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Spotlight
Scottish Office Market

Summer 2017

The recently completed 1 St Andrew Square, above, provides 16,000 sq ft of comprehensively refurbished office space.

- The Scottish office market saw leasing activity reach 1.4m sq ft for the first half of 2017, 20% above the five year half year average.
- This was partly driven by the GPU (Government Property Unit) signing a pre-let on 180,000 sq ft of space at New Waverley, Edinburgh, which will house 2,900 civil servants from 2020.
- Scottish office investment reached £227 million during the first half of 2017, 19% below the 10 year first half average.
- We expect more stock to trade in the Glasgow market towards the final quarter of 2017 as prime yields remain at 5.75%, offering an attractive discount to the rest of UK regions.
- The 25-50 basis points yield gap which previously existed between Scottish office yields and the rest of the UK's regional office markets is showing signs of closing.

"Occupiers with upcoming lease events and those looking to expand in the city are facing a severe lack of options and rents on refurbished offices are rising as a result." Keith Dobson, Director, Office Agency, Edinburgh

One year on from the EU referendum, the Scottish office markets remain in good strength from both an occupational and investment perspective.

Economy

The most recent figures show that Scotland's economy rebounded during the first quarter of 2017, with economic growth reaching 0.8%, the strongest quarterly growth for two years and outperforming the UK average of 0.2%.

This was largely due to a rise in output in industries linked to the North Sea. Supply of oil is beginning to ease off and with increased global demand during the second quarter of 2017, Brent Crude Oil has risen to $53 per barrel at end July 2017.

Strong economic performance has fed into improved sentiment among employers according to Deloitte's Q2 2017 CFO survey. 9% of CFOs expect hiring to increase over the next 12 months, a significant increase from the 1% recorded this time last year.

Indeed, Oxford Economics' latest employment forecasts indicate a net additional 10,000 office based jobs across the Aberdeen, Edinburgh and Glasgow markets over the next five years, reflecting growth of 2.8%, equating to a further need for one million sq ft of office space. We expect around half of these to be delivered within the professional, science and tech sector.

Occupational

The Scottish office market saw leasing activity reach 1.4m sq ft for the first half of 2017, 20% above the five year half year average.

Accelerated leasing activity within the **Aberdeen** office market has been largely driven by the increased oil price. Take up during the first half of 2017 reached 238,000 sq ft, exceeding the 2016 full year level (Graph 1). 78% of take up was accounted for by the engineering, extraction and utilities sector, up from 17% last year. Savills have consequently upgraded Aberdeen's full year take up forecast from 350,000 sq ft to 400,000 sq ft.

There remains an excess supply of office space in the Aberdeen market, which has fallen 3% from end 2016 to stand at 2 million sq ft (Graph 2). This being said, with the Silver Fin building and Marischal Square both expected to complete during the second half of 2017, this will provide an additional 287,000 sq ft of speculative space into the market.

Top rents remain at £32 per sq ft for the best space, and we expect rent free periods to remain steady throughout the second half of 2017.

Edinburgh's wider office market recorded the strongest quarter of take up on record during the second quarter of 2017, which pushed the half year total to 772,000 sq ft, 50% above the five year first half average. Total city centre take up at half year reached 541,000 sq ft, well on course to reach our forecast of 750,000 sq ft for the full year in the city centre.

This was largely driven by the GPU (Government Property Unit) signing a pre-let on 180,000 sq ft of space at New Waverley, which will house 2,900 civil servants from 2020. Other large scale deals included Computershare signing a pre-let for 41,000 sq ft of space to be refurbished in Four North and Burness Paull regearing on 27,000 sq ft at 50 Lothian Road.

Key deals also took place in the out of town market, with Standard Life signing for 31,000 sq ft at South Gyle Broadway.

Availability of Grade A space remains scarce in the Edinburgh market, with only 313,000 sq ft of space remaining, which is enough to cater for only one year's worth of Grade A demand. We expect more refurbished schemes to deliver space over the next two years (see Keith Dobson's column, right).

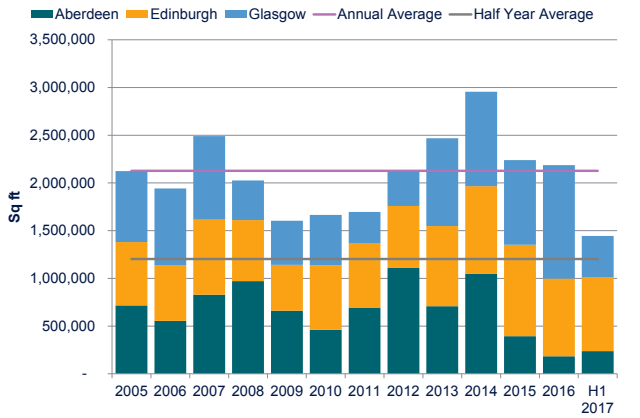
Glasgow saw office leasing activity reach 434,000 sq ft across the wider market during the first half of 2017, in line with the five year first half average. The largest deal was the Student Loans Company's 41,000 sq ft letting of Europa House.

Despite modest take up figures for the in town market, the out of town market saw a number of engineering companies take space, which has accounted for 25% of the wider market take up this year.

With a number of large deals under offer in the city centre, take up in Glasgow looks set to reach Savills forecast of 600,000 sq ft for the full year.

GRAPH 1

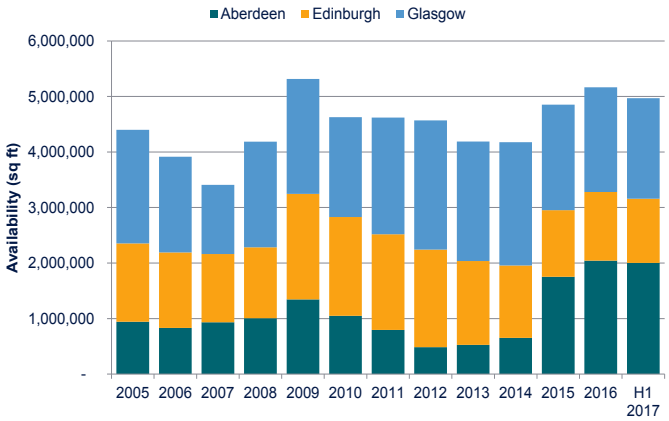
Office take-up 20% above half year average



Source: Savills

GRAPH 2

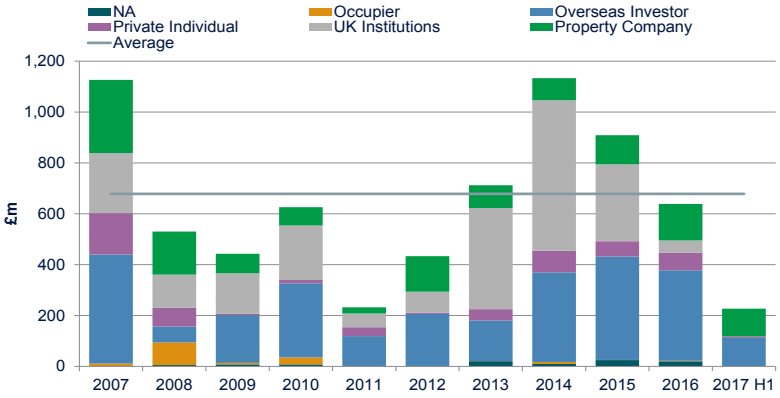
All cities have seen supply fall since 2016



Source: Savills

GRAPH 3

Office investment reached £227m during H1 2017



Source: Property Data

Availability remains limited in the Glasgow market, which now stands at 1.8m sq ft, of which only 473,000 sq ft is Grade A. With 394,000 sq ft of refurbished space currently underway, this will fill the Grade A void in the short term. Until any speculative office developments get underway, we expect top rents to remain steady in Glasgow at £30 per sq ft.

Occupiers and landlords are increasingly concerned with the prevalent theme of wellness in the workplace, to attract and retain both staff and tenants. Savills' What Workers Want survey found that workers in Edinburgh (79%), Glasgow (66%) and Aberdeen (68%) all prefer working in city centres than out of town. The city centre is also the preferred location amongst all age groups. Organisations considering relocating out of the centre will therefore need to consider carefully the impact on staff recruitment and retention.

Investment

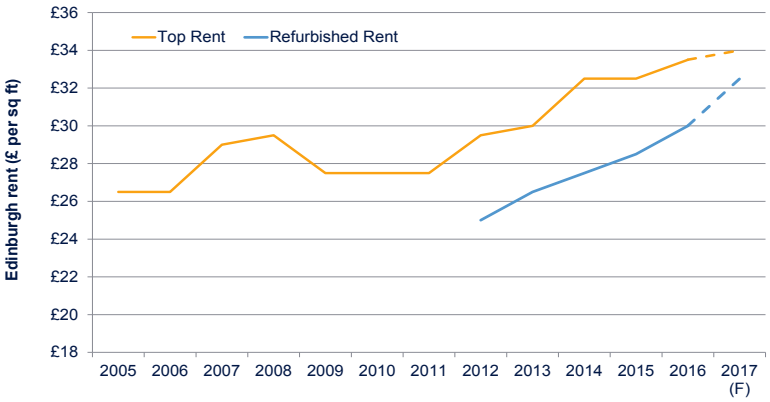
Scottish office investment reached £227 million during the first half of 2017, 19% below the 10 year first half average (Graph 3).

This was due to both a shortage of on-market prime stock and the disparity in pricing between buyers and sellers. Despite UK institutions having funds to spend, they have been unwilling to meet landlords' valuations. The round-trip costs of buying and selling have also discouraged landlords from disposing of assets at a time where returns are income led.

The UK Institutions have turned their attention back to Scotland off the back of the SNP losing 21 seats in the General Election last quarter and the possibility of a second Scottish

GRAPH 4

Edinburgh's new/ refurbished rental gap is closing



Source: Savills

THE GAP BETWEEN REFURBISHED AND NEW BUILD OFFICE RENTS IN EDINBURGH IS SET TO NARROW

Keith Dobson, Director of Office Agency, Edinburgh highlights his key themes

A severe shortage of new office development in Edinburgh has led to a rise on refurbished office rents and by Q3 2017 we expect this to hit £32.50 per sq ft. This closes the gap between refurbished and new build rents to the lowest level on record at only £1 per sq ft.

While Edinburgh's office supply/demand imbalance is nothing new, the pressure on both has never been greater. Occupiers with upcoming lease events and those looking to expand in the city are facing a severe lack of options and rents on refurbished offices are rising as a result.

At the tail end of last year, rents on refurbished options had climbed to £30 per sq ft and new refurbishments, including 1 St Andrew Square (pictured, cover), recently launched by Standard Life Investments and attracting significant occupier interest, could see rents reach £32.50 per sq ft by Q3 2017.

The rising cost of refurbished office space will ultimately push rents on top offices in the city further, probably up to £34 per sq ft by the end of 2017 (Graph 4). We also anticipate the market will see a number of pre-lets on the existing speculative developments as occupiers compete for the best space. This could place Edinburgh alongside Manchester as the most expensive office market outside London and the south east.

Of the two speculative office developments currently under construction, M&G's Quartermile 3 now has just 7,000 sq ft of the 73,000 sq ft building available following a letting to State Street (due to complete in Q4 2017) while GSS Development's 2 Semple Street (40,000 sq ft) will be available for occupation from Q2 2018. The Mints, where construction has recently commenced will provide 60,000 sq ft of Grade A open plan space due for completion in Q4 2018.

2.8%pa
office based employment growth over the next five years

1.4m sq ft
take-up across the Scotland cities during H1 2017

335k sq ft
speculative office space currently under construction across the Scottish cities

5.25%
Edinburgh prime office yield

referendum looking less likely. We expect competition for prime assets to intensify as the institutions compete with the overseas market.

Overseas investors were again the most dominant investor type, accounting for £111m (49%) of the total activity, followed closely by property companies £109m (48%).

Overseas investors are increasingly turning their attention to Scotland, acquiring 1 and 2 & 3 Exchange Place, Edinburgh, and Cuprum, Glasgow, during the first half of 2017. Northern Irish property development company, Wirefox Investments expanded across Scotland, acquiring nine out of town office blocks within a variety of business parks for £35m, whilst UK property company, George Capital purchased Empire House, Glasgow in a £17.5m deal, representing a 7% yield.

Edinburgh has seen strong investment levels over the past 18 months, which has seen prime yields for the very best office stock move in to stand at 5.25%, from 5.5% at the end of 2016. A relatively high proportion of prime stock has traded in the last 18 months, which could suggest volumes could ease off during the second half. We expect more stock to trade in the Glasgow market towards the final quarter of 2017 as yields remain at 5.75%, offering an attractive discount to the rest of UK regions. We have also seen renewed interest from the overseas market in Aberdeen and expect activity to pick up during the second half.

The 25-50 basis points yield gap which previously existed between Scottish office yields and the rest of the UK's regional office markets is showing signs of closing. Investors' improving sentiment towards Scotland relative to the rest of UK points to higher investment volumes and firm yields throughout the remainder of the year.

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