# Our market

## Through our London and Retail portfolios we're active in the two largest sectors within the UK commercial property market.

### Market during the year

**London office market**

**13.6m sq ft**
Take-up of office space in central London (2017: 11.9 million sq ft)

**4.8%**
Vacancy rate (Q1 2017: 4.4%)

**-4.5%**
Decline in prime headline office rents in the West End (2017: -8.3%)

**-2.1%**
Decline in prime headline office rents in the City (2017: flat)

Source: CBRE

**Retail market**

**-2.2%**
Physical retail store sales[1] (2017: -1.9%)

**-0.1%**
All retail sales (including online)[1] (2017: +0.3%)

**-2.5%**
UK footfall[2] (2017: -2.5%)

Source:
1. British Retail Consortium
2. ShopperTrak

## London Portfolio

We buy, develop, manage and sell office, retail, leisure and residential space in central London.

**Dynamics**
The London office market sees marked periods of over- and under-supply, and the balance can shift from one to the other quite quickly. Economic and political uncertainty continues to influence the decision-making of customers and property investors in the capital. Overall, however, the investment market remained relatively strong this year, with a weaker pound attracting overseas buyers. This generated record pricing for trophy assets. Healthy levels of leasing activity continued, leading to a pause in the rise of vacancy rates. The market continued to be shaped by the fast-evolving needs and expectations of customers. We are seeing growing demand for serviced office options.

**Enduring appeal**
Central London has enduring appeal for investors and occupiers. It offers:

- Attractive mix of offices, retail and leisure at street level, which appeals to employees
- Capabilities and opportunities of a global financial centre
- Deep and liquid property investment market
- International gateway
- Relatively stable tax framework
- Strong business and transport infrastructure
- Diverse community and English-speaking population
- Access to top universities.

London's strengths attract a large and varied mix of property investors, many from overseas. This helps us when selling assets but increases competition when buying.

**Challenges**
Challenges for London include:

- Uncertainty over the outcome of Brexit negotiations
- Potential impact of Brexit on skills and capacity in construction sector
- Limitations on economic growth due to restrictions on immigration
- Lack of housing at affordable or attractive prices
- Pressure on an ageing infrastructure
- Continued lack of clarity around airport expansion
- High levels of stamp duty
- Political uncertainty within the UK
- Need for better/faster digital connectivity.

**Outlook**
We expect uncertainty to continue to affect demand for space over the short term and the market to be subdued. Further out, we expect London to remain a highly successful, dynamic global city that provides great opportunities for us and our customers.

## Retail Portfolio

We buy, develop, manage and sell retail, leisure and residential space in the best locations.

**Dynamics**
The retail property market is generally less volatile than the London office market and is fundamentally driven by long-term structural changes such as population trends and the impact of online retailing. But currently it's also facing cyclical challenges including weaker consumer spending and growing cost and price inflation. Across the market, retail sales in physical assets were down 2.2%. Physical stores remain the dominant sales channel, with 85% of UK spend on retail goods touching a store. The retail property market is polarised between destination centres and convenience-led assets, with space in the middle facing growing pressure.

**Opportunities**
Shopping destinations can achieve higher dwell time and average spend per visit by providing a great visitor experience based on a strong mix of retail, food and leisure.

The best destinations continue to drive above average performance for retailers and attract the greatest demand for space. In successful centres, the arrival of new international retailers is more than offsetting the impact of departing brands. A growing number of online brands are using physical stores to create brand experiences.

**Challenges**
An uncertain economic environment is putting pressure on discretionary spending. Confidence is muted as retailers deal with challenges such as higher business rates, new regulation, a higher National Living Wage and investment in multi-channel retailing. Some food and beverage operators have expanded too fast. As a result of this pressure, a small number of retailers have sought to reduce store numbers using a Company Voluntary Arrangement.

**Outlook**
The best performing retailers are likely to have a carefully selected footprint of physical locations and a good multi-channel offer. Destination and convenience centres will continue to outperform other types of retail asset. Success for asset owners will be driven by being in the best locations, very active asset management and smart responses to the changing needs of retailers and visitors.

## Six big drivers shaping our markets

1

### Evolving customer needs

Many office occupiers are placing growing importance on flexibility of layout, capacity, service levels, leases and payment terms. They're looking for efficient, attractive environments that promote productivity, wellbeing and culture – and express their brand. Physical and digital connectivity, and technical resilience, are all key. Cost per head is now more important than £ per sq ft. Artificial intelligence and other applications of technology are set to grow demand for greater flexibility and diversity of space. In a market increasingly shaped by online, successful retailers are generally looking for fewer but larger spaces where they can showcase their range, provide an experience and connect directly with consumers. People are shopping less often but will travel further for – and stay longer in – the best destination centres. The food and leisure offer, comfort, accessibility and a healthy environment are increasingly valued by customers.

2

### Balance of supply and demand

The balance between supply and demand of space in the London office market is shifting towards over-supply, but more slowly than we expected. Overall, investment values remained high, partly due to demand for trophy assets which are likely to retain value. Looking ahead, weaker investment values would present opportunities for companies with capital to buy assets. In retail, the market is generally over-supplied with space, not to the extent of some other regions such as the US and not all retail space is the same. Assets providing a great experience or convenience are performing better than those caught between the two. As catchments evolve, shopping destinations must ensure they can compete against others further afield.

3

### Economic uncertainty

Wider uncertainty continues to affect the ability of many customers to plan and take decisions. For businesses that have to take new space, there's good choice and attractive incentives. Others are opting to sit tight, extending leases and repurposing space or taking additional space if required. The full impact of this has not yet been seen in investment values. For consumers, increased economic uncertainty – especially around interest rate rises – may lead to lower spending. The UK's vote to leave the EU has brought change and challenges but also potential for economic and financial benefits, not least for businesses and exporters looking to move into or expand in the UK. Given the uncertainties and complexities involved in Brexit, it's especially important to analyse economic, financial and business news and data carefully before drawing conclusions.

4

### UK competitiveness

In the short term, ongoing negotiations with the EU create uncertainty and commercial caution. Whatever the final agreement, we fully expect London to continue as one of the world's most successful financial and cultural centres, and we are confident the UK will remain a major world economy.

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### Product innovation

Technology and design innovation can change the face and functionality of buildings in exciting ways. They also impact the construction process. While investment markets can evolve at remarkable speed, the design, construction, leasing and operation of commercial property remain relatively slow and inflexible. We see opportunities to change that. Our industry can do more to reduce time-to-market, cut cost and increase flexibility, resilience, efficiency and sustainability. Our ongoing challenge is to design buildings today that will work successfully in 5-10 years' time and beyond.

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### Sustainability as advantage

Businesses, government and the public increasingly recognise the need for long-term thinking on social and environmental issues. We are seeing the impact of climate change and profound social change. And there is growing scrutiny of how companies treat a broad range of stakeholders in their supply chain. How businesses respond to these issues will determine their resilience and competitiveness over the long term. Smart, progressive thinking can help support the people and resources that companies rely on to prosper and grow – and it can bring all sorts of business benefits too. The best companies in our industry are expected to lead on areas such as diversity, local employment, community relations, responsible supply chains, the wellbeing of occupiers and visitors, climate risks, energy and biodiversity.

To see how our strategy directly addresses these market drivers go to page 17

## Market cycle