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Savills World Research
UK Commercial

Spotlight
Regional Office Market Report

October 2014

Bridgewater House, Finzel's Reach completed in 2011 and totals 110,000 sq ft. Occupiers include Barclays and BDO. 78,000 sq ft is available.

- The recovery in the UK commercial property market was further confirmed this year. Capital value growth, for the IPD Monthly Index for Offices, is showing 21% growth in London over the last year, with an 8% growth in the rest of the UK.
- There is growing confidence to invest outside of London and this has been led by the UK institutions, particularly for the office sector.
- We expect regional yields in tier one cities will reach sub 5% by the end of the year.
- Severe lack of available stock, in particular Grade A, has led to a pick-up in investor demand for secondary assets in strong locations.
- The first half of 2014 saw a marked change in sentiment within the regional office markets, which is now reflected in the take-up figures.
- Rents have started to show growth in key cities, with definite signs of incentives shortening in the majority of the regional cities.

"The best prospects for capital value growth over the next five-years will be outside the Greater London area."Jeremy Bates, Head of National Office Agency

■ Economic and financial uncertainty have hit a four-year low. Despite geopolitical issues, which knocks global confidence, the UK is on a stronger path of occupational demand recovery. News flow, both positive and negative, has come in equal waves during the past few months, however, analysts remain bullish and suggest that the corrections are due to the markets adjusting to the anticipation of higher interest rates.

Regional investment market

■ The recovery in the UK property market was further confirmed this year. Capital value growth, for the IPD Monthly Index for All UK Property, is showing 5.8% growth over the half year.

■ There is a marked difference between the three main property sectors. The office sector is out-performing all other sectors at 8.6%, which has been driven by Central London. Over the last year Central London offices have seen a 21% rise in Capital value growth, with the regions seeing only 8%, with the expectation that the regional office markets still have further to go.

■ Investors have already been encouraged by significant value gains right across the UK regional market in the first half of 2014. There is growing confidence to invest outside of London and this has been led by the UK institutions, particularly for the office sector. This group of investors now account for 46% of the office investment market to September 2014, compared to 33% at the same period in 2013.

■ The regional markets are now seeing significant investment activity as the ripple effect moves out from London. The improving occupier market, with requirement levels increasing, is the driver of this higher level of positive sentiment.

■ With inflows into retail funds continuing and their greater allocation to property, the weight of money targeting commercial property shows no sign of abatement. This will generate further downward pressure on yields.

■ Office investment volumes reached a six year high of £23bn in 2013. This was 55% up on 2012 and only 10% off 2007 peak levels. The proportion being invested in office markets outside London has risen sharply in 2014.

■ Regional volumes only made up 16% of total volumes in 2013 and to date they make up 27%. Encouragingly, to date, total regional volumes are only 9% down on the 2013 end year figures. We expect this trend to continue as we go through the rest of the year.

■ Over the past two years, office investment yields in the UK have been trending downwards due to rising investor interest in regional cities, lack of available stock, increasing amounts of money to invest and the differential between London and the regional cities.

■ At 5.05%, NFU Mutual has set a record yield this cycle for Chancery Place, a prime Manchester office, which is evidence of the strength and depth of the investor recovery in the key regional markets. Recent deals proceeding this for prime offices such as One Piccadilly Gardens and Direct Line House achieved just above 5.5%.

■ We expect regional yields in tier one cities will reach sub 5% by the end of the year. In some markets this will be exacerbated by the lack of good quality product. However, these value improvements are likely to encourage the release of more stock to the market.

■ Manchester has already started to buck the trend and is now beginning to see an increased level of investment stock, including some very high profile sales such as the sale of City Tower on behalf of Bruntwood, which has recently transacted at £130m (7% yield) to Schroders, as well as a number of larger prime investments such as One Spinningfields and One Hardman Boulevard.

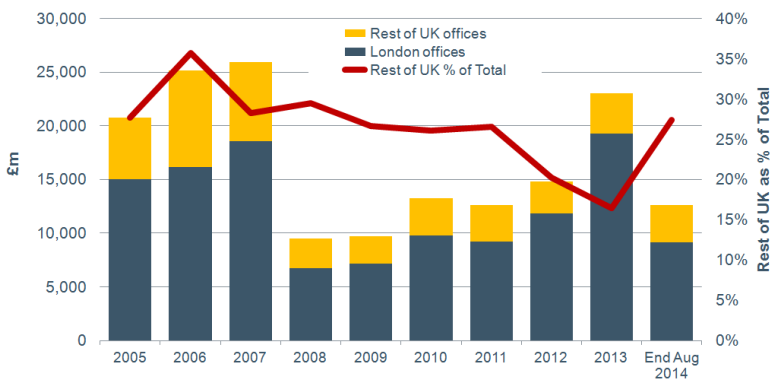
■ The largest regional deal in 2014, and in Manchester's history, was the deal where M&G Real Estate purchased the 500,000 sq ft Manchester office space let to RBS for around £320m. The purchase of 1 Spinningfields Square was made on behalf of an internal client fund of M&G Real Estate; 1 Hardman Boulevard was purchased on behalf of a third party institutional client of M&G Investments. The two Grade-A offices are leased in their entirety to RBS for a further 23 years and are subject to annual fixed uplifts of 3%.

■ Another significant deal in terms of size this year has been M&G Real Estate's £140m acquisition of the flagship Two Snowhill building in Birmingham from fund manager Hines. The deal, reflects a net initial yield of sub 6%, between M&G and Hines Interests Limited Partnership on behalf of Hines European Development Fund II.

■ Two Snowhill is a 319,000 sq ft, 14-storey multi-let building that completed last year. Tenants include Wragge & Co, serviced office provider i2 Group and HS2 Ltd, which took

GRAPH 1

The proportion being invested in office markets outside London has risen sharply this year



Graph source: Savills/Property Data

The BBC are relocating their Welsh HQ to Capital Square, where they will take a new 150,000 sq ft building

90,000 sq ft within the building in July.

■ Although the outlook for the UK office market is a positive one, with strong demand from the UK institutions, this severe lack of available stock, in particular Grade A, has led to a pick-up in investor demand for secondary assets in strong locations, where a successful refurbishment will lead to rental growth and significant increase in values.

■ Examples of these type of sales in 2014 include the former Bank of Wales building known as 'Plas Glyndwr' in Cardiff, which was acquired by Ardstone Capital for £3.5 million reflecting £100 per sq ft. They are planning a comprehensive refurbishment of the building.

■ 55 Colmore Row in Birmingham, is a 150,000 sq ft building in a prime location with asset management/ redevelopment opportunities, which is let to Wragge & Co until 2017 at a passing rent of 3.3m. The property has recently been acquired by IM Properties for £34m, which equates to a NIY of approximately 9.25%.

■ With a limited amount of prime stock available to occupiers over the last 12 months, coupled with the pent up demand implied by upcoming lease breaks, rental growth is becoming a reality. This has resulted in some transactions achieving above their asking price, as seen with Vintry House, Bristol, which was originally brought to the market for £3.54m. This property generated strong levels of interest finally selling at £4.4m in July 2014. 24% above asking.

■ Small lots and lack of liquidity in the regional investment market may lead to investor disappointment going forward, however, the next big opportunity may be to package up groups of smaller assets to create high quality regional portfolios which are large enough to satisfy investment requirements.

■ In our last report we predicted that investors should start to move up the risk curve and start backing speculative development in the regions as we move through 2014. Part pre-lets are still very much on the agenda, however, we believe that with institutions now having money for funding and with a restored market confidence and positive sentiment, large scale speculative development should follow in the next 12 months.

Regional occupational market

■ The pace of change in the regional office market has continued into 2014 following the record take-up last year. The second half of 2013 saw a marked change in sentiment within the regional office markets, which has started to reflect in the take-up figures. We expect year end figures to be broadly in line with 2013.

■ Deloitte UK's latest Survey of Chief Financial Officers found that the top corporate priority is now expansion. A record 72% of respondents believe this is a good time to take risk on hiring, which is positive news for commercial property.

■ Take-up in the first half of 2014 was 22% up on the same time in 2013 (19% including the M25) and we expect take-up to end the year at 2% above 2013 levels (3% including the M25).

■ After Leeds, Glasgow and Cambridge stole the limelight in terms of take-up in 2013, key cities to watch in 2014, will be Manchester and Cardiff, who are likely to see a 38% and 69% increase respectively on the previous year.

■ Demand in Manchester reached its highest quarterly level for 14 quarters in Q2 2014. Restored confidence and positive market sentiment has resulted in a considerable spike in demand that is likely to see take-up reach 1.2 m sq ft by year end. 45% up on the long term annual average.

■ Cardiff take-up at the half year was an impressive 102% up on the same time in 2013. We expect take-up to end the year at c.500,000 sq ft. This is 69% up on the same time last year and 16% above the five year average.

■ The M25 office market take-up was in line with the long-term trend for the first half of 2014. However, there are numerous requirements and space currently 'under offer' is much higher. Therefore, we expect the remainder of the year will see an increase in take-up levels.

■ Going forward, job creation in the UK will be concentrated in the private services sector, particularly the strongly expanding professional and support business services. Both these two sectors alone are forecast to create an additional 1.1 million jobs in the UK by 2024. We anticipate UK wide activity also points to additional and increasing demand from sectors such as Telecoms, Media and Technology sector (TMT).

■ According to Oxford Economics over the last 12 months, Yorkshire and the Humber enjoyed the highest rate of growth across all 12 UK regions in the professional services sector, with growth of 13%, equating to 37,000 additional jobs. This will translate into a steady recovery in take-up to above average annual levels over the period 2014-2018 (though Grade A take-up

"Schemes capable of early delivery are well placed to take advantage of pre-let opportunities and rental growth" Jonothan Holmes, Head of funding

could be held back by lack of new stock in 2015/16).

■ Attracting inward investment plays a crucial role in the economy of any regional city; Deutsche Bank set a trend of large scale inward investment into Birmingham back in 2013, with the city now seeing HS2, taking 90,000 sq ft at Two Snowhill. We expect this will lead to further speculative development in the city.

■ Manchester has seen a number of in-movers this year, however, one of the most significant deals of 2014 is the letting of 60,000 sq ft at ASK Developments' First Street to Trader Media. This deal really sets the tone for future inward investment, which should enhance the case for developers and funds to speculatively build in Manchester city centre.

■ Development activity in the regions is now starting to accelerate. While London remains a key focus, the regions offer attractive development opportunities. This is beginning to filter through to the office pipeline figures, with the speculative development pipeline currently 42% up on where it was six months previously. However, it is still 72% down on the long term average. 60% of the current pipeline is in Edinburgh and Glasgow, with seven schemes (850,000 sq ft), completing in 2015 and 2016.

■ Leeds, which has seen a large drop in supply over the last 12 months (-35%) and with less than one years worth of Grade A supply, is one of the other key cities to actually start fully speculatively at Wellington Place (100,000 sq ft).

■ However, in the majority of regional cities they are still reliant on a pre-let or government funding to secure a start. We do believe however, that this is going to change in the next 12 months, with particular attention being paid to lot size, micro location and floorplates if these schemes are to be successful in the current market.

■ Manchester. for example, is likely to see up to five developments commence construction by year end, totalling c.900,000 sq ft, representing two years Grade A take up, with Leeds seeing a potential 300,000 sq ft likely to start on site in the next 12 months.

■ Savills believe that the development pipeline is approximately 18 months behind the current demand curve. Occupiers need to think ahead to ensure they secure high quality accommodation in the right location, with pre-lets likely to be the only option in many cases.

■ With a bubble of lease events coming up in the next three years, occupiers will need to start looking now, to make sure they secure the best deal. Whilst not all will move, less austerity driven decisions should generate demand for more Grade A offices.

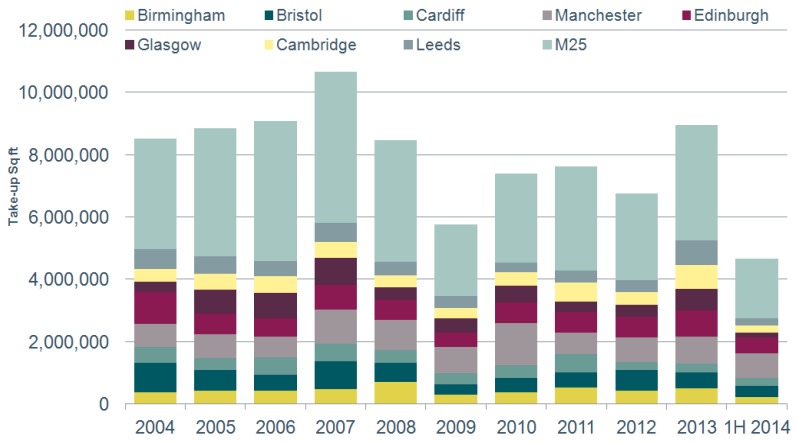
■ Although there is a limited amount of Grade A supply (27% of all regional supply), there is still a question mark over what will be done with the steadily increasing secondary space in these regional cities.

■ Much of the larger take-up this year has been under pinned by inward movers, resulting in an erosion of supply. Looking forward to the rest of 2014, a significant amount of larger regional lettings are likely to be from incumbent occupiers who, now more confident in the economic outlook, seek to upgrade their space. As a result we are likely to see a increased amount of 'grey' space returned to the market, consequently adding to the already oversupplied second-hand market.

■ Although more of this non-prime office space is being refurbished to absorb increasing demand, the trend for conversion to student housing is expected to continue in the short term. However, the gap between prime office and residential values has closed in many locations, due generally, to rising prime commercial values.

GRAPH 2

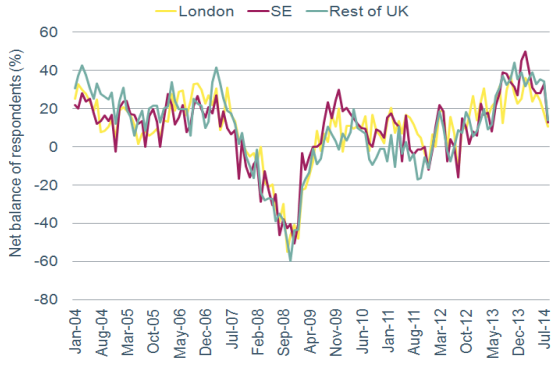
1H 2014 take-up is 22% up on the same time in 2013



Graph source: Savills Research

GRAPH 3

Regional development activity remains robust



Graph source: Savills Research

■ Savills June 2014 analysis shows that the rationale is becoming increasingly slim in many markets, and that office owners might better consider refurbishing the building to Grade A office standards.

■ The aforementioned lack of Grade A supply, however, is likely to drive prime rents higher as competition for existing accommodation heightens. The following 12 months could be an interesting time for landlords.

Outlook

■ The last 12 - 18 months has represented a positive change for the regional office markets, with demand increasing across the majority of key markets, representing a significant growth in take-up and falling supply. Office rents are now returning to growth.

■ The markets predicted to see the biggest year-on-year growth in rents by the end of 2014 are; Edinburgh at 8% and Manchester at 7%, which will largely be driven by a shortage of Grade A stock and improving occupier demand for certain office product.

■ Over the next five years we expect Manchester, Birmingham, Edinburgh and Leeds will see a growth of 3% per annum. Cardiff, Cambridge, M25 and Glasgow 2% per annum and Bristol 1% growth per annum.

■ 2014 has continued to see a marked rise in investor interest in UK regional Cities from UK Institutions, Property Companies as well as Overseas Investors. Interest is driven by the improving occupational market, and the yield gap between London and the regions. The lack of supply in London, coupled with the weight of overseas demand means the focus is now firmly on the regional economies, which offer excellent characteristics for both security and potential for growth.

■ London will continue to appeal to investors who are looking for safety and security, as well as those looking for development opportunities. However, the best prospects for capital value growth over the five-year forecast period will be outside the Greater London area.

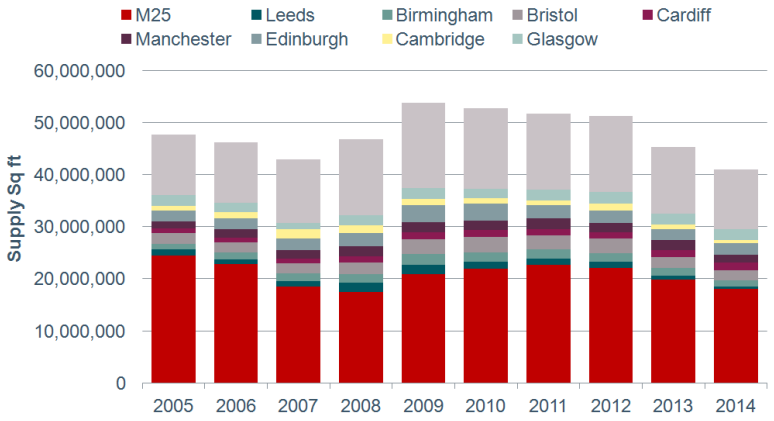
■ Tenant demand is recovering in the majority of key regional cities, coupled with a severe under-supply of Grade A space and a very restrained development pipeline, there are now increasing opportunities for developers going forward.

■ The case for speculative development in the UK regional cities is strong. A paucity of existing stock and the significant number of lease events due over the next few years will further fuel demand.

■ Although there is a limited amount of speculative development committed, increasing occupational demand is fuelling potential rental growth and further speculative development activity.

GRAPH 4

Supply continues to fall in 2014



Graph source: Savills Research

2014 forecast

Expert view

Chris Meredith, Director of leasing, Bristol, highlights his key themes

Like a number of key regional cities, Bristol's second-hand office stock has been alleviated in the last 12 months by the rise in office conversions to other uses, predominately private residential and student accommodation, due to the Permitted Development Rights Scheme (PDR) which temporarily relaxed planning restrictions on such change of use applications.

This has resulted in a 'tightening' of supply in the middle tier Grade B office market, which has had a positive effect on rents and rent frees. Lewins Place, The Pithay, St Lawrence House and Crown House are just some notable former second hand office buildings that are undergoing conversion. We estimate total office space lost to be around one million sq ft across the City.

Coupled with the tightening of the Grade B office market, Bristol, like the majority of the key regional office markets, is also experiencing a shortage of Grade A office stock, hence the return of speculative development across the City.

Salmon Harvester's 2 Glass Wharf scheme (c.98,000 sq ft) is due for completion in Q4 2014 and Skanska's 66 Queen Street (circa 60,000 sq ft) is due for completion mid 2015.

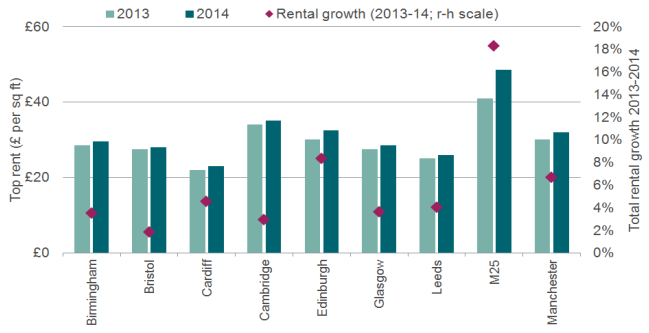
Total Grade A availability in Bristol currently stands at circa 370,000 sq ft with Cubex Land's Bridgewater House (see front page), being the most prominent building of the current built stock having recently undergone extensive improvement works. This has resulted in a top rent of £27.50 per sq ft being achieved in the building in the first half of 2014.

Due to these tight levels of supply, upward pressure looks set to continue on top rents in Bristol, indeed, we have already seen the first signs of this with PwC going under offer at 2 Glass Wharf at a headline rent of £28 per sq ft. Once complete this transaction will mark the end of a seven year stagnation in Bristol's top rents.

Key Charts

GRAPH 5

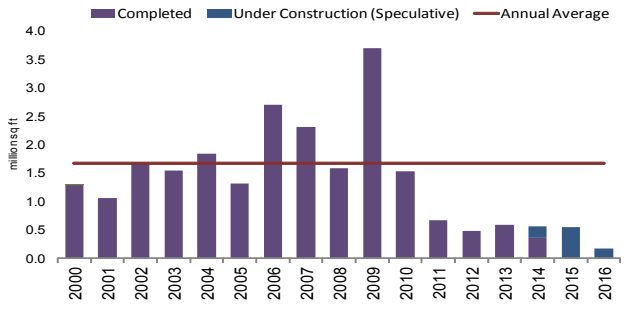
Rental growth is expected in all regional cities



Graph source: Savills Research

GRAPH 6

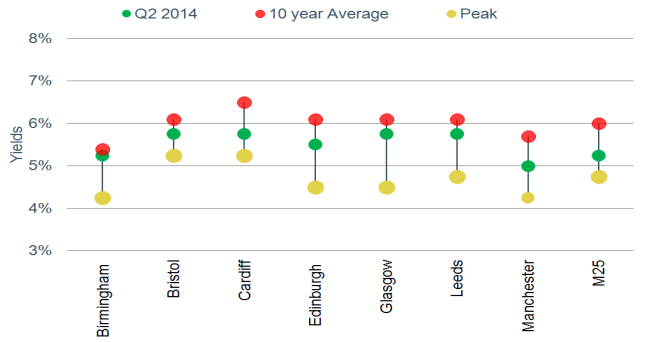
The development pipeline is still 72% down on the long term average



Graph source: Savills Research

GRAPH 7

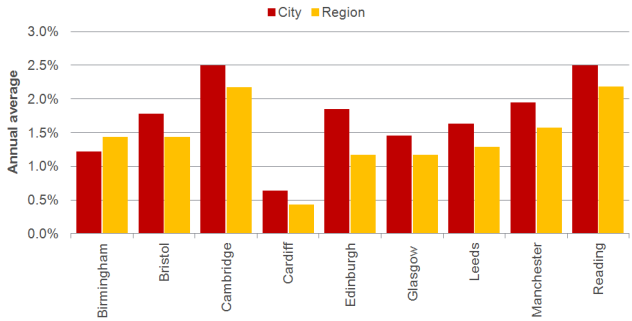
Regional offices yields are hardening, but still above central London



Graph source: Savills Research

GRAPH 8

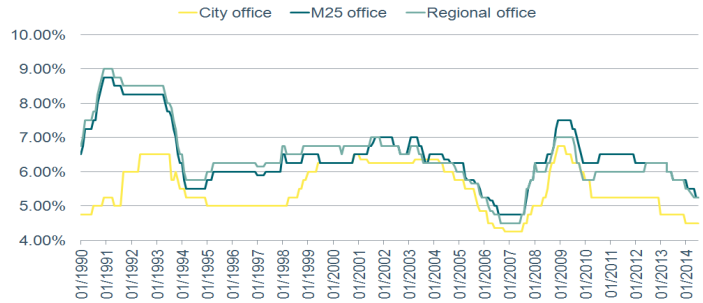
Cambridge and Reading are set to see the best office-based employment growth (five years)



Graph source: Oxford Economics

GRAPH 9

Wider than normal spread between London and regional office yields, though it is closing fast



Graph source:: Savills Research

TABLE 1

Definitions

Definitions	
Property criteria	Transactions and supply recorded for units in excess of 1,000 sq ft.
Top rent	Highest rent achieved in one or more transactions in the given period.
Grade A	All new development (including speculative schemes reaching practical completion within six months, plus major refurbishments).
Grade B	Space previously occupied, completed or refurbished in the last 10 years.
Grade C	Space previously occupied, completed or refurbishment more than 10 years ago.

Please contact us for further information

Jeremy Bates
Head of UK Agency
020 7409 8813
jbates@savills.com

Richard Merryweather
Joint Head of UK Investment
020 7409 8838
rmerryweather@savills.com

Nick Williams
Office Agency
Birmingham
0121 634 8401
nwilliams@savills.com

Andrew Bull
Investment
Birmingham
0121 634 8403
abull@savills.com

Chris Meredith
Office Agency
Bristol
0117 9102 216
cmeredith@savills.com

Andrew Main
Investment
Bristol
0117 9102 207
amain@savills.com

Gary Carver
Office Agency
Cardiff
02920 368 963
gcarver@savills.com

Ross Griffin
Investment
Cardiff
02920 368 961
rgriffin@savills.com

Rob Sadler
Office Agency
Eastern Region
01223 347 209
rsadler@savills.com

James Emans
Investment
Eastern Region
020 7409 8132
jemans@savills.com

Keith Dobson
Office Agency
Edinburgh
0131 247 3801
kdobson@savills.com

Nick Penny
Investment
Edinburgh
0131 247 3803
npenny@savills.com

David Cobban
Office Agency
Glasgow
0141 222 4101
dcobban@savills.com

Bruce Patrick
Investment
Glasgow
0141 222 5837 bpatrick@savills.com

Paul Fairhurst
Office Agency
Leeds
0113 220 1207
pfairhurst@savills.com

Simon Lister
Investment
Leeds
0113 220 1208
slister@savills.com

James Evans
Office Agency
Manchester
0161 277 7238
jevans@savills.com

Peter Mallinder
Investment
Manchester
0161 277 7211
pmallinder@savills.com

Jonathan Gardiner
Office Agency
M25
020 7409 8828
jgardiner@savills.com

Mark Porter
Investment
M25
020 7409 9944
mporter@savills.com

Nick Berrill
Office Agency
Oxford
01865 269 066
nberrill@savills.com

Martin Hastelow
Office Agency
Southampton
023 8071 3989
mhastelow@savills.com

Clare Bailey
Commercial Research
020 7409 8863
cbailey@savills.com

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