The London Report 2021

HIGHLIGHTS

RESILIENCE, REINVENTION AND RESPONSIBILITY

London: Primed for growth

2021 has begun with multiple vaccine successes and a broad-based rollout programme in the UK. The Brexit transition period has passed, and with forecasts for a rapid mid-year economic rebound, London's resilience is set to shine through.

As we look to the year ahead and beyond, our research explains why London is uniquely placed to adapt, reinvent, and thrive in the coming global recovery. It offers our perspectives on the evolution of the workplace in light of the pandemic, and how landlords should respond to changing corporate requirements. It provides a forensic analysis of the development pipeline and the rental implications of a structural shortage of office space. And it draws upon both our deep global network and innovative research techniques to detail the future sources of global capital destined for London.

London's lasting legacy will be a greater sense of responsibility and the embrace of common causes: from the pursuit of sustainability, to the reimagining of cities that better reflect their stakeholders' needs, to more flexibility over working patterns and a higher regard for workplace wellbeing. With this insight, we aim to help you navigate these themes and demonstrate why London is a world-leading city in which to live, work, operate, and invest.

This report features the highlights of The London Report 2021.

Explore our full research at
knightfrank.com/london-report

Numbers you need to know

1ST
London was the top city for cross-border investment in 2020

RESILIENCE

As the world economy shifts into recovery mode, our research demonstrates how London is uniquely placed to drive innovative business investment and attract global capital inflows.

£46bn
is the amount of capital targeting London offices

1ST
London is the world's most innovative city

90%
of global occupiers regard real estate as a strategic device

REINVENTION

Cities thrive on their ability to react and adapt. We explain how London's real estate will respond to the new demands of a post-pandemic world, and highlight the opportunities inherent in the reimagining of a global city.

67%
of London graduates plan to stay in the capital after they graduate

2,000
is the number of research institutions in London – the highest level in the world

3,000
London has the highest number of green-rated buildings in the world

RESPONSIBILITY

A lasting legacy of the pandemic is the embrace of common causes: from the pursuit of greater sustainability to stronger governance, to more flexibility over working patterns and a higher regard for workplace wellbeing.

40%
of the capital chasing London assets this year will be targeting stock that can align with investors' own ESG targets

Image: Roots in the Sky, Pocock Street, Southwark

CHAPTER 1: THE CASE FOR CITIES

Imperatives for Global Cities: Resilience, Reinvention and Responsibility

The Covid-19 pandemic has exposed a need for change in our global cities. As the focus shifts from resilience to recovery, dynamic, urban hubs such as London must grasp the opportunity to evolve and reshape to meet the future needs of businesses, investors, workers and residents.

FROM RESILIENCE TO GROWTH

Covid-19 has raised existential questions over the future of global cities. Many of their inhabitants are temporarily dispersed and visitors are required to stay away. Will they ever be quite the same again? This period of reflection is a valuable opportunity to consider or refine how cities can evolve to better support their stakeholders.

As we look towards a path out of the pandemic, we believe one characteristic of cities that is unchanged is their magnetism towards businesses, talent and people more widely, which enables them to fulfil a unique and essential role as facilitators of culture, innovation and wealth.

Indeed, innovation will play a pivotal role in determining the prosperity of cities over the next decade, with successful innovation clusters able to monetise ideas and generate strong local economic growth even in times of uncertainty.

THE WORLD'S MOST INNOVATIVE CITY

Supported by the highest concentration of research institutions in the world and a healthy funding ecosystem, our extensive analysis shows that London is the world's leading innovation hub. Consequently, it will continue to attract global businesses seeking the best partnerships and talent, bolstering London's economic growth as it emerges from the pandemic and forges a subtly different path outside the EU. Ultimately, innovation attracts and retains the population, investment and the wealth needed for active and resilient commercial and residential real estate markets.

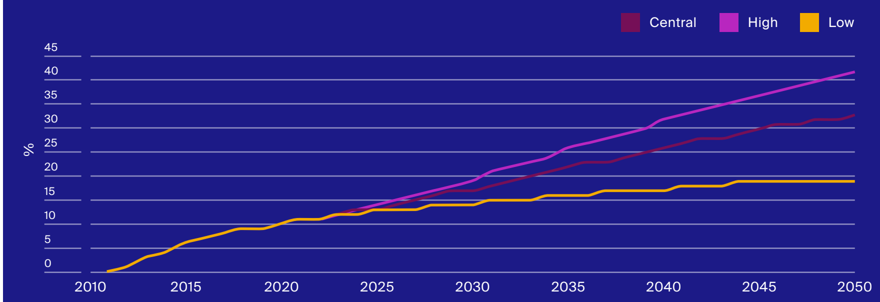
A GROWING TALENT BASE

The Greater London Authority's (GLA) November 2020 forecasts envisage a temporary Covid-induced fall in population growth to 50,000 per annum until 2022, from a recent average of 88,000. However, the long-term trajectory is unchanged. London's population will grow steadily over the coming years, rising from a current level of just under 9 million people, to a potential of 10.9 million (+21%) by 2050.

Importantly, the working population could grow by 1.3 million over that time, supported by natural growth, inward migration from beyond the EU, and the retention of university leavers. Indeed, our 2020/21 Student Accommodation Survey, conducted in partnership with UCAS, suggests that 67% of London's students plan to stay in the capital after they graduate.

"Innovation will play a pivotal role in determining the prosperity of cities over the next decade"

LONDON'S POPULATION GROWTH FORECASTS



Source: Greater London Authority

REINVENTING THE RESIDENTIAL ENVIRONMENT

While the future of the office and its subsequent reconfiguration may have garnered most of the headlines, London's growing population is placing equally important demands for change on the configuration of their homes. There is a greater focus on digital connectivity and usable workspaces, as well as healthier and greener environments.

Our survey of more than 160 leading global developers showed that future homes will not necessarily be built to survive further lockdowns, but rather to be flexible and adaptable to changes in circumstances. Investors will focus more on mixed-use, mixed-income, walkable places, especially in high-density central London locations – sparking the evolution of the 15-minute city.

A RESPONSIBILITY TO ENACT CHANGE

Globally, there is a broad recognition of a generational opportunity to reshape cities: to fully support a new and more flexible working culture; to maximise the role of cities as engines of innovation and economic growth; and to tackle critical sustainability concerns. Backed by significant fiscal measures as governments seek to kick-start recoveries, successfully addressing these issues will be a point of competition amongst global cities.

A number of common themes are in the ascendency, promoted by stakeholders from academic institutions, think-tanks, governments and developers, all of which are highly relevant to any London stakeholders taking a long-term, strategic view of the outlook. These include:

- *The creation of smaller self-contained, amenity-rich districts, as a counter to the sprawling, "unlivable" mega-city – encouraging a return to local.*
- *A recognition that wellbeing and sustainability have become even more important considerations for all s takeholders, from businesses to employees and inhabitants.*
- *A call for city infrastructure to support businesses as they transition to post-Covid working patterns.*
- *The need to protect and foster the kaleidoscope of talent, finance, education, technology, culture and diversity that contributes to both community and innovation, whilst fueling economic growth.*

London will recover from the pandemic in a strong position: it's already the world's most innovative city, the number one destination for cross-border investment, and home to the highest number of green-rated buildings. It will take consideration of all of the above themes to maximise its vitality in the decade ahead and doing so will offer up rich opportunities for those developers and investors willing to play their role in this reinvention.

THE CASE FOR CITIES

Larger cities have been disproportionately impacted by the Covid-19 pandemic due to their symbiotic relationship with commuters, but the flexibility that challenged office-based employment in 2020 will be one of the very factors that enables cities to recover rapidly in 2021.

VIEW ARTICLE

CITY OF INNOVATION

Recognising that innovation is an essential feature of cities with robust real estate markets, we identified the top global innovation-led cities in our recent Active Capital research. Assessing 288 cities, this saw London emerge as the world's most innovative.

VIEW ARTICLE

RETHINKING RESIDENTIAL

In the wake of the Covid-19 pandemic, developers must be ready to adapt to a growing desire among residents for flexible living space that supports their physical and mental wellbeing as well as meeting the practical needs of everyday life.

VIEW ARTICLE

CHAPTER 2: THE FUTURE OF THE OFFICE

Brave new world of work

The recent debate about the future of the office has been fierce and extreme. Our global occupier clients continue to see real estate as a device that supports, facilitates, or portrays their business strategies. Indeed, initial 'flash' findings from our Global Occupier Survey, to be launched in our (Y)OUR SPACE report in April, shows that 90% of global occupiers regard real estate as a strategic device.

Our survey respondents identify a wide range of strategic agenda items that real estate supplements and, key amongst these are corporate brand and image, employee wellbeing and increased collaboration.

So, what does this year have in store? 2021 will be the year when the focus turns from revolution to evolution, as the office is repositioned in a new, hybrid world of work.

Of course, there will be huge variations across business sectors, companies and job types, but it is clear that our relationship with the office will become less fixed and more flexible. This is far from spelling the death of the office. Instead, it points to an accelerated evolution of the office to deliver greater business benefits while supporting and supplementing new and emerging working styles grounded in greater choice and increased flexibility.

THE OUTLOOK FOR WORKPLACE STRATEGIES

Vaccination programmes have now begun in earnest and provide some light at the end of the tunnel. A key influence on near-term market dynamics will be the extent to which the behavioural changes required by both employers and employees persist.

A further, linked, influence will be the strategising that many occupiers have undertaken over the last year, drawing on lessons, both good and bad, from the great global workplace experiment.

Interestingly, despite the protracted nature of the Covid-19 pandemic, just 22% of occupiers in our survey said that their real estate strategies have been altered forever, while 56% see Covid-19 as a medium-term influence; with a further 22% believing it will have no significant impact on their property strategies.

WHAT DOES THIS MEAN FOR LONDON'S OFFICES?

Whilst impact will clearly vary between businesses and indeed, sectors, it is likely that some changes in working styles will be retained, thus driving occupiers towards new and different approaches to the workplace. We believe this demand will be different both quantitatively and qualitatively from what went before, hastening the evolution of London's office product, especially as environmental, social and governance issues (ESG) begin to shape occupational strategies.

"Remote working will have its place for some people, for some tasks and for some of the time"

There are many implications for office space product, but three will be particularly relevant.

01. AMENITY RICH SPACES

In an intensification of a recent trend, we expect to see a further flight towards quality spaces with first-class amenities and services that support physical and mental wellbeing, education and personal development, and socialisation. In a hybrid world of work, such spaces are central to giving employees a reason to invest in their commute.

02. DATA CAPTURE

There will be a greater adoption of building technology to generate data that supports the curation of the workplace experience, the active management of the workplace environment, and to underpin the occupier's future business case for continued investment in office space.

03. STRIKING THE BALANCE BETWEEN OFFICE OCCUPATION AND HEALTH AND SAFETY

We see an emerging tension between creating workplaces that are able to accommodate a more flexible and agile workforce, but which at the same time, conform to heightened expectations around workplace health and safety. As offices move further away from being fixed bases for administration towards places for more fluid collaboration and innovation, the trend toward desk sharing will continue. Creating and managing an office environment that enables de-densification and more agile occupation, but also keeps occupants safe (or protected) from transmission risk, will be critical to meeting customers' needs.

Delivering on the changing occupier requirements, brought about by new workspace demands will be challenging. Market polarisation is a real possibility as the gap between those landlords who respond and those who revert to pre-Covid approaches widens.

Those who create offices that are more customer-centric, reduce environmental impact and proactively utilise technology and data will win in the brave new world of work. Spaces that are safe, sustainable and smart will command the highest rents, generate the strongest returns and be best placed to secure longer-term income. From an occupiers' perspective, these are the sort of work environments that will most strongly resonate with changing expectations and support the needs of both business and staff.

A GLOBAL PERSPECTIVE ON OFFICE OCCUPATION

Despite the shift in working patterns brought about by the Covid-19 pandemic, demand for office space is not going away any time soon; however, as our (Y)OUR SPACE survey shows, occupiers' shifting priorities, including a new emphasis on sustainability and making smarter use of technology, are nevertheless set to have a major impact on the market.

VIEW ARTICLE

THE FUTURE OF FLEXIBLE OFFICES

We are all re-thinking our work-life balance on the back of the Covid-19 pandemic. As new hybrid working models start to emerge, we asked six providers of flexible office space to share their insights on the key trends that they believe will shape the future provision of offices.

CHAPTER 3: THE LEASING MARKET

Prime Offices: Supply shortages and persistent demand

While the Covid-19 pandemic has resulted in almost all of us working remotely, a shortage of prime office space has protected the market from a slump in prime rents. As demand returns, we predict that a flight to quality will result in a focus on those spaces that can deliver the flexible, dynamic and amenity rich workplace experience that occupiers are seeking.

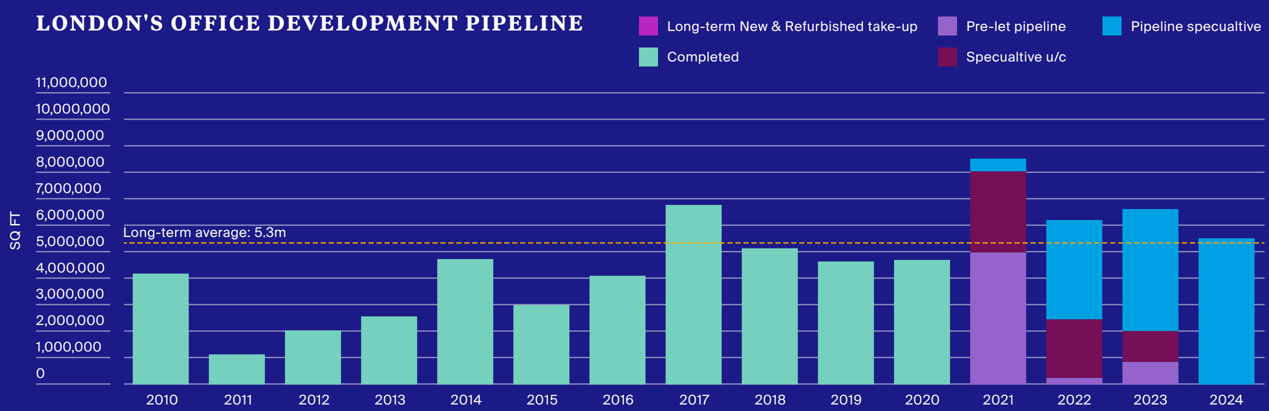
BACKDROP

Leasing activity in London's office market seized up in 2020 for obvious reasons, with most businesses postponing decision-making where possible. This was not unique just to London, with major cities like New York, Paris and Sydney all experiencing record low leasing volumes last year.

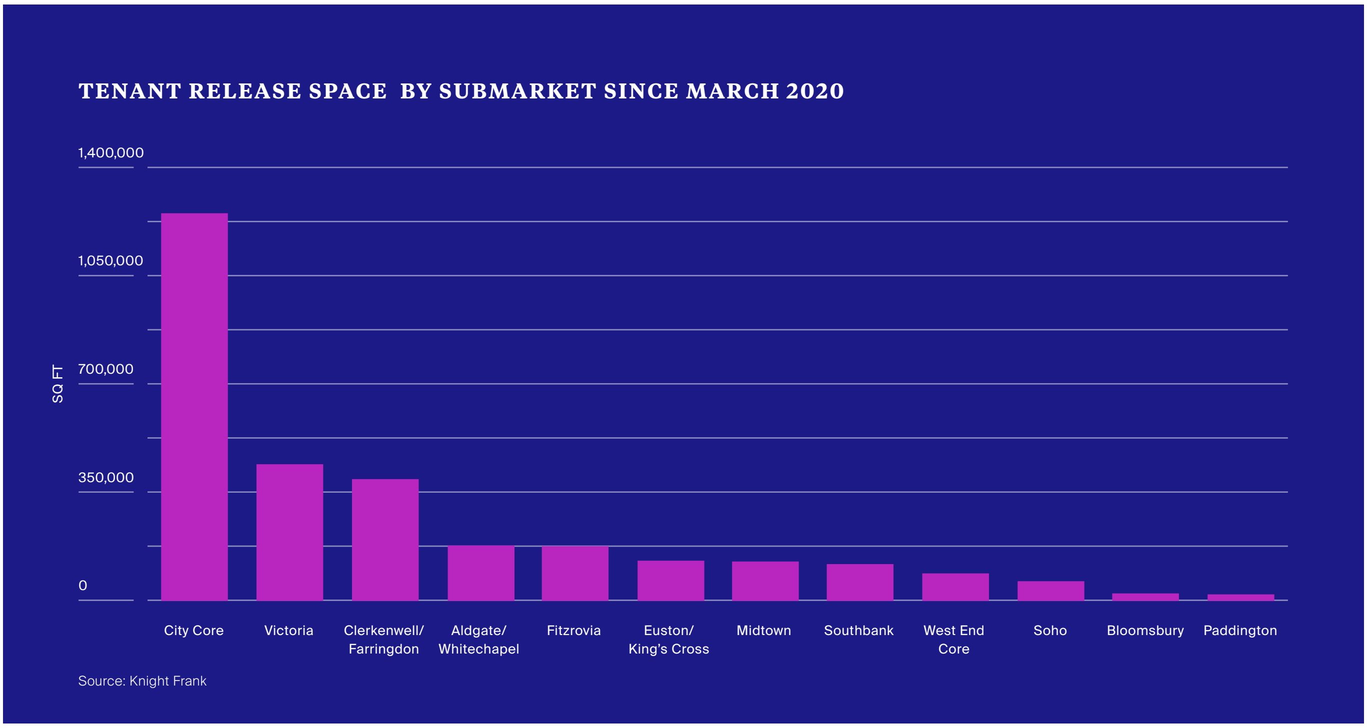
A REVIEW OF THE BASICS

Nearly a year since the UK first went into a Covid-19 induced lockdown and with the rollout of the first vaccines now well underway, what does the future hold for London's office market? While the five-day commute was already being challenged, the forced period of working from home has proved extremely challenging for businesses and individuals with neither extreme necessarily providing the optimum balance. What forced working from home has done is pull the value of the office into sharper focus. Occupiers will be looking to adapt the workplace to cater for the key areas of collaboration, creativity and culture, all of which have proved so difficult to replicate remotely.

LONDON'S OFFICE DEVELOPMENT PIPELINE



Source: Knight Frank



The market remains supported by strong underlying fundamentals, three of which are reviewed below.

01

DEMAND

Prime headline rental rates are still within touching distance of pre-pandemic record high levels, highlighting the resilience of rents for top-quality space, albeit lease incentives continue to increase. Requirement levels have remained subdued, but there is evidence that occupier demand is being deferred, rather than eliminated. In fact, during 2020 we recorded a 32-fold increase in lease renewals, hinting towards delayed decision-making by businesses.

02

SUPPLY

Here we mean the very best offices: brand new, Grade A stock. And such offices remain in short supply across London. We entered the pandemic with approximately half of all stock under construction already pre-let: at the end of 2020, that figure was unchanged. While leasing volumes have declined, pre-letting activity has persisted, with occupiers, particularly those in professional services and banking and finance, committing to space still under construction.

A central issue that will transcend the pandemic revolves around the war for talent. Businesses were already responding to this challenge prior to the pandemic by seeking out higher-quality office space, and the resilience of this trend over the last 12 months highlights the criticality of this issue.

As a result, we expect competition to grow for prime office space as occupiers vie for the best buildings as a means of attracting and retaining the best people, whilst at the same time, looking at all areas of their business, including real estate, to help them achieve their environmental, social and governance (ESG) goals.

03

TENANT RELEASE SPACE

This has been a significant area of concern since the start of the pandemic. Excluding 2020, the volume of tenant-controlled space on the market in any given year has been around 3.5 million sq ft. Since March 2020, 3.1 million sq ft of space has been released.

This is where the quality of stock released comes into play: just over 50% of tenant release space since the start of the pandemic falls into the Grade B (or lower) category. We expect much of this space to be discounted by occupiers, unless refurbished to a new modern standard. Furthermore, the increasing focus on prime office space that delivers on flexibility, quality, and aids ESG goals means poorer quality stock will face challenges in attracting interest.

THE OUTLOOK

For 2021, we expect demand to steadily increase as the year progresses, catalysed by the momentum building behind the UK's vaccination rollout programme, which will drive a resumption in corporate decision-making and a general improvement in economic prospects.

Demand for office space is also likely to be more qualified, considered and grounded in occupiers' experiences of the great global workplace experiment, spawned by Covid-19. And a continued and increasing proportion of that demand is set to take a flight to quality as businesses seek offices that engender their ESG intentions, offer the flexibility they desire and provide a rich workplace experience for its employees.

Image: View from 80 Fenchurch Street

PERSISTENT SUPPLY SHORTAGE

Vacancy rates have only now crept just above the long-term average for London, despite the Covid-19 pandemic. Looking ahead, the supply of new stock will be constrained according to the Knight Frank Development Viability Index. Just 3.2 million square feet of the 26.6 million square feet of pipeline development is likely to complete in the advertised time frames. This compares to an average annual take up of new and refurbished space of 5.3 million square feet.

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FUTURE OFFICE DEMAND

Where might future office demand come from and what will it look like? What will happen to the demand from existing occupiers? We investigate the emerging evidence.

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THE LIMITED IMPACT OF TENANT RELEASE SPACE TO DATE

The impact of tenant release space is expected to be felt at a submarket level. Overall, the supply of premium office space is likely to remain constrained for the foreseeable future, especially as occupier attention remains focused on prime office space.

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OUTLOOK FOR PRIME RENTS

Our rental growth forecasts are predicated on a long-term structural shift in the market, which assumes a reduction in existing office footprints; however, with a shortage of planned supply, combined with expected growth in new businesses, what is the impact on rental growth?

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CHAPTER 4: THE INVESTMENT MARKET

What next for London's commercial investment market?

After a bumper Q4 2020, investment volumes are set to trend towards "normal" levels this year. We look at key themes shaping the market and in particular, the increase in demand for buildings with strong ESG credentials.

A RETURN TO "NORMAL" IN 2021?

With the number of available assets on the market, including those under offer, at 58% above this time last year, 2021 looks set to be a year in which investment "normalises". During 2020, investment turnover reached £9.3 billion, down on the long-term annual average of £12.5 billion, but well ahead of what was experienced during the depths of the Global Financial Crisis in 2009 (£6 billion).

83% of the capital deployed in 2020 was from overseas, highlighting London's amazing liquidity even at a time of global economic uncertainty and questions over the impact of Brexit. We predict that investment volumes will rise significantly in 2021 in light of a gradually fading pandemic impact and greater clarity over London's post-Brexit position.

This outlook is supported by the results of our 2021 Global Capital Tracker survey, which monitors the level of real estate capital that investors intend on deploying in London in the following 12 months.

This figure reached £46 billion in early 2021, an insignificant fall from the £48 billion recorded a year ago when set against the backdrop of a global pandemic.

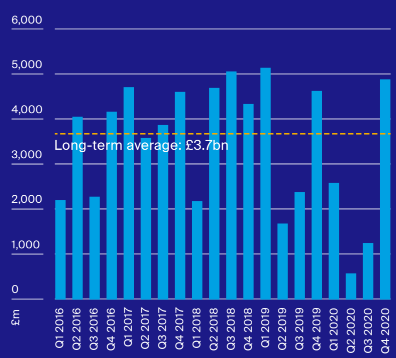
Our capital tracker demonstrates that without doubt, global investors remain committed to London, even if not all of their capital can, in practise, be spent during the space of one year.

FUTURE CAPITAL FLOWS

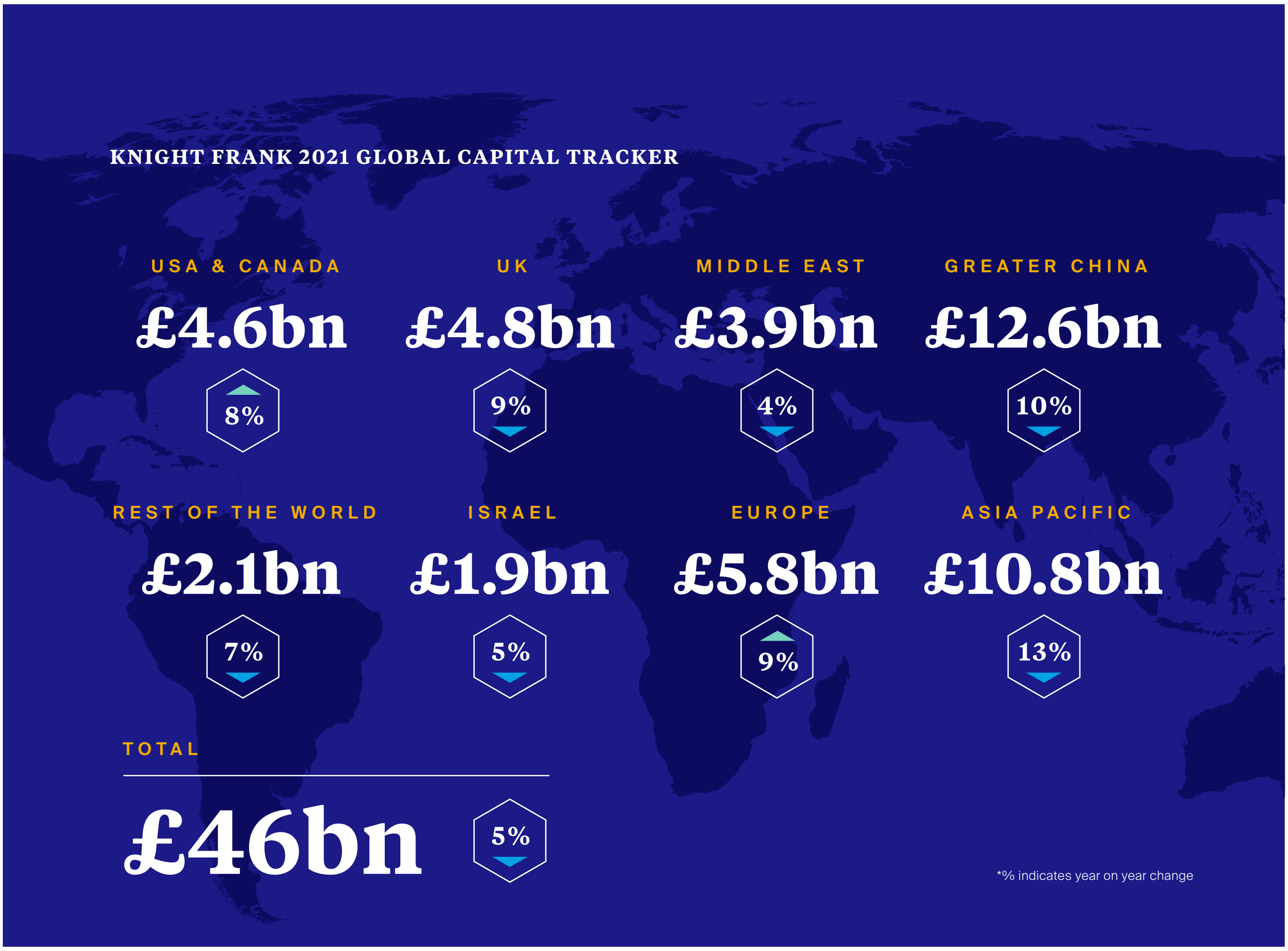
To better understand the likely sources and volumes of overseas capital reaching London in 2021, we have modelled and forecast capital flows using a technique developed over the past two years.

Our London Capital Gravity Model shows that London's cross-border office investment activity could exceed £10 billion in 2021, up from £7.8 billion last year. And should domestic investment volumes remain in line with historic levels (£2.5 billion), this will take the total to £12.5 billion, matching the long-term annual average.

CENTRAL LONDON OFFICE INVESTMENT VOLUMES



Source: Knight Frank



THE CHARACTERISTICS OF AN ACTIVE 2021

So, how will the weight of capital we have identified target assets in London?

We investigate four key themes:

01

FIERCE COMPETITION FOR PRIME, CORE ASSETS

We expect pricing for core assets to remain under upward pressure, as investors continue to pursue the relative discount available in London, compared to other European cities and alternative investment classes. Investors reacting to key occupational indicators will favour global gateway cities, such as London, that provide greater resilience to the impact of any office space rationalisation.

02

"DEVELOP TO CORE" PLANS

This is where "core" buyers are competing in the "value-add" market, with a lower cost of capital than traditional developers. Typically, these buyers seek opportunities in locations usually centred on Elizabeth Line interchanges, offering either favourable existing market dynamics (think demand versus supply), or the opportunity to deliver best-in-class offices.

03

THE WIDENING GAP BETWEEN PRIME AND TERTIARY ASSETS

Inevitably, a flight to quality will see the gap between prime and tertiary assets widen and discounts are already appearing. From an income perspective, medium-term profiles will be more challenging as investors and lenders, fixated on five-year horizons, struggle to adapt their plans.

04

A SHIFT IN STOCK SELECTION CRITERIA

The post-pandemic environment will result in closer scrutiny of key specifics, the most important being income quality and, more specifically, covenant conviction. Environmental, social and governance aspects (ESG) will be increasingly fundamental.

PRIVATE WEALTH REMAINS FOCUSED ON LONDON

Private wealth continues to grow and so too investor interest in both residential and commercial property, with "safe haven" locations, such as London, exerting a strong pull in these uncertain times.

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KNIGHT FRANK LONDON CAPITAL GRAVITY MODEL

Using a bespoke "capital gravity" model, combined with our Knight Frank London investment data, we have forecast the likely sources of flows of capital into London, as well as the estimated size of potential flows over the next five years.

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LONDON INVESTMENT SET FOR A REBOUND IN 2021

The 2021 Knight Frank Global Capital Tracker shows £46 billion of spending firepower has amassed globally for deployment into London's commercial market. So, which global regions have the greatest spending power?

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Image: Here East, Stratford. Credit: Rory Gardiner

THE IMPORTANCE OF ESG

Four key considerations for 2021:

01

MOUNTING INVESTOR PRESSURE:

ESG used to be compliance-driven and a "tick-box exercise", but now investors expect more, putting direct pressure on institutions, funds and property companies, driving competition and creating peer pressure.

02

INCREASING REGULATION AND CORPORATE REPORTING

There is a significant shift towards the reporting and benchmarking of ESG performance. The most prevalent example is the Global Real Estate Sustainability Benchmark, which was used by 1,200 companies in 2020, representing US $4.8 trillion worth of assets under management.

03

PORTFOLIO/BUILDING OBSOLESCENCE:

More awareness of "transition risk" will mean that "non-compliant" buildings, i.e. those that don't meet the prevailing investor and occupier expectations around green ratings, will likely deplete in value rapidly.

04

GREEN FINANCE:

Green lending is increasing in popularity and will be an avenue for investors to gain exposure and in some cases, access a pricing advantage. The UK Government recently announced its ambition to make the City of London the global centre for green finance, so expect an even greater focus on this area.

IS LONDON THE WORLD'S LEADING ESG CENTRE?

We estimate that 40% of the capital chasing London assets this year will be targeting stock that can align with investors' own ESG targets.

Investors are increasingly examining transition risk when evaluating acquisitions and their existing portfolios. Whether or not an asset can be aligned to an investors' own carbon targets and other ESG performance benchmarks will ultimately impact which assets they hold, acquire and divest from. And with nearly 3,000 green-rated buildings – the highest number globally – London is well placed for the green (r)evolution in investor behaviour.

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