Edinburgh Office Survey

Autumn 2010

"Edinburgh will surprise on the up-side in the medium term"

- Take-up in the first three quarters of 2010 has almost exceeded the full year total for 2009.
- Supply remains at the same level as the end of 2009, and with only one development in the pipeline is likely to begin to fall in 2011.
- Prime rents in Edinburgh have remained broadly stable this year.
- Prime office yields have stabilised, however the last few months has seen a slight softening in secondary yields.
- By mid to late 2011 we expect to see net-effective rents beginning to rise, followed by headline rental growth in the most sought after locations.

Image: Silvan House, Edinburgh - currently being marketed as part of Project Blue.

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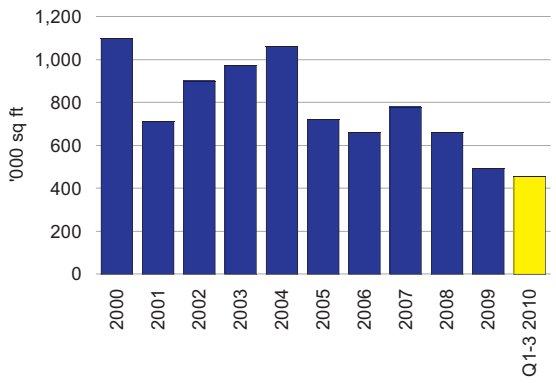
Leasing market

At the beginning of this year we predicted that "tenant demand will remain muted in 2010", and that supply was unlikely to start falling until 2011. The first nine months of 2010 have broadly proved our predictions correct, though there remains a considerable degree of uncertainty about the future in the Edinburgh office market.

Over the last decade the average annual take-up in the Edinburgh office market has been 805,000 sq ft per annum, however this average has not been exceeded since 2004. There is no prospect that 2010 will get close to this annual average level, however the take-up in the first three quarters of this year, at 456,000 sq ft, does indicate that the full year total for 2010 will be higher than the 492,000 sq ft full year total in 2009.

Take-up in 2010 should exceed 2009's total



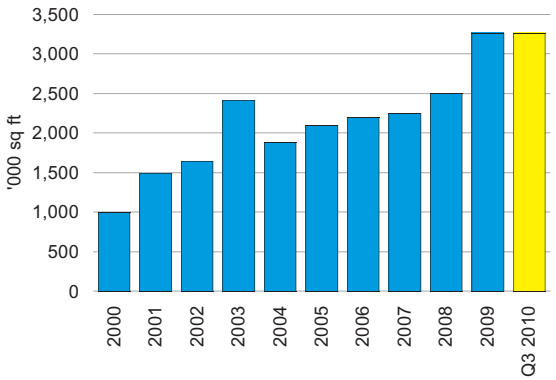
Some of this year's leasing activity is clearly motivated by a desire to capture the very tenant-friendly terms on offer in this weak market, with nearly half of all the lettings that have taken place this year being on Grade A space.

The Business & Consumer Services sector continued to be a major acquirer of space, accounting for 18% of the office space that has been leased this year. However, in a repeat of its dominance at the top of the market, the Public Sector has returned as the most significant lessor of office space in Edinburgh. Over 35% of the take-up this year has been by Public Sector bodies of various types, a very different story to the virtually non-existent activity that has been seen from this sector in England & Wales.

This may well be the last gasp of the Public Sector in the Edinburgh office market for a while, because Scotland's austerity programme is expected to kick in in 2011 and this will not only dampen demand, but may well result in some re-organisation and release of surplus office space onto the market.

Additional vacant office space, particularly of non-prime quality, is the last thing that the Edinburgh office market needs at present. While the overall availability has not risen during 2010 (staying stable at around 3.2m sq ft), this is still too high to stimulate any kind of rental growth.

Office availability has remained high during 2010



Indeed, if we compare the total availability with the average annual take-up in Edinburgh, there appears to be nearly four year's supply of office space currently on the market.

However, as is always the case with statistics, the headline hides some interesting stories. At the end of 2009 we estimated that 49% of the available office space was Grade A. However, over the course of 2010 a combination of Grade A take-up and Grade B returns has led to a decline in the amount of Grade A space on the market. Indeed, as at the end of September 2010 we estimate that only 32% of the current availability was of the best quality. Furthermore, with more than half of the Grade A availability being in four buildings, the choice is already beginning to look limited.

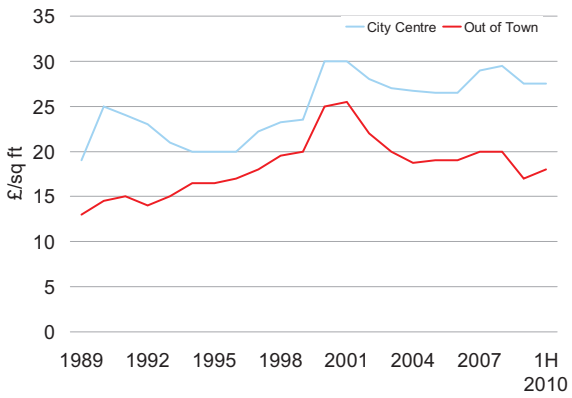
This is particularly relevant when you consider that there is only one speculative office development under construction that is due for completion in 2011-2013. Edinburgh Council have commenced construction of 185,000 sq ft at site HI on Exchange Square. Thus, while the overall availability may not come down fast, the proportion of the total that is of the best quality should continue to fall steadily.

From a landlord's point of view 2010 has been a tough year with heavy competition for the comparatively few requirements putting pressure on headline and net-effective rents. 30 months rent-free remains typical on a 10 year lease for a good quality building, with longer rent-free periods on offer in the more over-supplied secondary market. 2010 has seen little headline rental evidence at the very top of the market and as a result of this we are forced to make an estimate of where

Investment market and outlook

Grade A headline rents stand (at least in the in-town market). Our current view is that prime headline rents in the City Centre have remained at £27.50/sq ft. However, these are being propped up by falls in net-effective rents. In the out-of-town market it does appear that prime rents may have crept up over the course of 2010, with a lettings at 7 Lochside View achieving around £18/sq ft. While this does not take rents in that market back to their 2007 plateau, it is the first sign of upward movements in rents in the Edinburgh market, albeit for a fitted out suite.

City centre prime headline rents remain stable, but some evidence of rises in the out-of-town market



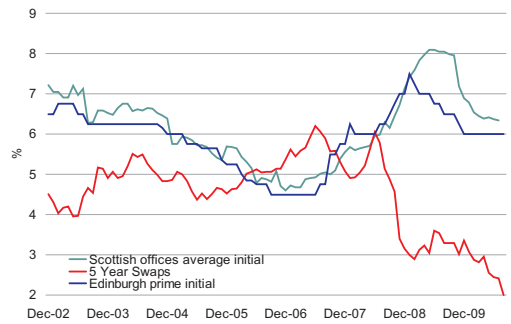
Investment

2010 has seen a combination of cautious buyers and limited sellers which has led to very low levels of investment activity over the last quarter.

Edinburgh is by no means unique in this theme, with most office markets other than London experiencing very low levels of activity since the run up to the general election. Investors have not lost interest in Edinburgh and other key regional cities, they are merely drawing breath following last year's sprint. There is now a widespread acceptance that distressed sales at knock down prices are unlikely to be available, and this has lead those investors who want to acquire office investments in Edinburgh and other regional cities to examine the relationship between rental growth expectation and current yields.

Prime yields have undoubtedly stabilised over the last six months, and remain at around 6% for the best and most secure, fundable lot sizes. Average yields, at least according to IPD, have also begun to stabilise. However, away from the valuation-based indices we have noticed softening in secondary yields in Edinburgh over the last quarter.

Yields have stabilised



Source: Investment Property Databank, Savills, Reuters

Outlook

On the face of it the current state of the Edinburgh office market does not make for hugely attractive reading. This is a City where public sector demand has been a major driver of leasing activity for a sustained period. However, the contagion of public sector austerity will undoubtedly catch up with Scotland soon. This is also a City with very high levels of available office space in comparison to typical levels of tenant demand.

However, we remain of the view that Edinburgh is likely to surprise on the up-side in the medium term. Tenant demand from the public sector will be muted, and there are still concerns about the potential for estate rationalisation by the two major Scottish banks. However, this rationalisation seems to so far have been focused south of the border and we believe that the more the two banks cut their English operations, the more jobs they will "repatriate" back to Scotland. Another positive trend is the return to growth of the banking and financial services sector in the UK. Businesses throughout this sector are now net-recruiters and in most cases are reporting better than average profitability. Edinburgh remains one of the UK's major financial centres, and we expect to see this optimism beginning to translate into some new acquisitions in Q4 2010 and 2011, with current active requirements in the market from Virgin Money, Tesco Finance and Baillie Gifford.

There is definitely no boom in demand ahead, but a gradual return to average annual levels of take-up, combined with a limited development pipeline will continue to diminish the amount of good quality office space that is on the market in Edinburgh. By mid-to-late 2011 we expect to see net-effective rents beginning to rise, and this will be followed by headline rental growth in the most sought after locations in and around the City. This growth will be limited to the diminishing number of Grade A buildings, and the picture will undoubtedly be less rosy in the secondary market.

Survey area & key contacts

Recent significant deals

Investment	Size (sq ft)	Purchaser	Vendor	Price	IY
Edinburgh Quay Phase 2	60,000 office Retail on ground	Cordea Savills (ECF)	Miller & British Waterways	£21.1m	6.1%

Leasing	Size (sq ft)	Tenant	Rent £/sq ft
2 Exchange Place, Exchange District	38,000	Wood MacKenzie	£28.00
4/5 Lochside View, Edinburgh Park	26,000	Agilent	£17.00

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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