savills

Spotlight
Scottish office market

Autumn 2016

Image: 6 St Andrew's Square, Edinburgh, completes during November 2016, following a 108,000 sq ft prelet to Standard Life Investments.

- Office take up within the three Scottish cities remains strong, reaching 1.7m sq ft as at end Q3 2016, the same level as this stage during 2015.
- Total availability in the Scottish cities has only risen 5% to 5.1m sq ft over the course of 2016, which is largely down to an oversupply within the Aberdeen market.
- Rents on good quality refurbishments are growing in Edinburgh and Glasgow and the differential between this market and new build stock is narrowing in both markets.
- As at end Q3 2016, office investment volumes have remained healthy in the three Scottish cities and reached £529m, only 5.5% down on the same period during a strong 2015.
- Office investment has remained strong in the Scottish cities and has been less affected by Brexit concerns than the UK average.
- With Scottish commercial property yields around 50 to 100bps higher than comparable English cities, Scotland offers investors a highly attractive yield, at a time when returns will be income led.

"The office investment market in Scotland has remained active with transaction volumes consistent with 2015 and income returns more attractive than comparable English cities."

Economy

Following a Scottish referendum in 2014, a General Election in 2015 and both a Scottish Election and a European Referendum in 2016, Scotland eagerly awaits a period of relative stability.

However, in the event of a "hard" Brexit, the prospect of a second Scottish independence referendum will not go away any time soon. Should Scotland gain independence and remain a member of the EU, it could become a more attractive place to do business, particularly if corporation tax is reduced and other initiatives such as fracking are pursued. Though, this depends on how long it takes to get from a period of negotiation to a period of stability.

According to the latest figures from Oxford Economics, Aberdeen, Edinburgh and Glasgow's combined office based economy has seen output rise by 1.7% per annum (pa) over the past five years, and is forecast to grow by a further 2.4% pa over the next five years, slightly behind that of the UK. There is a similarly positive story for office based employment within the three cities, which is expected to rise by 0.6% pa over the next five years, outperforming the previous five years average of 0.5% pa.

Office based employment growth acts as the key driver of future office take up and these forecasts indicate that by the end of 2021, a net additional 10,800 office based jobs will be created, which will boost total office based employment above the peak level recorded during 2009 (Graph 1). At a relatively dense ratio of 1:8 sq m, this indicates a net increase of over 900,000 sq ft of occupied space. Glasgow is set to contribute the highest number of office based jobs, followed by Edinburgh. Aberdeen is also set to see a pickup in office based employment growth over years four and five, though this is likely to depend on whether the energy markets recover their losses.

Following a shock EU referendum result, hiring sentiment has already swung back. According to Deloitte's CFO survey, 9% of CFOs expect hiring to increase over the next 12 months, up from 1% immediately after the referendum. With improving sentiment on the UK's relationship with the EU, employers are increasingly optimistic.

Occupational

Office take up within the three Scottish cities has remained strong, reaching 1.7m sq ft as at end Q3 2016, the same level as this stage during 2015 (Graph 2). Scotland has been a strong performer thus far, compared to the UK average, which has seen a 10% fall in take up.

Edinburgh has seen a very strong first half of the year, followed by a typically quieter third quarter. Total take up as at end Q3 2016 reached 771,825 sq ft, in line with the level recorded at this stage during 2015. One key deal during the second quarter was Chris Stewart Group's acquisition of 35,000 sq ft Blenheim House for refurbishment.

Aberdeen has seen a timely pick up in its office take up during the third quarter of 2016 as it reached 146,514 sq ft as at end Q3 2016. 64,550 sq ft of this was recorded during the third quarter and was the strongest quarter since Q2 2015. With 22,000 sq ft of this being taken by a serviced office provider, it is a positive sign that a pickup in occupational demand is anticipated as investors closely observe the recovery in the Brent Crude Oil price.

Glasgow has seen a stellar year so far, with take up reaching 761,271 sq ft as at end Q3 2016, a 26% increase on the same period during 2015. AXA took 49,500 sq ft at Cuprum during the second quarter as it moves its headquarters from Atlantic Quay. Glasgow's out of town market has remained buoyant, contributing one third of total take up, as rents remain competitive for high quality space.

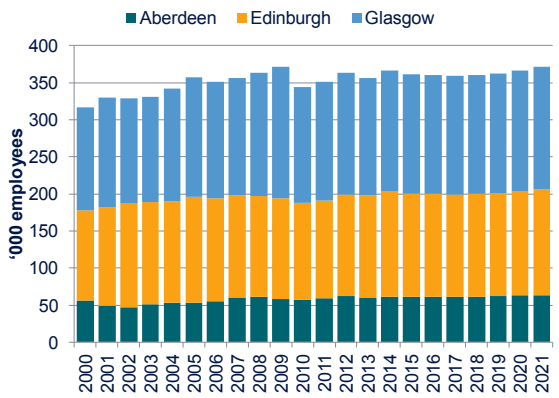
So far during 2016, the fast growing TMT sector has been the dominant business sector, with Cirrus Logic taking 70,000 sq ft of space at Quartermile 4, Edinburgh, while Sky also took 41,700 sq ft of space at City Park, Glasgow.

Total availability in the Scottish cities has only risen 5% to 5.1m sq ft over the course of 2016, which is largely down to an oversupply within the Aberdeen market (Graph 4). However, availability for the Edinburgh and Glasgow markets both saw further falls.

Edinburgh faces a challenge as to where good quality space will come from over the next 12 months. Atria

GRAPH 1

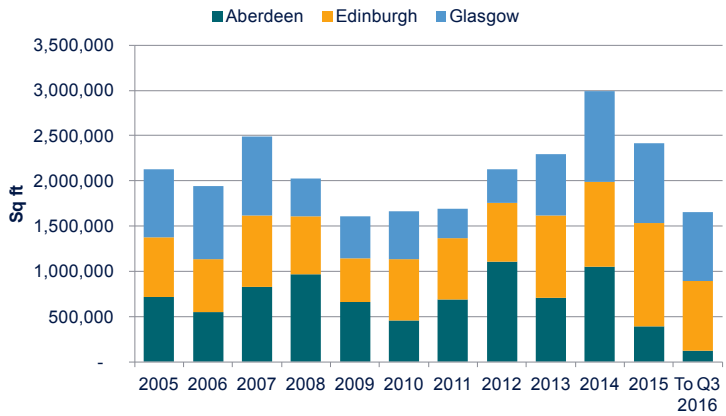
Outlook for office based employment



Source: Savills, ONS, Oxford Economics

GRAPH 2

Office take-up



Source: Savills

One currently provides 63,000 sq ft of Grade A office space. The mixed use scheme, 6 St Andrew's Square (front cover) has just completed, of which 108,000 sq ft of office space has been prelet to Standard Life Investments on a 15 year lease. However, it is high end refurbishments; including 16,000 sq ft at 1 St Andrew's Square, set to complete in Q1 2017; which are expected to plug the gap until the next development phase in 2018.

Despite availability seeing a marked increase in the Aberdeen market, a lot of this is older, secondary stock. However, The Capitol provides high quality, large floorplate city centre accommodation, with 61,000 sq ft of Grade A space still available after PWC took 10,600 sq ft on the top floor during the second quarter.

In Glasgow, new build Grade A availability has halved over the course of 2016 to stand at only 131,000 sq ft, consisting of 1 West Regent Street and St Vincent Plaza. With all the developments coming out the ground already pre-let, refurbishments are set to cater for demand until the next development cycle in 2018/19. We have also seen trends of older office stock being converted to student accommodation.

With all three Scottish cities having seen prime headline rents in excess of £30 per sq ft, we are seeing rents on good quality refurbishments increase and the rental differential narrowing in all markets.

Investment

As at end Q3 2016, office investment volumes have remained healthy in the three Scottish cities and reached £529m, only 5.5% down on the same period during a strong 2015 (Graph 3). The Scottish cities have been less affected by Brexit concerns than the UK average, which have seen a 27% fall. We believe this is down to the fact that Scottish offices were already priced attractively, relative to other UK regions.

Following Theresa May's announcement that she intends to trigger Article 50 by the end of March 2017, sterling has seen a considerable fall against the US dollar. This is welcome news for foreign purchasers and we expect them to take advantage of this discount during the end of 2016 and through early 2017. Overseas investment has accounted for 65% of the three cities' total office investment so far during 2016, as they have been less concerned about the UK's relationship with the EU, seeing it as a potential buying opportunity.

The UK institutions, however, have put some deals on hold. With a mismatch on pricing; purchasers are looking for post referendum price reductions, whereas vendors are concerned about what they are going to buy with the proceeds of any sale as there is a lack of quality stock.

In fact, a large quantity of high quality stock had already traded during the first half of 2016, so a quieter second half of the year was always expected.

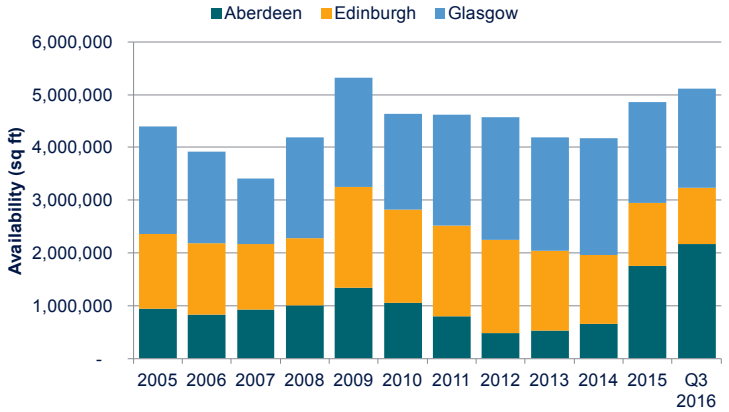
Edinburgh has been the most active Scottish city for the year to date, with £462m invested as at end Q3 2016, the city's highest level for this stage in the year since 2007. Deals are still being made in the Scottish capital post referendum, with TRUIVA purchasing Waverley Gate, Edinburgh for £62m, representing a 5.5% yield after the building was previously under offer to a separate investor who activated a Brexit clause.

So far this year, Edinburgh has seen its strongest year of office investment. The fourth quarter has also seen Dutch pension fund APG take a 75 per cent stake in the £1bn St James Centre regeneration project in Edinburgh, and were advised by Savills. This is expected to act as a catalyst for further office based investment in the Edinburgh city core.

As expected, office investment in Aberdeen has seen a quiet 2016 so far and is expected to remain

GRAPH 4

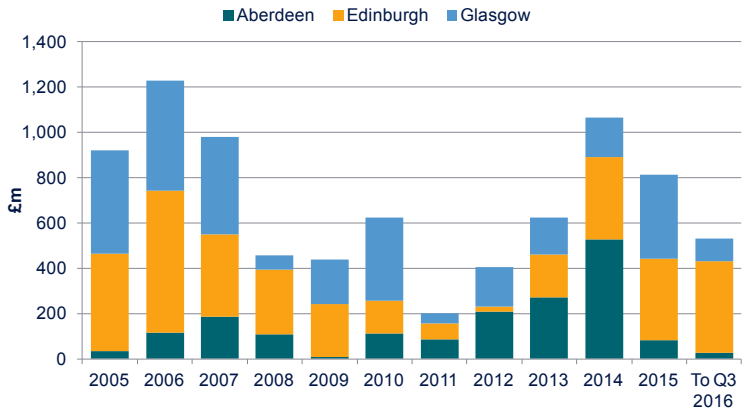
Office availability



Source: Savills

GRAPH 3

Office investment by city



Source: Property Data

quiet until there is more activity on the occupational side. The key deal was the purchase of the Anderson Anderson & Brown HQ at Prime Four Business Park for £17.24m / 7.25%, by a private client of Citi Bank during the second quarter. Plans have since been unveiled for a £100m retail complex to be developed alongside the business park, which will shortly be considered by Aberdeen City Council.

The key deal in Glasgow during the third quarter was Fore Partnership's £23.25m purchase of 50 Bothwell Street, comprising 77,000 sq ft of office space. Out of town, the Clyde Gateway based development scheme, branded 'Magenta', has received planning consent which will provide 1.2m sq ft of office space and is set to become one of the UK's largest office parks. Clyde Gateway has invested £20m in infrastructure development which will help to deliver an estimated 12,000 new jobs to the area, with Glasgow city centre only 10 minutes away by train.

With Scottish commercial property yields around 50 to 100bps higher than comparable English cities, Scotland offers investors a highly attractive yield, at a time when total returns will be income led. Since the start of the year, yields have moved out 25bps in Edinburgh, to stand at 5.5%. Glasgow has recently seen yields sit 25bps higher, to stand at 5.75%, whilst Aberdeen has seen yields push out 100 bps to 7.25% since the end of 2015.

Outlook

Despite concerns over sustained low oil prices, the "spectre" of a second referendum on Scottish independence and the UK's relationship with the EU, the outlook for the Scottish economy remains fairly positive. Yields have readjusted given the initial referendum shock and we expect them to remain steady going forward.

The Aberdeen market is showing green shoots after what has been a quiet 18 month period as the oil price recovery slowly continues to build momentum.

Both the Edinburgh and Glasgow markets currently have large Government Property Unit (GPU) requirements of 180,000 sq ft and 650,000 sq ft respectively. That being said, after the recent phase of lease events, we expect indigenous demand to ease in the Glasgow market until the next stage of lease events in 2018. We are generally expecting top rents to remain fairly flat during 2017 across the three cities, however when new developments arrive in 2018, we can expect to see an uptick in rents. For the most prime stock in Edinburgh, we could see a rise from £33.50 to £34 per sq ft during 2017, once incentives come back in.

As investors reassess their investment portfolios post referendum, it should be noted that the Scottish office market has benefitted from seeing lower total return volatility than all other UK regions, according to MSCI's Quarterly Digest. Scottish offices are more sheltered from downside risk during periods of weaker capital growth. We believe this will provide an opportunity for the Scottish markets to outperform other regions as investors look to hold Scottish offices as part of a stable portfolio.

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