Edinburgh Office Survey

Review of 2011 and outlook for 2012

"Prime headline rents will begin to come under upward pressure in the second half of this year"

- Take-up was below the long-term average in 2011. This was driven in part by significantly below average levels of Banking & Financial Services take-up. We expect this to change in 2012, as there are several large B&FS requirements that are currently active.
- Availability continued to fall throughout last year, and this will be the story for the next 2-3 years given the very low level of development activity in the City.
- As take-up stabilises and Grade A supply continues to fall we expect to see upward pressure on prime headline and net-effective rents from 2012.
- The investment market will continue to be polarised between prime, secure income streams and the rest. We expect yields on the former to remain stable in 2012, but the spread between prime and secondary will widen as more bank-led sales emerge.

Image: Edinburgh One

Savills Research

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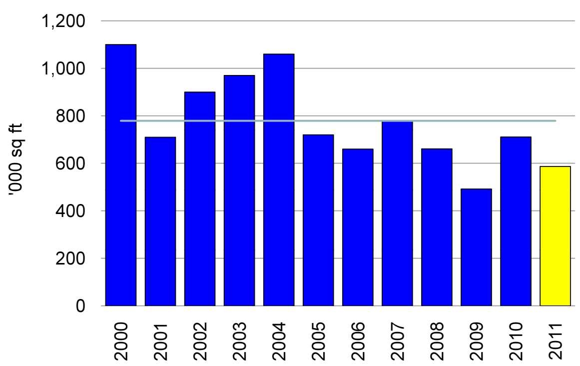
Leasing market

2010's rebound in take-up to near normal levels was not mirrored in 2011. This is typical of the story across most of the UK's office markets, with the Eurozone sovereign debt turbulence having had a marked negative impact on business sentiment across the country.

Take-up over the year was generally unimpressive, however the final quarter of the year saw under 200,000 sq ft let. This brought the total take-up for 2011 to just under 600,000 sq ft, well below the 12 year average, though not far behind the five year average of 640,000 sq ft per annum.

Take-up was below average in 2011



Large unit deals were particularly limited in the final quarter of last year, with the largest letting being Avaloq's acquisition of 22,000 sq ft at Tanfield. This deal is not only notable in terms of it size, but it also continues Edinburgh's recent trend of being successful at attracting footloose inward investors to the City.

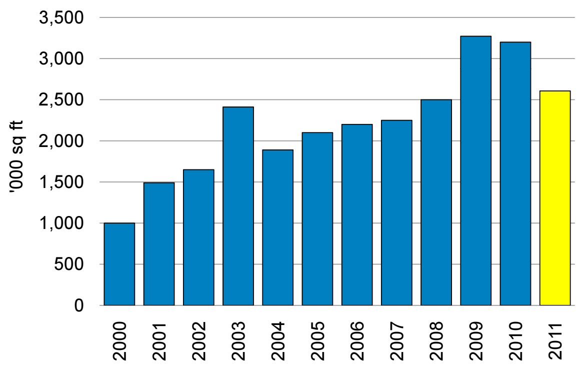
Grade A take-up was particularly limited in the final quarter of the year, with all the Grade A lettings in the City centre being less than 5,000 sq ft. While an optimist might argue that this a reflection of the limited availability of space in the CBD, this is only part of the story, and we believe that occupier commitment remains weak.

While companies in the Banking and Financial Services sectors are yet to commit to expansion and relocation, they are amongst the larger requirements in the market at present. These sectors have always tended to be major drivers of demand for office space in Edinburgh, but were notably absent from the market in the final quarter of last year. Indeed, businesses from the Banking and Financial Services sector only accounted for 1% of the take-up in the Q4 2011.

While Edinburgh seems to be mirroring the trend of weak financial services activity that is being seen in London, it is also mirroring the pick-up in demand from the Telecoms, Media & Technology (TMT) sector. This sector was the most active acquirer of office space across the City in the final quarter of 2011, accounting for 38% of take-up. We believe that this sector will remain one to watch in 2012 and beyond.

The supply-side of the office market in and around the City continues to tighten. The overall availability at the end of last year was 2.6m sq ft, well down on its 2009 peak of 3.3m sq ft.

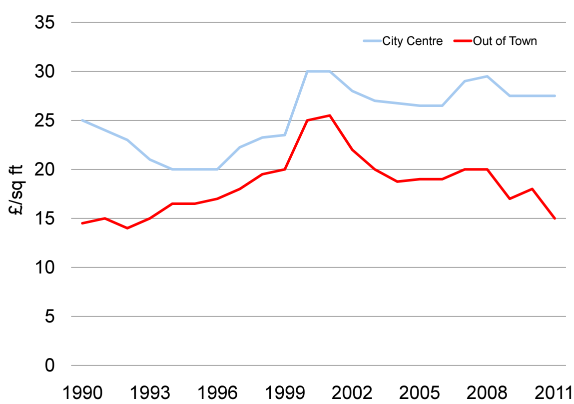
Availability continues to fall



Only a quarter of the available office space is Grade A quality, with the bulk of this in two buildings (Tanfield and Exchange Place). As we commented in our last few reports, there remains only one speculative office development in the City, though there are a number of refurbishment projects underway.

Prime headline rents in the CBD remained unchanged in Q4 2011, at £27.50/sq ft. However, prime rents out-of-town have fallen to £15/sq ft.

CBD rents remain stable

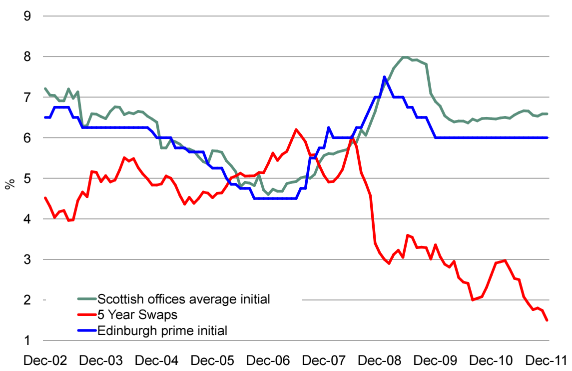


Investment market and outlook

Investors in the City and across the country became more cautious as 2011 progressed. This led to an ever-increasing focus on prime, long-term secure income streams and in this respect Edinburgh has not bucked the trend.

The investment deal of the quarter was undoubtedly Deka's acquisition of Edinburgh One for an initial yield of 6.41%. This ten year rack-rented investment provides us with some useful evidence on pricing, and we believe that prime assets with 15 on more years of income security should achieve around 6.00%, while those with 10-15 years will be a quarter point softer.

Prime yields remain stable at 6%



Source: Investment Property

Away from the prime market we believe that investors' rising risk aversion is leading to some softening in secondary and tertiary yields, thought there is little market evidence of this. We expect this trend to continue through 2012, particularly since we expect to see more bank-led sales of secondary and tertiary assets that will crystallise this widening of the prime/secondary yield spread.

We expect to see limited numbers of prime assets coming to the market in 2012, and this combined with steady investor demand should be enough to support prime yields in the 6-6.25% range depending on the degree of income security on offer.

One area where we do expect to see more investment activity in 2012 and 2013 is on development opportunities. Over the last quarter there has been a rising recognition that the City is short of Grade A office space, and this combined with a number of high profile lease expiries in 2014-16 should stimulate some development starts over the next two years.

Outlook

While occupier sentiment did weaken in the second half of 2011, this has not diminished the number of high profile medium term requirements for generally prime office space in Edinburgh. We believe that the story over the next five years will be one of falling Grade A availability in the City, and this will deliver rising prime rents.

At the moment the largest requirement for office space in the City is from Blackrock who are facing a 2014/15 lease expiry. They are joined in the market by smaller but no less significant requirements for prime office space by Brewin Dolphin and BNY Mellon.

There is an increasingly widespread perception amongst Edinburgh's major occupiers that a shortage of suitable space is imminent, and we believe that this will stimulate those who have lease expiries in 2014-2016 to try and secure suitable premises as soon as possible (i.e. before rents start to rise and options diminish).

The supply-side will undoubtedly begin to react to this supply/demand imbalance, but with the difficulties in borrowing for speculative office development still severe, we expect that most of these medium-term requirements will be satisfied by pre-lets.

Initially this supply shortage will be intensified by an increasing amount of conversions from office to hotel or quasi-residential useage. As a result of this our central forecast for Edinburgh is a steady fall in total availability, and a sharper fall in Grade A availability over the next five years.

The impact on rents will be staggered, with a rise in net-effective rents in the second half of 2012, as rent-free periods shorten on spot lettings. Larger pre-lets will attract more attractive rent free periods this year, though we expect these to tighten as the supply shortage intensifies.

Prime headline rents will also begin to come under upward pressure towards the end of this year, and we expect a steady rise towards the previous peak of £30/sq ft, as prime office space becomes harder to source.

Take-up will recover over the next five years, though we do not expect volumes to significantly exceed the long-term annual average. In common with most of the rest of the UK's major office markets the key driver of rental growth will be a restrained development pipeline and limited Grade A supply.

The short term prospects for secondary office rental growth are less positive, and we believe the best option for landlords of such space is to consider refurbishment to capitalise on the impending shortage of Grade A space.

Survey area & key contacts

Recent significant deals

Investment	Size (sq ft)	Purchaser	Vendor	Price	IY
Edinburgh 1	55,022	Deka	F&C Reit AM	£23.75m	6.41%

Leasing	Size (sq ft)	Tenant	Rent £/sq ft
Tanfield	22,000	Avaloq	circa £18-£19/sq ft
Tanfield	17,300	FNZ	circa £18-£19/sq ft
Quartermile Two	10,311	Mercer	£26/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 developments (including speculative schemes reaching practical completion within six months, plus major refurbishments).

Grade B space
All other space

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