Edinburgh Office Survey

Summer 2011

“We expect that rent-free periods will begin to tighten over the next six months”

- Take-up in the first half of 2011 was up on last year’s first half total, at 300,000 sq ft.
- Availability continues to fall across the CBD and out-of-town market. Grade A space now accounts for only 25% of the total 2.8m sq ft of available space.
- The investment market remains quiet, however we believe that Edinburgh is well-placed to capture investors who are unwilling to pay low yields in London and the South East.
- The leasing recovery, when it comes, will be driven by low Grade A supply rather than strong tenant demand. We expect upward headline rental growth to emerge in 2012.

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Leasing market

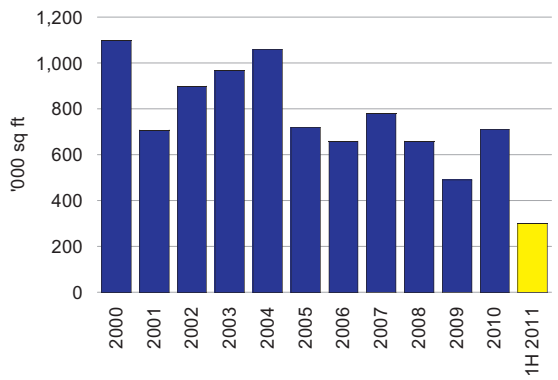
After 2010's strong recovery from the downturn, tenant demand for office space in both Edinburgh City centre and the out-of-town market has remained fairly stable.

The bulk of the lettings in the first six months of this year have been in the sub 5,000 sq ft band in and around the CBD, and driven more by lease events than either expansion in terms of headcount or floorspace occupancy.

The stand-out deal of the first six months of 2011 was Amazon's acquisition of 57,000 sq ft on two floors at Highcross' Waverley Gate. While this letting did not set any records in terms of the rent achieved, it is interesting in that it reflects two emerging tenant trends that we are tracking elsewhere in the UK. Firstly, amongst larger businesses in particular there appears to be an increasing desire to find modern, yet cost effective offices. Waverley Gate, which has been placed in the market at a 30-40% discount to the prime CBD rents, clearly ticked this box. The other reason that this is interesting is that this particular requirement was fairly footloose, with Amazon looking at several other UK cities. The choice of Edinburgh reaffirms our view that once the recovery starts this will be one of the stronger regional cities.

Amazon's letting brought the half year total for Edinburgh take-up to 300,000 sq ft, slightly ahead of the situation at the same time last year. Amazon's deal has also meant that the retail sector has been the dominant business sector over the last six months, however the public sector (10% of take-up), and the technology sector (16%) were also significant acquirers of office space.

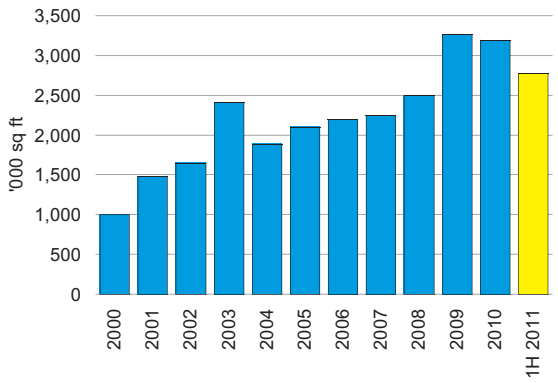
Take-up at the mid year is ahead of 2010's mid-year level



Availability has continued to fall during 2011, with the total mid year availability now at 2.8m sq ft (down from 3.2m sq ft at its peak in 2009). This equates to a vacancy rate of 12%, which is broadly in line with the current vacancy rate in most of the UK's key regional cities, and only slightly higher than the current vacancy rate in the City of London.

The level of Grade A availability has fallen faster over the first six months of 2011, and as at the middle of this year we estimate that only 25% of the total availability is new or recently refurbished.

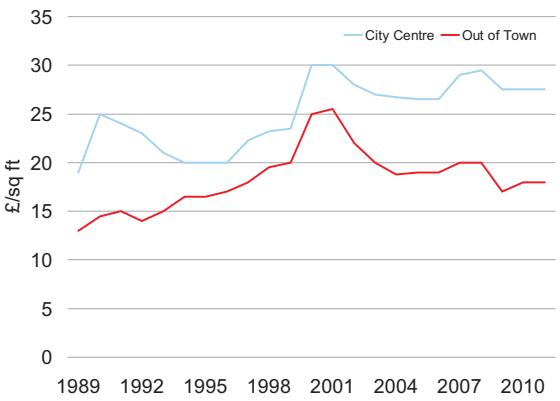
Total availability continues to fall, with Grade A space only accounting for 25% of the total



We do not anticipate any change to this downward trend in availability in the short to medium term. With only one major new development in the pipeline, we expect that prime office supply in particular will fall steadily over the next few years. The supply-side of the local property market is clearly trying to respond to this with a pick-up in refurbishment activity, though the best of these projects also remain fairly limited.

The last quarter has not really delivered any useful prime rental evidence. We estimate that prime headline rents have remained stable over the last three months at £27.50/sq ft in the City centre, and £17/sq ft in the out-of-town market.

Rents were stable in Q2 2011



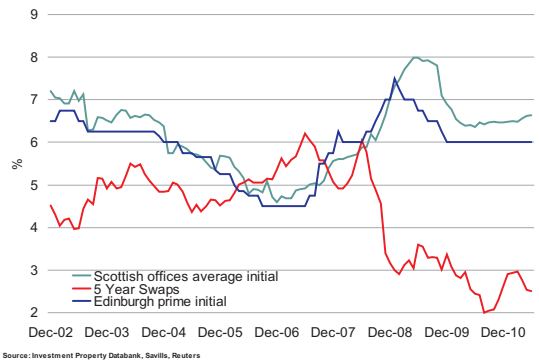
Investment market and outlook

The investment market in Edinburgh has stayed pretty quiet this year, both in terms of stock to buy and investors looking to acquire assets in Edinburgh. There remains a huge investor bias towards the perceived risk-aversion of the London office and retail investment markets, but we are beginning to detect a disatisfaction with the low yields on offer in London, and this is leading to a pick-up in interest in Edinburgh and a few other UK cities.

The last three months have also seen renewed buying activity from the UK institutions, most of who are unable to find right-priced asset management opportunities in central London.

Limited transactional activity over the last quarter means that it is hard to put an accurate figure on what prime, well-let office investments might achieve in Edinburgh. However, we believe that the right product is likely to achieve a yield of 6%.

Prime office yields are stable at 6%



This view of stability in yields is borne out by the IPD monthly index of average Scottish office yields, which has been broadly stable at around 6.6% for the whole of the last quarter.

The second half of 2011 and early 2012 will undoubtedly see more stock coming onto the market, primarily from the banks and special servicers. We believe that there are two types of asset that are likely to be particularly appealing to investors over the next 6-12 months. The first, which is likely to appeal to the more risk-averse buyers like the German funds, will be prime CBD offices, with 10+ years income security. Assuming that these are available around the 6% mark, then they look attractive in comparison to London. The second grouping will be asset management opportunities, of interest to the UK institutions and property companies, where there is the opportunity to enhance the value and the return through re-letting and riding the rental recovery.

Outlook

So, when will Edinburgh's rental recovery begin? A year ago we voiced concern that rationalisation in the Scottish banks could result in not only the release of surplus office space onto the market, but also a knock on to general banking and financial services sentiment towards the City. This view seems to have come true in part, with several recent financial services requirements being put on hold. This is by no means a purely local issue, and rising concerns about sovereign debt in Europe and the USA, as well as the weak economic recovery in the UK and USA, are affecting tenant demand across the country.

We also remain concerned about Scottish public sector austerity. The true scale of Scotland's austerity programme is yet to be revealed, but at best it is not going deliver much in the way of new public-sector office requirements over the next 2-3 years.

The key drivers of demand for office space in the City over the next five years will be gentle increases in office-based private sector headcount (chiefly from the business and professional services sectors), as well as a slightly above average level of lease expiries.

Inward investment is always a possibility, and Amazon's letting indicates that Edinburgh scores well with footloose occupiers. As office rents continue to rise in London and the the South East there may well be some more relocations attracted to the City.

Does this fairly dull view on demand change our outlook for the Edinburgh office market? In short, no. Our forecast for the period 2011-2015 has always been based on a gentle recovery in take-up back to its long-term average, with the driver of rental uplift being a shortage of Grade A office space in various size bands and locations.

The outlook on the supply-side has not changed, and while there has been a slight pick-up in refurbishment activity over the last six months, there is still only one speculatively developed office building due for completion in the next five years (HI). When office-based employment in the City returns to a net growth situation in 2012, the shortage of Grade A office space in the market will become a driver of upward rental growth. We expect that rent-free periods will begin to tighten over the next six months, and by this time next year we will be seeing some selective upward movement in prime headline rents.

With headline prime rental growth beginning to emerge in 2012, our five year annual average rental growth forecast for Edinburgh has risen slightly to 3.4% per annum.

Survey area & key contacts

Recent significant deals

Investment	Size (sq ft)	Purchaser	Vendor	Price	IY
Edinburgh House	39,828 office	Prudential	Alliance Trust	£11.5m	7.5%

Leasing	Size (sq ft)	Tenant	Rent £/sq ft
Waverley Gate	57,442	Amazon	Confidential
Auction House, George St	1,670	Xodus	£21.50
10 Melville Street	3,206	Melville Independant	£22.85

Definitions & statistical notes

Top rent
Highest rent achieved in one or more transactions.

Property criteria
Transactions and supply recorded for units in excess of 1,000 sq.ft.

Grade A space
All new developments (including speculative schemes reaching practical completion within six months, plus major refurbishments).

Grade B space
All other space

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