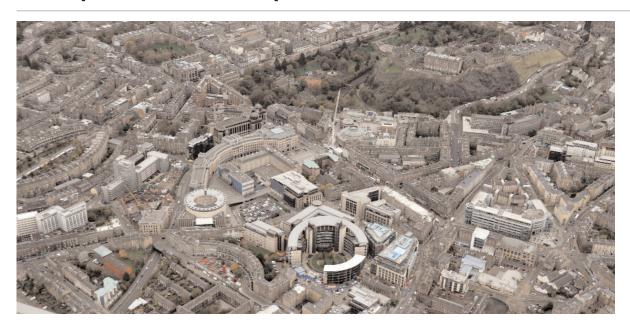
Edinburgh Office Survey

Review of 2009 and outlook for 2010

"2010 will be the best year of this cycle for occupiers to capitalise on attractive terms on which to acquire new office space."



- Take-up fell to just under 500,000 sq ft in 2009, 47% of which was Grade A.
- Supply continued to rise throughout the year, ending 2009 at 3.2m sq ft. The bulk of this increase was due to speculative development completions. However, there are no planned speculative completions in 2010-2012.
- Headline rents fell by 5% in the City centre market, and by 15% in the out-of-town market.
- Investor demand heavily outweighed supply, and prime yields fell by 150bps in 2009.
- We expect that tenant demand will remain muted in 2010, and those tenants who are active in the market will be able to acquire new office space on very attractive terms. Take-up will improve as the economy enters a firm recovery in 2011. This combined with the lack of development completions will lead to sharps fall in Grade A vacancy rates, and upward growth in net-effective rents from next year.
- Risk aversion amongst investors will continue to drive a focus on prime buildings with secure income streams. Stock of this type of product will remain limited, and as a result of this we expect to see some gentle further hardening in prime yields in 2010.

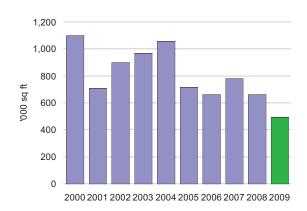
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Leasing market

Recession continued to stalk the Edinburgh office market in the second half of 2009, with take-up in the second half of the year identical to the first half at around 246,000 sq ft. This brought the full year total to just under 500,000 sq ft, well down on 2008's total of 661,000 sq ft, 47% of which was Grade A.

Take-up fell in 2009



While the largest letting of 2009 was to a financial services tenant, aside from that this sector was notable in its absence from the Edinburgh market last year, accounting for just 19% of the space leased. The most dominant sector in 2009 was the Business & Consumer Services sector, which accounted for 30% of the space leased, with the next most active grouping being the public sector at 20% of the total.

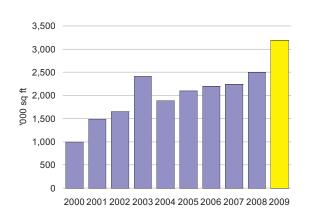
On the supply side, the trends continued to mirror those of both London and other key regional cities, with the total amount of vacant space rising from 2.8m sq ft at the end of June 2009 to 3.2m sq ft at the end of December (49% of which is Grade A). While some of this rise was due to tenant returns, the bulk of it was due to the delivery of the final few speculatively developed projects in the City's pipeline.

Around one million square feet of this total is accounted for by just ten schemes, the majority of which were built or refurbished in recent years.

As the chart at the top of the next column shows, the current level of availability is markedly higher than the level reached in the last downturn of 2003. This is a relatively unique situation in comparison to other UK cities where vacancy rates have stayed lower than in previous downturns due to a cessation in development starts from early 2007

While there is no immediate prospect of a return to normal levels of take-up, we expect that the key driver of the market in 2010 and beyond will be the fact that there are now no planned development completions in the immediate future.

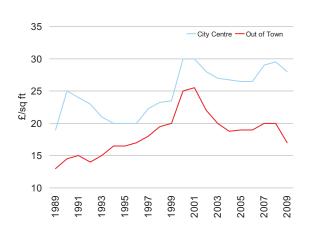
Edinburgh office availability rose sharply in 2009



Indeed, at present we are unable to identify any schemes with a definite completion date between 2010 and 2014.

The inevitable impact of the low levels of demand for office space in and around the City, and the rising levels of availability, has been a fall in rents. We suggested in our last report on this market in July, that the falls in net effective rents that were seen in the first half of 2009 would be followed by falls in headline rents in the second half of the year. This has come true with prime rents in the CBD falling by 5% in 2009, and rents in the out-of-town markets falling by 15%. These are very similar falls to the levels seen in both of the last two downturns in the Edinburgh and national property market downturns of the early 1990s and early 2000s. The big question for the next five years is whether this downturn will be shortlived as it was in the early 2000s, or whether the city will see the six years of flat rents that it saw following the early 1990s recession.

In town rents fell by 5% in 2009, while OOT fell by 15%

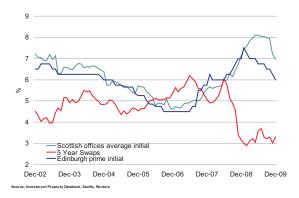


Investment market and outlook

Investment

While the trends in the leasing market in 2009 were uniformly negative, the same was not true in the investment market. Indeed, Edinburgh saw the largest fall in prime yields of any regional city in 2009 with yields starting the year at 7.5%, and ending it at 6%.

Prime yields fell by 150bps in 2009



Given the poor performance of the leasing market why were investors so keen on office investments in Edinburgh in 2009? The chief driver behind the strength of demand for UK commercial property investments was risk aversion, and Edinburgh's investment market was driven by the same desire to acquire good quality buildings with long term leases to strong companies.

With the long term average yield in Edinburgh for prime office investments at 6.2%, and the current level being below that at 6.00%, we have to raise the question of whether the strength of demand for, and relatively limited supply of, prime office investments has led to some overheating in the market. All over the UK at present some commentators are raising the question of a potential double dip in property pricing following the sharp fall in prime yields in 2009. So, what would cause this trend to reverse? Simply put we would need to see either a sharp decrease in the number of buyers and/or a rise in the number of available investments on the market. While we do expect to see a decline in interest in the UK market from international buyers in 2010, this gap will (and is already) being filled by the return of the traditionally dominant UK insurance, retail and pension fund buyers.

On the other side of the pricing equation we do expect to see more sellers in the market in 2010 and 2011. These will be both voluntary and involuntary sellers as some vendors take advantage of recent price rises to make tactical sales. On the involuntary side we do expect to see more "distressed " sales as lenders begin to be firmer about repayment dates.

While 2009's debt market was characterised by the maxim of "extend and pretend", 2010 will see a return of cautious new lending as well as adhesion to repayment dates.

Will these changes be enough to stall or even reverse the recent trends in prime asset pricing? In our view the answer is "no". We do not expect to see similar levels of price rises in 2010 to those seen in 2009, but we also do not expect to see sufficient changes in the vendor/purchaser dynamic to drive price falls this year.

Outlook

While our view on the prospects for the investment market are relatively benign, there is only so long that total returns can be driven by falling vields. A return to upward rental growth is needed for a sustainable recovery in prices. Will we see a return of rental growth in 2011? This will depend heavily on the supply side of the Edinburgh office market.

As we stated earlier, the development pipeline is severely contrained. Even against a background of below average levels of tenant demand this will be enough to deliver a steady fall in the level of availability (particularly of Grade A office space) over the next three years. As demand begins to recover towards its long run average level (as it is forecast to from 2011), the fall in vacancy levels will accelerate.

One other factor to consider on the supply side is the potential for tenants to rationalise their property occupancy in the City. In both of our last two reports we raised concerns about the property plans of the two major Scottish banks. While the global banking industry is clearly in better shape that it was six or twelve months ago, the new challenge to its recovery are the twin spectres of increased regulation and taxation. Until the "work out" of bank's own businesses has been finalised we cannot rule out the prospect of further drives to cut costs, which might include the release of operational office space onto the market. If this does happen then it would stall the expected fall in total availability levels in the Edinburgh office market, and hence the recovery in rents. At present this issue is one that we have our eye on, but it does not feature in our central forecast for the Edinburgh office market. This forecast has take-up recovering to average annual levels next year, and vacancy rates beginning to fall from the end of 2010. These two factors will lead to a further 5% fall in prime headline rents in 2010, before they begin to stabilise in 2011. Net effective rents will begin to recover early next year due to shortening rent free periods.

Assuming that this central scenario is correct, the next big question for Edinburgh's office market will be when will developers, investors and lenders feel comfortable enough about the market prospects to press start on some of the City's stalled development projects?

Survey area & key contacts

Recent significant deals

InvestmentSize (sq ft)PurchaserVendorPriceIYEdinburgh Quay60,000 officeCordea Savills (ECF)Miller & £21.1m6.1%Phase 2Retail on groundBritish Waterways

Leasing Size (sq ft) Tenant Rent £/sq ft

2 Exchange Place, 38,000 Wood MacKenzie £28.00 Exchange District

4/5 Lochside View, 26,000 Agilent £17.00

Definitions & statistical notes

Top rent

Highest rent achieved in one or more transactions.

Property criteria

Edinburgh Park

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

For further market information please contact



Keith Dobson Head of Business Space Agency in Scotland 0131 247 3801 kdobson@savills.com



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



Kate Byrne Associate Office Agency 0131 247 3821 kbyrne@savills.com



Caroline Parker
Director
Valuation
0131 247 3820
cparker@savills.com



Mat Oakley Director Commercial Research 020 7409 8781 moakley@savills.com

Savills Edinburgh

Wemyss House 8 Wemyss Place Edinburgh EH3 6DH

Tel: 0131 247 3700

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