An undeniable trend is increased interest in new occupational models. The market has witnessed the astonishing growth of coworking and this is an area of the market that is evolving rapidly. Once the domain of small start-up companies, coworking is now a solution to the needs of larger occupiers or, in popular parlance, enterprises. Yet often what is missed in assessments of the coworking phenomenon is what we believe is its most important attribute. Coworking has shifted the supply of real estate from being product to service based. Space as a service is now also part of the lexicon of the London market. More importantly, it taps entirely into the needs of the modern occupier to be housed within well serviced space that creates a positive experience and a sense of community, with a level of service and attention that is consistent irrespective of the amount of space occupied. Coworking operators recognise the occupier as the customer and serve them accordingly with high quality service.

> "Tech giants influence and inspire the real estate strategies of occupiers drawn from across all other industry sectors"
>
> **Bill Gates**

CENTRAL LONDON OFFICE TAKE-UP

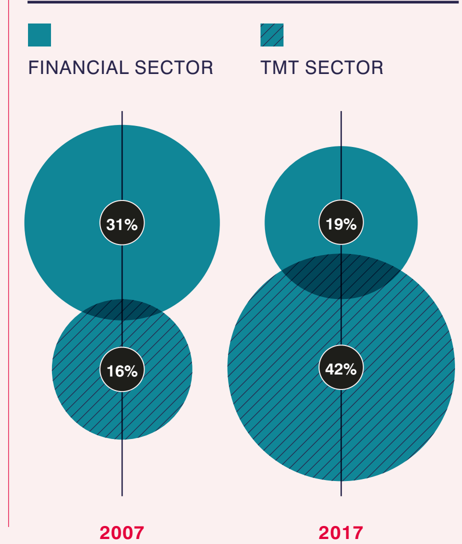


Source: Knight Frank Research

WHAT DOES THIS MEAN FOR THE MARKET GOING FORWARDS?

Clearly, the London office market will continue to evolve. There will be much talk of more revolutionary times in the next 24 months. Brexit will continue to dominate the headlines and will eventually lead to tangible changes in the operating environment. Lease accounting will also change and focus occupier attention on the financial impacts of their portfolios. Critically, the next wave of technology will hit business. Robotics, AI, and the Internet of Things will all challenge business processes and structures. Once again, their true impact is unlikely to be revolutionary in the short-term but will be huge over the longer-term. As that impact becomes evident, the basis of occupier decision making will change forever. The key implication of this for occupiers and investors alike can be found in the very next line of that Gates' quote; "Don't be lulled into inaction".

FINANCIAL SECTOR VS TMT SECTOR, CENTRAL LONDON TAKE-UP 2007/2017



Source: Knight Frank Research

Flexible working in London

The success of coworking and its effect on the London market

Victoria Shreeves
Associate, Central London Research

Amanda Lim
Associate, Flexible Office Solutions

London has experienced rapid change in the provision of flexible workspace and coworking in recent years. Since 2014, the average level of flexible office take-up in Central London has exploded and is now more than double the ten-year average. We explore the drivers of its success, and what effect it will have on the Central London office market.

THE RISE OF FLEXIBLE SOLUTIONS

The unprecedented rise in demand for flexible working, serviced and coworking space is not attributable to a single factor. A number of influencing trends have taken shape in recent years, allowing a 30-year old industry to essentially relaunch and rebrand itself so it is aligned with a new digital age.

The key drivers are:

- London has seen a 41% increase in small and medium enterprises (SMEs) since 2010, much of which has been driven by a marked increase in funding from venture capital
- The growth of the gig economy has led to an increase in freelancing and contract-based working
- Volatile economic conditions have increased the appeal of avoiding long-term lease commitments
- Working practices have evolved to include collaboration, sharing and a desire to be part of a community

Technology enablement has provided a reliable and efficient platform to work in a manner that historically was not feasible. Cloud computing, super-fast broadband, wireless internet and 4G smartphone devices have made digital working the norm. Technology advancement sits at the forefront of the flexible and coworking success story.

TRADITIONAL VS FLEXIBLE

Flexible solutions relieve occupiers of the significant capital expenditure associated with setting up conventional leased offices, such as fit-out, meeting rooms, catering and IT services which normally are included in the package. This allows the flexibility to grow or contract space to suit requirements; a convenient solution for new businesses growing rapidly, working on short term contracts or simply unsure what their headcount will be in 12 months' time.

Furthermore, occupiers benefit from other businesses in their own workspace communities offering services like financial, legal and digital services. Almacantar's chief executive Mike Hussey explains, 'WeWork is an early mover and recognises that if it fixes the cost of its property, it can develop superior returns through the services it offers to its growing community of users.'

WHAT IS THE EFFECT ON THE LONDON OFFICE MARKET?

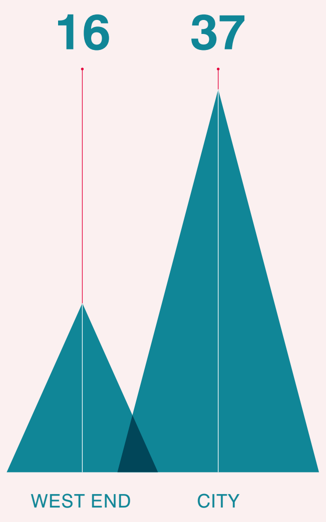
The long-term effect of the growth of flexible offices on the traditional office sector remains to be seen. It has been suggested that traditional offices in the smaller size bracket are under threat due to direct competition with the flexible office market. There has been a fall in demand across Central London for sub-5,000 sq ft units on traditional leases over the last three years, which is attributable, at least in part, to the rapid growth in the number of flexible working centres.

However, a more detailed examination of the figures reveals that the West End sub-5,000 sq ft market has actually performed at above average levels for the past two years; in particular the 0-1,000 sq ft size band, which is currently at levels five times the long-term average. The story in the City is the opposite, with sub-5,000 sq ft take-up below average since 2014.

The primary reason for this is that there have been fewer acquisitions by flexible workspace providers in the West End in comparison to the City – in 2017, there were 37 flexible office transactions in the City, compared to just 16 in the West End.

A point to consider is that space being let to small occupiers through coworking creates a neutral position, as coworking providers are committing to large units which are then servicing the small unit market.

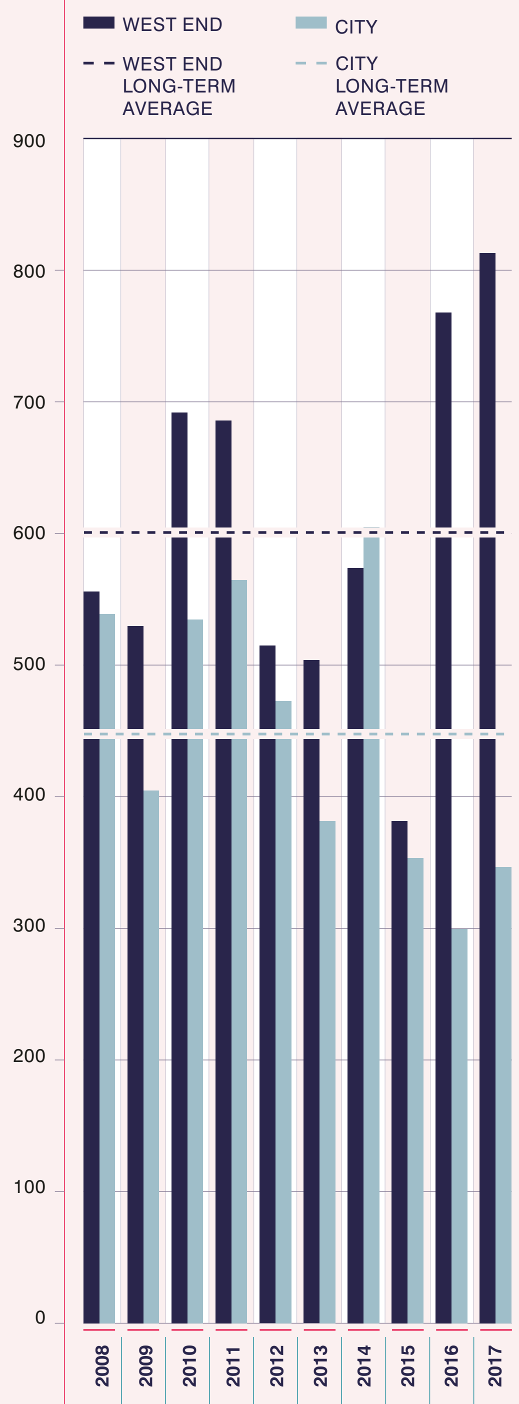
TOTAL FLEXIBLE OFFICE TRANSACTIONS IN 2017



Source: Knight Frank Research

> **"The "surprise" emergence of the coworking providers and noise around their apparently excessive growth, is not reflective of a revolution, it is a reaction to the general lack of engagement from the established property owners to provide what the future occupiers need. The shock of WeWork's success and speed of growth is only matched by the disappointment of others' inability to see where the demand sits. Even at 2 million sq ft in London, WeWork are catering for less than 1% of the capital's working population, or the size of two investment banks. There is scope for much more."**
>
> **Mike Hussey**
> Chief Executive, Almacantar

SUB-5,000 SQ FT TAKE-UP (NUMBER OF TRANSACTIONS)



SUB-5,000 SQ FT TAKE-UP PERFORMANCE AGAINST LONG-TERM AVERAGE (2017)

WEST END	CITY
35%	-23%

Source: Knight Frank Research

According to the Global Coworking Survey 2017, 45% of people currently occupying coworking space were previously working from home before becoming a member, and 26% were in traditional office space before moving, down from 37% in 2016. This suggests that increases in coworking do not have a direct, proportionate effect on traditional take-up.

What will have a greater effect on the traditional take-up is the marketing of flexible space to corporate occupiers on a larger scale. IBM has already reportedly signed a deal for all of the desks in a 100,000 sq ft WeWork centre in New York City; in Central London, partnerships of this nature are likely to provide direct competition to space offered on a traditional lease.

THE FUTURE OF FLEXIBLE SOLUTIONS IN CENTRAL LONDON

Flexible workspace providers are acquiring new stock at an ever accelerating pace, and will remain a key feature of the London office market in the future. As working practices continue to evolve, many employers, contractors and freelancers alike will experience an increasing need for flexibility in their accommodation. In addition, technological disruption will create a growing need for short-term, flexible project space; for corporates, flexible options will provide convenient solutions.

There will also continue to be many businesses for whom traditional office space will be the appropriate option. Occupiers with more stable and predictable growth projections may find considerable cost savings through opting for a traditional lease, despite the capital expenditure involved in a move. This is particularly true for larger corporates.

Occupier requirements are evolving to incorporate increased levels of flexibility. If traditional landlords can adapt to provide this, then we believe flexible working solutions can flourish alongside, not at the expense of, existing landlords.

Patrick Scanlon
Head of Central London Research

Julian Woolgar
Head of West End Tenant Representation

Despite Brexit uncertainty, there will be sector growth over the coming five years

The future of demand

Since the EU referendum, demand for office space in Central London has remained surprisingly robust. Leasing activity in 2017 vastly outperformed the previous year, with 4.1 m sq ft acquired – 31% above average.

The growing economy and workforce will create expansion-led demand for office space. Knight Frank has delved deeper to provide the following guide on sectors to watch:

TECH WILL DRIVE DEMAND FOR LONDON SPACE...

London has seen an unprecedented volume of office space taken-up by TMT firms over the past five years; more than 17 m sq ft of office space has been acquired during that period, equivalent to the entire Clerkenwell and Shoreditch office market.

Given that London's largest tech players have all made long-term commitments on new HQ premises, has demand from the tech sector peaked?

Perhaps the best way to approach this question is to ask ourselves if we believe that the evolution and development of new technology has ended. The answer is definitely "no"; we can be certain that the growth of tech companies will continue. Indeed, it has been suggested that the demand for tech-related goods and services could potentially triple over the next decade. So, where will the growth come from?

Over the past few years, attention has been on the tech giants; the London real estate industry has been trying to second-guess the sector and identify the next Google or Facebook to commit to large-scale developments. However, office demand from TMT firms has not just been from the global firms; 70% of all transactions to TMT firms in the past five years (by number) have involved units smaller than 5,000 sq ft.

The reality is that the sector will be driven forward as much by the small companies making technological breakthroughs that are hardly reported outside the sector. Wireless innovation and the Internet of Things are set to become an even bigger part of our everyday lives, both in the workplace and at home, and provide myriad opportunities for new innovation from small firms. In fact, according to data from UKTN, tech funding of London firms has accelerated since the referendum and shows little sign of slowing down.

We will also see growth from the larger occupiers as they continue to refine their products and services. Facebook recently announced its intention to double its staff working on security to 20,000; this will be a growing area of concern for all tech firms and will create growth as staff are hired to counter cyber threats.

In addition, we predict that new entrants from the biotech, Artificial Intelligence (AI) and life sciences fields will add to TMT demand in the next five years as they chase London-based talent and develop products via desks and computers rather than lab-based science.

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...BUT DON'T WRITE LONDON'S TRADITIONAL OCCUPIERS OFF JUST YET

As we have examined elsewhere in this report, demand from flexible working providers will play an important role in the Central London market in the future, with both WeWork and Knotel now offering managed space to corporates outside the traditional coworking parameters. However, we must take care not to write off the industries that have been taking space in London for the last 30-plus years.

Inevitably, change creates opportunity, and while some firms will suffer after Brexit, potential loosening of regulation could generate new demand across the financial and professional sectors in the longer term. In the short to medium term, the professional sector is likely to find itself under the spotlight.

The professional services sector faces Brexit-related challenges, but conversely could be a source of new demand. As companies seek guidance and assistance in preparing for Brexit, demand for legal services will inevitably grow; in fact, there is also likely to be a considerable ongoing need for legal services as firms negotiate the post-Brexit environment. The same is true for accounting and management consultancy services, whose foresight and expertise will be in demand.

> **"Unless we believe the evolution and development of new technology has ended, then we can be certain that the growth of tech companies will continue"**

However, there are potential pitfalls for the sector. Brexit could make it harder for law firms to operate in the EU and, like financial firms, cause some to downsize their UK operations and relocate some lawyers to EU jurisdictions. Some British lawyers have been fast to join the roll of solicitors in Ireland to maintain their legal privilege in EU cases; according to the Law Society of Ireland, around 1,250 UK solicitors have applied in the last two years. Prior to the referendum, applications would be expected to total between 50 and 100 per annum.

The future is less certain for the financial sector. Forecasts for the number of positions lost to the EU after Brexit vary wildly; the majority are headline-grabbing as they represent the unlikely worst-case scenario of a hard Brexit with no transition period deal. We believe banks remain unlikely to relocate staff to the EU in significant numbers. In addition, they are actively exploring mechanisms such as back-to-back trading as loopholes to continue operating in the UK while a more permanent solution is found.

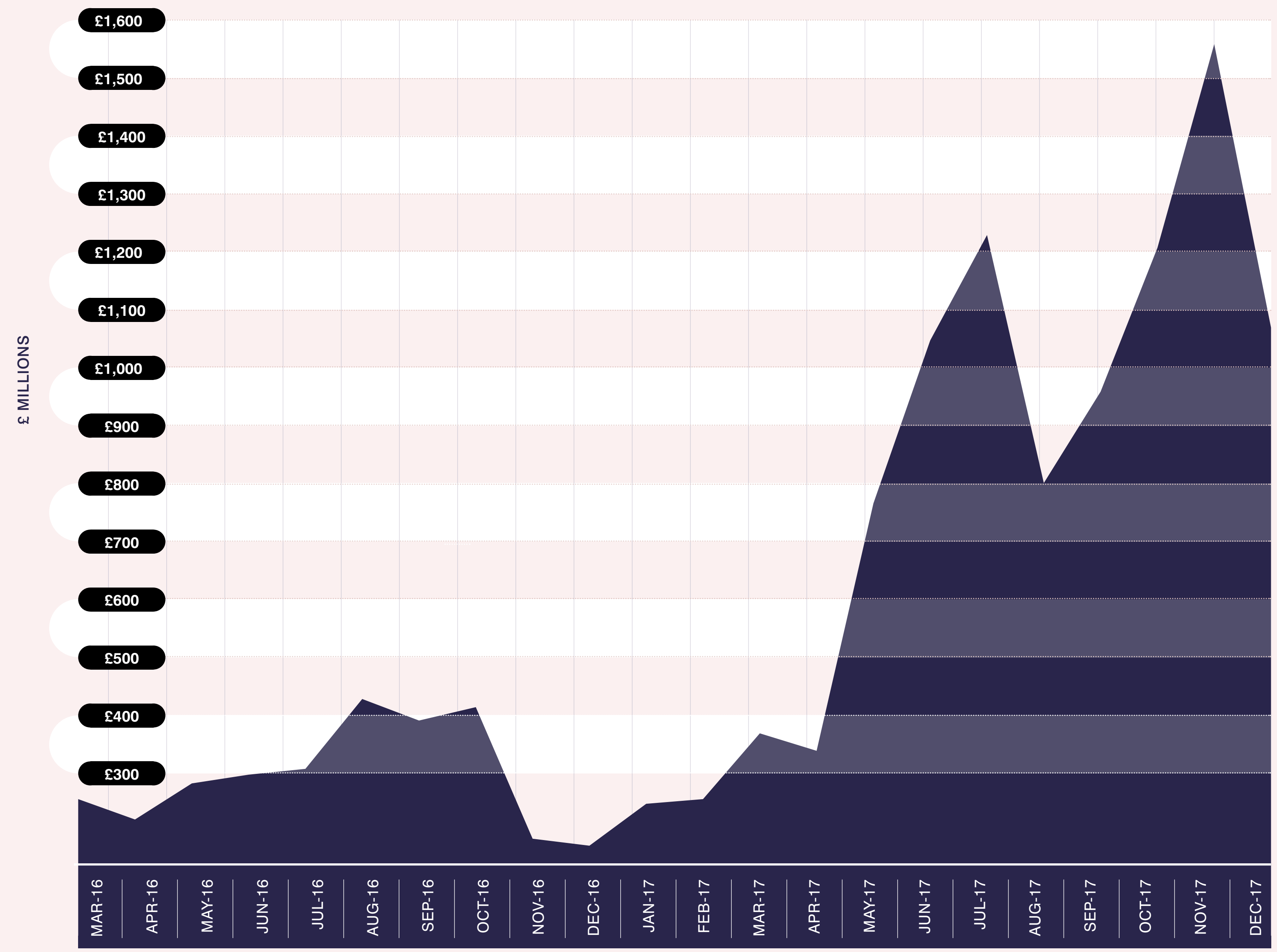
When considering the future of the financial sector, Brexit has undoubtedly overshadowed other opportunities such as fintech; according to research by London & Partners, London is the leading centre for fintech start-ups in Europe, despite fears that Brexit would harm the industry.

THE FUTURE'S BRIGHT?

As we move towards Brexit, speculation will continue over how London's businesses will be affected. It is impossible to predict the future but we have clear sight of what is taking place now: take-up of office space in Central London has performed well above expectations since the referendum and there is little sign of any major slow-down.

Short-term uncertainty is unhealthy in any market, but London's occupiers have taken the view that the capital is the place for their long-term future. The majority are here to stay.

THREE-MONTH ROLLING INVESTMENT INTO LONDON TECH FIRMS



Source: UKTN, January 2018

Anthony Duggan
Head of Capital Markets Research

Nick Braybrook
Head of City Capital Markets

Capital Markets Trends

Despite a number of potential headwinds, the London investment market roared back to strength in 2017 with a 33% increase in transaction volumes

TOP CITIES FOR CROSS-BORDER OFFICE INVESTMENT IN 2017

Source: RCA / Knight Frank

Strong demand from investors across the globe meant that London regained its crown as the world's most active real estate investment market in 2017. Its appeal – liquidity, transparency, high quality stock in large lot sizes and landlord friendly leases – was clearly undiminished post the EU referendum.

THE ULTIMATE GLOBAL MARKETPLACE

Our global transactions data shows that London remains the ultimate marketplace for global investors in terms of both the volume and the percentage of cross-border deals. 83% of all transactions were from overseas investors totalling over £14 bn spent in London last year.

London attracted capital from over 15 different nationalities, however the key buyer group was again investors from Greater China. While investment was, as expected, down from mainland China due to tightening capital restrictions, investors from Hong Kong accounted for 39% of all the money spent on London offices last year.

> "We are currently tracking £46.1bn of active requirements; up 11% from the £41.5bn we recorded at the same point last year"

GLOBAL CAPITAL TRACKER

Into 2018, we do not see investment demand for London letting up. While Brexit will cause periods of uncertainty, we believe that global buyers of London real estate will continue to transact. Using our Global Capital Tracker, we are currently monitoring £46.1 bn of active capital; up 11% from the £41.5bn we recorded at the same point last year. This money remains dominated by requirements from Greater China, specifically Hong Kong, but also including noticeably increasing interest from Japan, South Korea and Singapore.

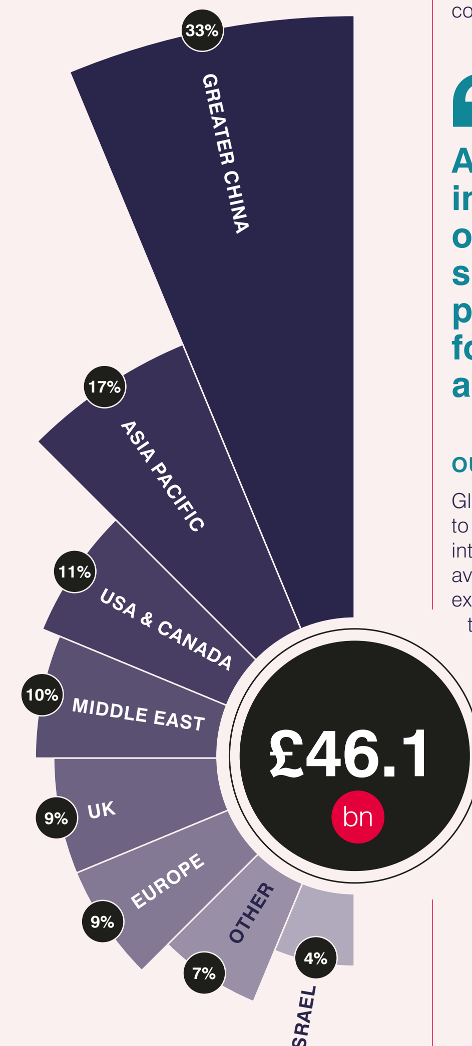
> "London remains the ultimate marketplace for global investors"

With 39% of transactions last year coming from a single geography, some commentators have voiced concerns over the reliance of current pricing on demand from China. Our Global Capital Tracker shows that rather than reduce, 2018 starts with nearly double the capital chasing London offices from this buyer group. However, the data also shows a deep pool of demand from a range of other geographies and, while undoubtedly of significant importance, we believe that any subsequent reduction in requirements from China will be quickly replaced. In addition, we are currently tracking an extensive amount of 'latent' demand that is currently sitting on the sidelines waiting for any signs of weakness in the market.
We believe that this should prevent any material price falls, and, indeed, expect that some of this money will start to come forward as it becomes increasingly under pressure to deploy over the course of 2018.

NEW MARKET ENTRANTS

Importantly, our analysis of 2017 transactions shows that a large proportion of deals are from first time buyers, who accounted for a third of the transactions over £100 m last year. London remains the gateway destination for investors who are looking outside their domestic economy for the first time with market transparency, liquidity, language, law, advisors and currency all providing comfort for those on a new journey.

KNIGHT FRANK GLOBAL CAPITAL TRACKER



Source: Knight Frank Research

FAVOURABLE GLOBAL PRICING

A key driver for continued global demand for London offices is the attractive relative pricing on offer across the capital. London assets remain good value on a global basis with prime yields running at 4.25% for City of London offices and 3.5% for the West End. This remains ahead of not only the major Asian markets but also most of the key European markets as well.

ROTATION TOWARDS RISK

The strong demand and record pricing paid during 2017 drove a number of owners to consider asset sales, and the available stock of opportunities rose considerably in the latter part of the year, particularly in the City market. Following a relative dearth of availability over the previous few years, this came as a welcome change and helped to drive the high transaction volumes recorded.

We expect that this period of high sales activity has now passed and assets will be brought to the market in a more restrained fashion during 2018. This market stability will allow investors to continue to take profits and recycle capital; we anticipate that an increasing number of sellers will look to rotate from relatively dry, prime stock into more opportunistic assets given the increasingly consensus view of stabilising rents and a progressively more constrained development pipeline.

> "An improving confidence in the underlying occupier markets will support pricing for both prime and, increasingly, for more opportunistic assets"

OUTCOME

Global investors have shown they are willing to dial out the short-term noise in order to buy into the solid fundamentals and relative value available from London real estate, and we expect them to continue to do so. Indeed, as the outcome of Brexit and the current political uncertainty become clearer, an improving confidence in the underlying occupier markets will support pricing for both prime and, increasingly, for more opportunistic assets.

Dr Diana Babacic
PRS Research
Associate

Housing London's workforce

Through a mix of necessity and choice, London's younger workers tend to live closer to their place of work, a trend which offers opportunities for developers and investors

In a city weary of the tales of the long distance commuter, younger workers appear to be striking out on a different path. A third of those aged under 25 live less than 5km from their workplace; a substantially greater proportion than their older colleagues.

Not only do younger workers live closer to their place of work, but research by Eric Klinenberg in his book Going Solo, confirms what many of us might have already suspected – that today's young workforce is spending an increasing amount of their free time at work.

This attentiveness is partially down to the speed of change in the modern workplace. Klinenberg believes that fast growth and increasing competition mean that professional advancement is partially dictated by an individual's commitment to their work.

RAPID CHANGE LOOKS SET TO REMAIN WITH US

If we look at the largest employment sector in London, financial and business services, even this mature sector has seen employment grow at 2.6% each year over the past decade compared to the 1.6% London average. According to Oxford Economics, the same sector is expected to account for 40% of the nearly 900,000 new jobs expected to be created in London over the next decade.

The impact of this change is being seen in employee behaviour. The priorities of millennials today appear to be very different from the priorities of their parents when they started work. According to Klinenberg, the younger workforce accepts the need for, and is more prepared to learn, a variety of new skills. There is also a desire among workers to retain flexibility in their lifestyle and to be able to re-locate for future employment opportunities, which has been borne out in the Knight Frank Tenant Survey.

This desire for flexibility, as well as a requirement for affordability, is helping support the growth in demand for privately rented accommodation in London, and in many urban centres across the UK.

Apple plans to consolidate all of its London office space into the Power Station at Battersea comprising a mixed-use redevelopment arranged over 42 acres. The move was driven by a number of business-related factors, including the building's iconic status and space, Zone 1 location and transport connectivity. The building's proximity to the surrounding residential development, both on the Battersea Power Station Estate and wider Nine Elms regeneration area, was also a pull factor by potentially providing residences for local workers.

Google also plans to consolidate all of its office space at King's Cross. Again, this is another regeneration area where new residential developments could potentially provide residences for employees who will work there.

Tenants' desire for flexibility and proximity to employment centres is driving demand. This process creates an obvious opportunity for developers.

However, the risk for those considering large-scale private rental development is in not understanding tenant requirements in detail.

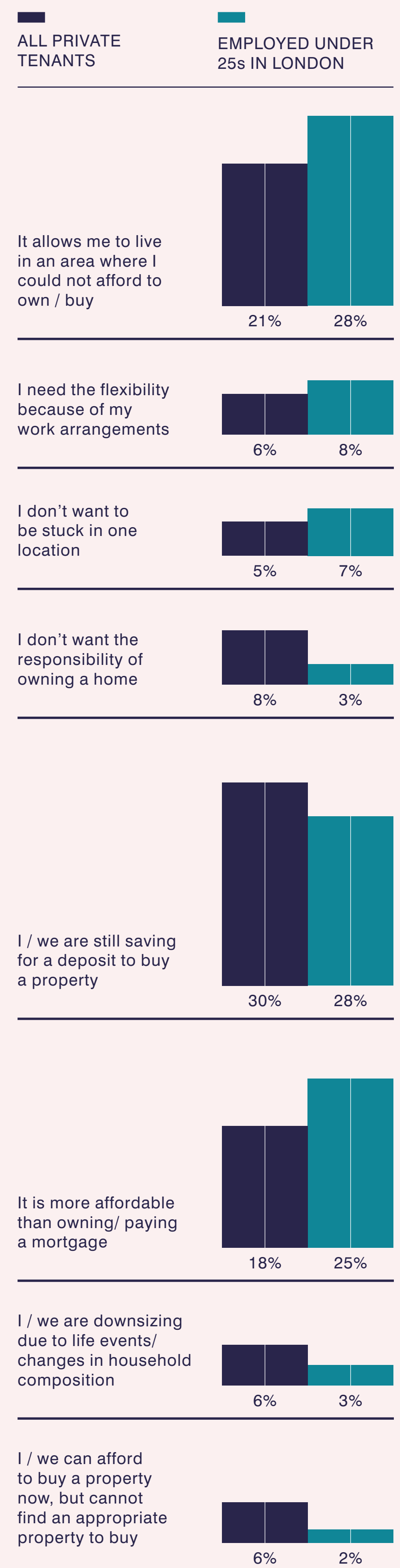
> **"The opportunity for developers is in understanding the requirements of this growth market"**

TOTAL NEW JOBS OVER THE NEXT TEN YEARS WILL BE NEARLY

900,000

Source: Knight Frank Tenant Survey 2016/17

WHY DO YOU RENT?



Source: Knight Frank Tenant Survey, 2016/17

Through Knight Frank's Tenant Survey, we have focused relentlessly on understanding this specific question. The results showed that tenants would consider paying additional rent for amenities such as an on-site gym, en-suite bathroom and weekly cleaning.

Private renters tend to choose smaller properties than owner occupiers. Their desire to be close to work and spend time in a productive way, whether working or socialising, means that private renters in employment will prioritise the location over size.

Trends identified in the Knight Frank Tenant Survey have already been recognised in cities such as New York. There, the city authorities held a competition in 2013 for a new housing model that would be able to help New York's growing number of "small households".

The winner developed a scheme which is today known as Carmel Place, located between East Village and Midtown Manhattan. This development is comprised of 55 small residential units, ranging in size from 250 to 370 square feet, with nine to ten-foot ceilings, as well as balconies. It is fully let and has revealed strong demand for compact homes.

Currently, more than half of all residencies in Manhattan are one-person units. Based on the 2011 Census, this proportion in Central London is at around 38% (i.e. studios and one-bedroom residential units). The density of one-person units is slightly higher in the private rented sector, at 45%.

The requirement among young workers to live centrally in cities in order to retain flexibility of tenure, and to access truly affordable rented accommodation, is clear.

The opportunity for developers is in understanding the requirements of this growth market.

For city authorities there is an equally big prize in attracting talented workers - supporting the urban economy for the benefit of all.

YOUNG WORKFORCE IN LONDON – AMENITY PREFERENCES*

Source: Knight Frank Tenant Survey, 2016/17

* Infographic shows top nine preferences

Connecting People & Property, Perfectly.

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