The challenges to London's attractiveness to international investors

SUMMARY

- In 2011, 60% of all central London commercial property investment was by non-domestic investors. Investors came from 27 countries, more than any other world city by a considerable margin.
- Amidst mounting turbulence in the eurozone and beyond, much of London’s current appeal reflects the security and quality of income.
- A mounting tide of regulations, a creaking international and internal transport infrastructure and the high cost of housing pose challenges for London’s business hub.
- To cope with these challenges, strong political will is necessary to ensure London continues to attract major occupiers, the backbone of London’s office market.
- Government has responded positively, though further action is needed. Furthermore, London’s inherent strengths of language, geography, legal system, and quality of workforce will ensure London remains internationally competitive.
- Investors will continue to see London as a reliable investment location.
**Graph 1**

**London's investor base was particularly international in 2011**

<table>
<thead>
<tr>
<th>City</th>
<th>Number of Projects</th>
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<tr>
<td>London</td>
<td>350</td>
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<td>NYC</td>
<td>300</td>
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<tr>
<td>Paris</td>
<td>250</td>
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<td>Sydney</td>
<td>200</td>
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<td>Hong Kong</td>
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<td>Moscow</td>
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<td>Paris</td>
<td>15</td>
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<td>Singapore</td>
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</tbody>
</table>

Number of countries: 5-30

Source: Real Capital Analytics

**Graph 2**

**Foreign projects into London remain strong**

Source: Ernst & Young European Investment Monitor

**Graph 3**

**London attracted the highest number of inward investment projects in 2011**

Source: Ernst & Young European Investment Monitor

**Graph 4**

**Term certain for London leases**

Source: Savills

**Introduction**

International appetite for London’s commercial property has never been stronger. In 2011, non-domestic investors came from 27 countries and accounted for 60% of the transaction volume. So far in 2012 (up to the end of May) international investors have accounted for 65% of the investment volume transacted, including the 13 largest deals.

London has many appealing characteristics to the international investor, but much of London’s current popularity rests on the security and quality of incomes. So key to London’s continued popularity with investors is its position as a major business hub. But what are the risks to London’s popularity, and how are these challenges being tackled?

This report assesses five areas which pose a threat to London’s continued success: regulations, taxation, immigration policy, transport infrastructure, and the cost of housing.

**Recent developments**

At the time of writing, problems within the eurozone have shifted from Greece, whose new government has stated a commitment to remaining within the euro, to Spain who has joined Greece, Portugal and Ireland in formally asking for a bailout loan for its banking sector. The euro’s continuing struggle is symptomatic of a world which has struggled for stability over recent years as it has been swept by a variety of crises from the credit crunch and recession to the Arab Spring and European sovereign debt crisis.

Turmoil in other parts of the world is often followed by the arrival of new sources of wealth in London, which is seen as one of the first ports of call because of its relative calm as well as the quality of its residential neighbourhoods and cultural vibrancy.

Global uncertainties have driven investors to seek security in gold, US dollars and increasingly in London’s commercial and residential property. A cursory look at government borrowing costs across Europe illustrates the UK’s relative stability. At the end of June, 10-year government bond yields were 1.73% in the UK. This compares with 2.69% in France, 5.79% in Italy and 6.42% in Spain.

**London as a global business hub**

Leases in the UK are considered particularly landlord friendly as they are triple net, rent reviews are upward only, and lease lengths are relatively long. Graph 4 shows that the average length of guaranteed income (from lease start to a break option) for leases of various size brackets. The properties capable of securing large corporate deals (of over 50,000 sq ft) tend to be those properties sought by major international buyers.

The high quality of London’s tenant base is a reflection of the volume of headquarters offices. In addition to hosting the majority of UK firms’ head offices, a third of Fortune 500 companies have their European head office in London; there are currently 20,000 foreign owned companies operating in London. This adds up to a large stock of blue chip corporate occupiers.

Data from Ernst & Young shows that despite the downturn in the global economy and general lack of corporate investment, the number of foreign businesses looking for a presence in London has not dipped. London is by far the most popular European destination for foreign direct investment (FDI) projects, in 2010 securing 78% more than Paris, its nearest rival. Indeed only France, Germany and Russia secured more projects than London alone.

American firms account for the largest number of FDI projects. This is reflected by the leasing market where three of the seven deals of 100,000 sq ft plus were by US firms in 2011, the same number as were by UK firms.

London’s appeal to UK and foreign companies rests on three key pillars; the quality of the workforce, its accessibility, and its pro-business environment. These characteristics owe to a mixture of history, such as language and a beneficial time zone, and government, which provides a stable regulatory and taxation environment. Whilst some of these characteristics are replicable, London’s cultural offerings, aspects which draw the young in particular, are more difficult to copy. But there are a number of risks.
Regulations
It is generally accepted that regulatory failures contributed to the credit crunch and that more effective supervision was needed. The aim of the new wave of regulations has been to lessen the likelihood of further government bailouts of banks that have become too big to fail. To achieve this, new regulations have been designed to curtail risky lending. Given the perceived failure of “Anglo-Saxon” style capitalism has resulted in a shift towards curtailing financial markets rather than expanding them.

In addition, the escalating eurozone crisis has created a need for exceptional policies in the interest of the euro 17 rather than the EU-27. For example, the ECB has proposed that clearing houses handling “sizeable amounts” of euro-denominated business be located in the eurozone. This would have a major impact on London, which has more clearing houses than any other EU competitor, including Clearnet, the world’s largest clearing house which may have to relocate to Paris or Frankfurt.

Solvency II is a set of binding capital requirements and risk management standards for the insurance industry. The ultimate consequence will be to make the underwriting of risk more capital intensive. One of the early consequences has been for the market to undergo some consolidation as the cost of meeting the new requirements has forced some smaller syndicates, such as Hardy and Omega to be sold to larger players. Furthermore, the rules give preferential treatment for investments with shorter maturities and Government bonds. This may deprive banks and companies of a major source of funding and therefore investment in the wider economy.

An OECD report suggests that the increased capital requirements called for by the Vickers report and Basel III will dim global economic growth by between -0.05% and -0.15% per year whilst the cost to the UK banking sector will be between £3.5 billion and £8 billion per year. One immediate impact has been the scaling back of many investment banking operations which is already being felt in the City.

The impact of the new wave of regulations will dampen financial and insurance services in all markets, but because of London’s large concentration in the sector, the effects will be felt much more acutely here. That said, the UK government has made clear its position that all countries play on a level playing field. This is most clear with the proposed financial transaction tax (see overleaf) which the government is objecting to as it will disproportionately affect London.

Taxation
Whilst the government is legally bound to implement many European regulations, the government has greater autonomy over taxation. The Conservatives, who dominate the coalition, favour reducing the tax burden on workers and companies which will enhance London’s international competitiveness.

Having spent the 1990s with a highly competitive top rate of income tax, the UK has since been losing its competitive edge such that by 2009, following a new top bracket of income tax of 50%, only the Netherlands had a higher top rate amongst the OECD economies. The main change has been to increase the minimum capital requirement banks must hold. As well as Basel III the UK government had an Independent Commission on Banking. The end report called for the separation of retail banking from investment banking and an increasing of the banks’ capital requirement.

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Reasons for investing in London

- As a global centre for financial services, London has a high volume of large scale corporate occupiers; the type of occupier that is in high demand by large institutional investors.
- UK leases are longer and with upward only rent reviews, thus making them particularly landlord friendly. Added to this rents are triple net (the tenant pays all taxes, insurance and maintenance costs), which has the effect of making leases behave more like bonds as they ensure a minimum fixed income.
- The widespread use of the English language and English legal system provides a sense of familiarity to many investors which they would not get in other European cities. London is a very popular education destination, providing an incentive to parents to buy residential property and subsequently commercial property.
- Owing to the abundance of market research and vibrant property press London is amongst the most transparent markets in the world. Added to this, the real estate services firms in London operate on a global platform, allowing a familiar quality of service to be offered to investors coming to the UK.
- Unlike France and the USA, which punitively tax foreign ownership of real estate, the UK has few barriers to foreign ownership of real estate and there is confidence the system is stable and not likely to suddenly change. Recent moves to curtail foreign ownership of residential property are unlikely to be repeated for commercial property.
- London is highly liquid which allows buyers and sellers to enter and exit the market at any point in the cycle. For example, during 2008/09, many UK institutions sold their London assets to shore up their balance sheets.
- London’s large stock of high value product allows investors to benefit from economies of scale through reduced management and transaction costs. Graph 3 compares the size of the economy with the number of deals of more than £100 million in 2011. London has a disproportionately high number of very large deals. It is worth noting also that 19 of the 25 deals over £100 million were by non-domestic purchasers.
nations. According to a Treasury report the 50% tax rate failed to raise the projected £2.5 billion and encouraged high earners to seek ways to reduce their tax burden.

However, in the UK government’s budget for 2012/13, the Chancellor of the Exchequer declared the top rate would be cut to 45% from April 2013. Whilst meaning the top rate of tax in the UK will remain 15% higher than the G7 average, it reveals intent to improve the UK’s international competitiveness.

According to an OECD report, an uncompetitive corporate tax rate has the biggest detrimental impact on GDP growth. In 1997 the UK had a corporate rate 32% below the G7 average. This had fallen to a 9% advantage by 2010 as other countries have sought to attract major global corporate occupiers, creating jobs. However, along with reducing the top rate of tax on income, the Chancellor also announced the corporate tax rate would fall from 26% in 2011 to 24% in 2012 and would reach 23% by 2013.

Despite government attempts to improve the UK’s international competitiveness, taxation is also being used to reign in the financial services sector. Whilst the UK government has imposed a bankers bonus tax of 50% on all bonuses paid to bank staff, a more substantial threat to the banking sector comes from Europe as a financial transactions tax (a Tobin Tax), with the UK the only major economy opposed to the idea.

Sweden provides an example of where a Tobin Tax has been previously implemented. In 1984 a tax of 0.5% was introduced, sparking a significant exodus of financial activity as by 1990, half of all Swedish equity trading had moved to London. As by far Europe’s largest centre of finance the Tobin Tax would have a disproportional impact on London. A European Commission report suggested that 80% of revenues would come from the UK.

A commitment to having the most competitive tax system in the G20 and a regulatory system not materially more punitive than the other main financial centres seems to be working. If this policy line continues, the advantages of the UK as an international centre for doing business should continue.

**Immigration cap**

The UK attracts 10% of all students studying abroad, second only to the USA. However, the UK government is tightening its immigration policy particularly targeting the number of student visas being granted to non-EU residents. Hosting 100,000 international students, or 25% of the UK total, the effects will be most noticeable in London.

Whilst at university abroad students forge long-term ties with their host countries. Importantly, the majority of students coming to the UK are from China and India, two of the fastest growing economies in the world and a region the government is keen to increase trade links with.

Although the impact on London may not be immediately noticeable, the longer term impact of limiting links with emerging markets is less known. Furthermore, by potentially limiting the numbers of graduates with useful foreign language skills, London firms may struggle to expand into emerging markets.

**Infrastructure**

Over the next decade the IMF forecasts that more than half of global economic growth will come from the eight largest emerging market economies (including Brazil, Russia, India and China). If London is not to be at a competitive disadvantage with its European competitors it needs to expand the number of direct links with these economies.

The UK has seen an almost fourfold increase in air travel in the last three decades and demand is forecast to continue to expand to the point that all of London’s airports will be operating at capacity by 2030. Heathrow is already operating at 98% capacity and has fewer weekly flights to emerging economies than cities such as Frankfurt, Paris and Amsterdam.

One suggested solution would be to build a new hub airport in the Thames Estuary with four runways. However, costing in the region of £20 billion and with a horizon of up to thirty years if a decision were made now, it does not provide the immediacy needed.

The main alternative is to build a third runway at Heathrow.
This could be delivered within a decade and at a fraction of the cost of building a new airport, but owing to the location it is politically difficult.

Neither of these options tackle London’s immediate need for more capacity. Capacity could be increased by 10-15% overnight if Heathrow was able to use its existing runways more efficiently, by allowing planes to land and take-off concurrently on both runways. However, this would only provide temporary relief. If London is not to lose ground to its European competitor’s government must display significant political will to overcome financial and environmental concerns.

Another pressing transport issue for London is the quality of its internal infrastructure. According to a London First report, 56% of those entering central London during the morning rush hour use the Tube, of which 47% commute in overcrowded conditions. In part London has become a victim of its own success in attracting people and creating jobs. The Mayor’s office forecast London’s population to grow by 1.3 million by 2031, creating 790,000 jobs, whilst TfL forecasts that by 2025 40% more journeys will be made into and around London.

The government has responded positively to these pressures leading to major investment in London’s Underground network which will enhance the appeal of working in London. The most significant ongoing investment is Crossrail which, costing £16 billion will increase the capacity of London’s transport infrastructure by 10% when it completes in 2018.

In addition, the London Underground is undergoing a major upgrade which will increase network capacity by a further 30%, as illustrated by Graph 10. For example, when the Victoria Line upgrade completes in 2013 it will improve capacity on the line by 21%, whilst adding 3% for the whole network. Finally, Thameslink is undergoing a £5.5bn upgrade which will significantly increase the capacity of the service through longer trains and increasing the number of stations served.

Although London’s transport network has clear limitations, the major investment going into the local network and the discussions, if not yet action, about London’s connectivity indicates government is aware of London’s importance to the wider national economy. Further investment will be necessary if London is to continue to attract jobs and so it is promising that projects such as Crossrail 2, a line from Chelsea to Hackney, have received mayoral backing.

**Housing shortage**

London is experiencing a chronic under supply of new housing stock, including both market and affordable housing. Volumes need to increase, to ensure that employment growth is not limited by a lack of affordable priced housing, including mid to lower income workers where the affordability pressures are most acute.

Development has been constrained by a lack of finance for development and mortgages, particularly outside central London markets. Despite an upturn in housing supply in the year to March 2012, it still remains around one third below the Mayor’s minimum target and 45% below household projections.

International investors have provided a significant amount of funding for residential development in London, accounting for around 55% of new build sales in prime markets and 35% in other markets, delivering new homes for letting to London employees, as well as affordable housing that is delivered as part of the planning consent.

New initiatives to promote house building centre on NewBuy mortgage indemnity guarantees where lenders offer mortgages of up to 95% on new homes at affordable rates safe in the knowledge that loans will be underwritten by a new fund created by house builders and the government. By tackling the availability of mortgages, alongside the equity loans that are available under FirstBuy, this policy tackles the root of the problem.

Other aspects to the strategy include:

- Get Britain Building investment fund will provide £400 million to support building firms in need of finance and to unlock stalled development sites.
- Government is insisting that local authorities consult on renegotiating Section 106 agreements that were agreed in more prosperous conditions before April 2010.
- A commitment to accelerate the release of public sector land that has fallen out of use.
- The Growing Places Fund of £500 million will help the delivery of infrastructure where this is a key barrier to new development.

Further funding is required for housing demand to be satisfied, particularly in markets that are less attractive to the international investor. This is the gap that can be filled by institutional investment in the private rented sector, which has been expanding fast and now represents around 27% of London’s housing stock.
The new system of funding affordable housing has introduced tensions, by increasing rents at the same time as tenants capacity to pay is limited by forthcoming caps on welfare payments for the unemployed. However, these caps will not apply to households in employment, so we may see a partial re-orientation of scarce social housing in central London towards working households, close to their place of work. Provision of higher numbers of new affordable homes will require greater use of public sector land and it is no coincidence that new financial freedoms for local authorities give them greater opportunity to develop their own land for social housing.

Outlook

London’s commercial real estate has many attractions to investors, chief amongst which are the landlord friendly lease structures and large pool of high quality tenants. Therefore, the key to London’s future attractiveness to international investors will be continuing its appeal as a global business hub.

There are a number of threats, the most significant of which concerns how new regulations will affect the financial services sector. Whilst tougher regulations are potentially damaging, a more competitive tax system should help soften the blow. Added to this, government has been clear that it will fight any European moves which will disproportionately affect London’s international competitiveness, such as the Tobin Tax.

A lack of connectivity to the fast growing emerging economies is a growing cause for concern. The two most likely solutions are both highly contentious and require significant political will to see either of them through. Moreover, whilst London’s internal transport infrastructure often struggles to cope with demand, massive ongoing investment such as Crossrail will increase capacity and prepare it for continued job creation over the coming decades.

Added to this a housing shortage needs to be remedied across a range of pricing and tenures, to meet the needs of employees at all income levels. A number of initiatives have been announced and the industry is confident this will have a positive impact, particularly helping first-time buyers secure mortgages, a major impediment to developers.

Whilst London faces a number of challenges, it is encouraging that government has been active in defending London’s position as a leading international business hub. Although more can be done, with many incoming investors looking for holding periods of up to 30 years, this reflects long-term confidence in London’s future.

Five things London needs to do to maintain its popularity with international occupiers and investors

- In order to maintain London’s position as a major financial services hub, new regulations, although necessary, must not put London at a competitive disadvantage to other competing centres.
- A resolution to London’s international connectivity is needed in order not to lose business to European competitors.
- Continued investment in London’s internal infrastructure is needed to cope with a rising population.
- There is a need to increase housing stock, particularly low cost housing in central locations to reduce social polarisation.
- To maintain a world class global business hub, London based businesses must be able to hire the best talent from around the world.

Savills Central London and International

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