Edinburgh Office Survey

Review of 2008 and outlook for 2009

"The Edinburgh office market is better placed than other financial centres to weather the current downturn."

- Take-up held up well in 2008, only marginally below the long term average.
- Availability rose, but shortages of Grade A space in the City centre remain an issue.
- Headline rents remained stable in 2008, but net-effective rents fell.
- Yields have softened dramatically over the last 12 months. Pricing of prime, secure investments is looking increasingly attractive.
- We expect availability to rise in 2009 as a result of both tenant returns and development completions. However, in 2010 and beyond the development pipeline is very constrained and this should provide the driver for a recovery in Grade A office rents in Edinburgh.

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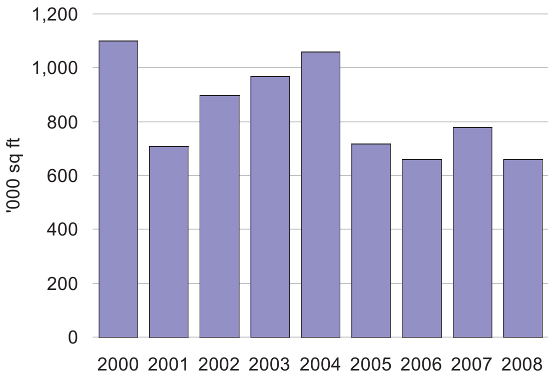
Leasing market

Given that Edinburgh is one of Europe's major financial centres it would be reasonable to expect that demand for office space in the City would have been hit hard by the financial markets events of the last 18 months. However, demand for office space held up well in 2008, with take-up of 661,000 sq ft. On top of this there were a number of owner occupier acquisitions, bringing the total for the year to around 700,000 sq ft.

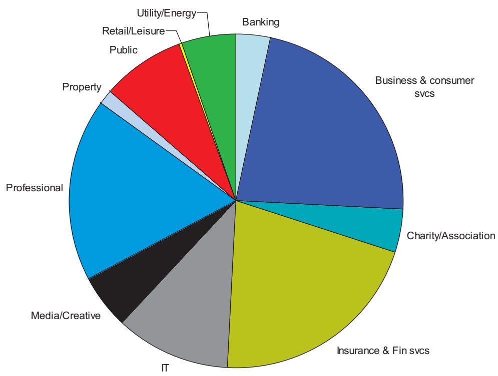
Take-up in 2008 was in line with the average



While the total amount of office space leased in 2008 was down on 2007's level, it was only marginally below the long term average of 690,000 sq ft per annum.

One of the reasons why the Edinburgh office market was so resilient in 2008 is its position not just as a financial centre, but also as the administrative centre of Scotland. While the proportion of the take-up that was to the Banking sector was down on recent years, this was compensated by resilient demand from the Insurance and Financial Services sector, and the Business and Consumer Services sector. The Professions, primarily the City's law firms, also remained acqusitive in 2008.

Edinburgh's diverse occupier base supported the market in 2008



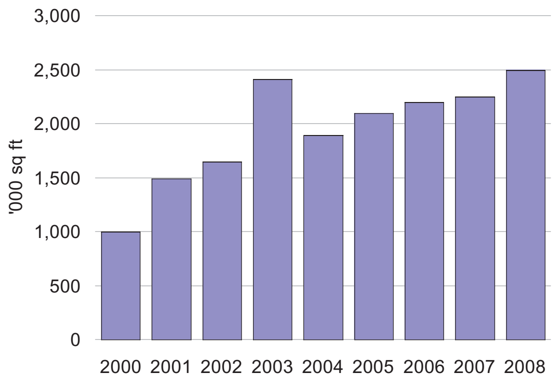
Unlike some of the UK's other financially biased office markets in the UK, rental affordability did not appear to be an issue to tenants taking new space in 2008. Nearly 80% of the office space leased in Edinburgh last year was of Grade A quality.

The main story of the last decade in Edinburgh's office markets has been one of limited availability of new office space in the City's core. The combination of the increasingly tight planning regime, and lack of developable sites, has meant that availability has remained relatively low in comparison to demand and take-up.

2008 saw an increase in the amount of office space on the market in Edinburgh, with the year-end availability rising from 2.2m sq ft at the end of 2007, to 2.5m sq ft at the end of 2008.

Aside from the 200,000 sq ft of new office space available at Waverley Gate, the bulk of the available Grade A office space in Edinburgh remains outside the centre of the City. Indeed, we estimate that the majority of the vacant office space in Edinburgh continues to be outside the core.

Availability has picked up, but remains restrained in the Core

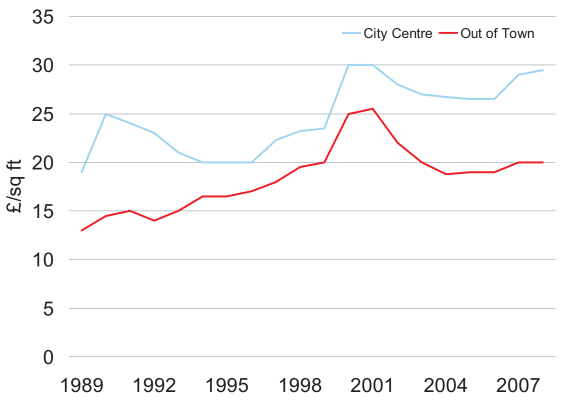


While falling rents in the second half of 2008 were the story in the UK's other financial centres, the low availability of Grade A space in Edinburgh has ensured that headline rents remained stable in the second half of 2008.

There has been some downward pressure on net-effective rents over this period due to lengthening rent-free periods on offer, but as the chart overleaf shows, headline rents ended 2008 at much the same level as at the end of 2007 in both the City centre and out-of-town office markets

Investment market and outlook

Headline rents stablised in 2008



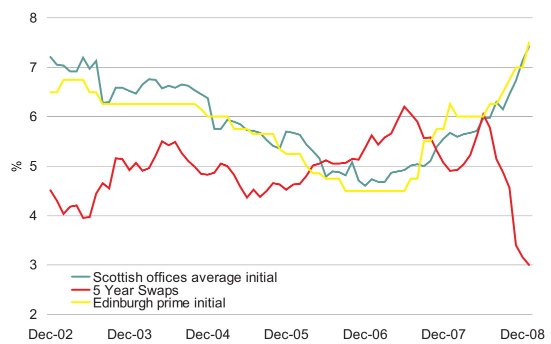
Investment market

The key stories in the investment market in Edinburgh in 2008 were similar to those at a national level. Yields continued to soften from their 2007 levels, and investment volumes were curtailed by the shortage of debt and willing sellers.

Over the course of 2008 we estimate that prime initial office yields in Edinburgh softened from 6.0% to 7.5%, a movement broadly in line with comparable cities across the UK.

While investment activity remained muted, the beginning of 2009 has seen increasing investor interest in the Edinburgh office market, reflecting the improving yield gap, and the reduction in the costs of hedging against currency risk for non-sterling denominated investors.

Pricing is starting to look attractive



Source: Investment Property Databank, Savills, Reuters

We expect investor activity to remain low due to the shortages of debt, and the higher costs of raising debt. However, equity-backed investors are likely to see 2009 as an opportunity to buy secure income at knock-down prices. We expect yields to stabilise on smaller, secure-income deals in Edinburgh this year.

Outlook

On the surface it would appear that the Edinburgh office market is better placed than other financial centres to weather the current downturn. While the City of London saw a sharp fall in leasing activity and rise in vacancy in 2008, this did not happen in Edinburgh. Furthermore, the development pipeline remains restrained with only 400,000 sq ft of prime core Grade A stock due for completion in 2009, the main scheme completing in April being Scottish Widows' Exchange Place comprising 210,000 sq ft. In addition there is approximately 190,000 sq ft of fringe city core Grade A space completing in Carlyle Group and Bellhouse Joseph's Tanfield development in July.

However, the major imponderable is the situation regarding tenant returns to the market, and the impact that this will have on the vacancy rate and hence on achievable rents. Aside from the public sector, the two major Scottish banks are the largest employers in and around Edinburgh, and their current problems are well documented. While there have been no specific announcements from either organisation about the extent of likely job losses in Edinburgh, we believe that it would be reasonable to assume that around 10% of their headcount nationally is likely to be lost, and that Edinburgh will not be immune from this. So, what would this mean for the Edinburgh office market?

Firstly, we can be reasonably sure that take-up will fall below average in 2009 and 2010, and is unlikely to recover strongly thereafter. However, a 10% fall in total employment is unlikely to result in significant releases of tenant-controlled space onto the market. This assumption is based on the fact that prior to the current downturn, these major occupiers were not sitting on significant amounts of surplus space.

We expect that the total availability will rise in 2009 and peak at 2.8m sq ft in 2010, before falling sharply as a result of the low levels of development completions. Take-up will return to average levels by 2011, but will be below average in 2009 and 2010. This will have a dragging effect on both headline and net effective rents, and our current forecast is for a 10-15% fall in headline rents between now and early 2010. Thereafter, rents will stabilise, before beginning to recover in 2010/11 as a result of the shortage of Grade A office space. This recovery will be led by the CBD where supply will continue to be short. If the prognosis for the Scottish banking sector is worse than that which we outline above, then the timing of the recovery may be delayed, but the rental fall should be limited by the state of the development pipeline.

Survey area & key contacts

Recent significant deals

Investment	Size (sq ft)	Purchaser	Vendor	Price	IY
Gemini, 24/25 St Andrew Sq	49,946	Private investor	Aviva	£16m	7.45%
George House, 126/8 George St	18,662	Thistle Property	SWIP	£8.7m	7.25%

Leasing	Size (sq ft)	Tenant	Rent £/sq ft
Edinburgh Quay 2	8,000	Companies House	£28.50/sq ft
Interpoint, Haymarket	46,826	Tesco Finance	£25.00/sq ft

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 development (including speculative schemes reaching practical completion within six months, plus major refurbishments).

Grade B space
All other space

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