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Spotlight
Scottish Office Market

Spring 2018

Cadworks, above, will provide Glasgow with 94,000 sq ft of Grade A space on its completion in 2020. Savills are acting on behalf of the landlord.

- Take up in the first quarter of 2018 reached 493,000 sq ft in Scotland's core office markets (Aberdeen wider, Edinburgh city centre, Glasgow city centre), 9% above the five year quarterly average of 452,000 sq ft.

- Over the next five years, Aberdeen, Edinburgh and Glasgow are forecast to see a combined 3.6% office based employment growth, in line with the national average.

- Traditional offices must continue to reinvent themselves in order to remain attractive and compete with serviced offices for the sub 5,000 sq ft deals

- Prime office yields remain at 6.25% and 5.5% for Aberdeen and Glasgow respectively, whilst Edinburgh's prime yields have moved in a further 25 bps to 5% amid strong investor demand for the capital.

"We forecast the sub 5,000 sq ft market to strengthen through 2018, boosting total office take up to 1.8 million sq ft during 2018," Mike Barnes, Savills Research

The Scottish office market has continued its steady occupational performance into 2018, as tight supply continues to add upward pressure to rents.

Occupational

Take up in the first quarter of 2018 reached 493,000 sq ft in Scotland's core office markets (Aberdeen wider, Edinburgh city centre, Glasgow city centre), 9% above the five year quarterly average of 452,000 sq ft.

We forecast 2018 core Scotland take up to reach 1.8 million sq ft (Graph 1), in line with both the previous five year average and 2017's level. This is despite bumper public sector requirements which were satisfied last year in both Glasgow and Edinburgh.

Throughout 2018, we expect to see a return in demand towards the sub 5,000 sq ft market, after a fairly modest 2017. Last year, take up in this market reached 393,000 sq ft, 11% down on the five year average.

Part of this fall was down to the emergence of the serviced office sector across Scotland. Spaces signed for 30,000 sq ft at One Lochrin Square, Edinburgh during Q4 2017, while Orega signed for 22,000 sq ft at 9 George Square, Glasgow during Q1 2018.

Around 13,000 startups were founded across Aberdeen, Edinburgh and Glasgow during 2017, according to Startup Britain. We will expect to see new office requirements emerge from these high growth companies over the next 12-18 months, as they progress from incubator space to traditional/serviced office space. Indeed, a number of Edinburgh and Glasgow's landlords are sub-dividing their space into smaller suites to cater for the strong appetite in the high quality 2-3,000 sq ft market.

However, traditional offices must continue to reinvent themselves in order to remain attractive and compete with serviced offices for the sub 5,000 sq ft deals. Landlords must also adapt to tenants who are in search of shorter lease terms.

Aberdeen's office market continues to strengthen, with enquiries at their highest levels since before the oil price shock in 2014. With take up exceeding 400,000 sq ft during 2017 (driven by Total's and Chrysaor Energy's 108,000 sq ft and 48,000 sq ft deals respectively), Savills forecast Aberdeen's take up this year will reach c.450,000 sq ft, driven by a steadier churn of deals.

Q1 2018, for example, saw 89,000 sq ft of space taken across 22 deals, the most deals in a quarter since Q3 2014. The key deal was Aberdeen Journals taking 19,000 sq ft at One Marischal Square as they relocate from the Lang Stracht in Mastrick.

With no further developments planned in Aberdeen, availability has peaked (Graph 2), and as tenant demand picks up throughout the year, we expect incentives to reduce.

Take up in **Edinburgh** city centre reached 155,000 sq ft during the first quarter of 2018, although 44,000 sq ft of this was FRP Advisors' acquisition of Buchan House for alternative use. The largest city centre deal was engineering consultant, Sweco signing for 14,000 sq ft at Quay 2, however, Instant Offices signed for 24,000 sq ft at Cornerstone, South Gyle, marking the largest serviced office deal in Scotland's out of town market on record.

Glasgow end 2018 top rent forecast: £32.50 per sq ft

With only 140,000 sq ft of Grade A space remaining in the city centre, competition for large floorplate stock is becoming even more competitive and tenants in search of larger floorplates are being forced to the fringes. This is only enough space for around six months of Grade A take up at average annual levels.

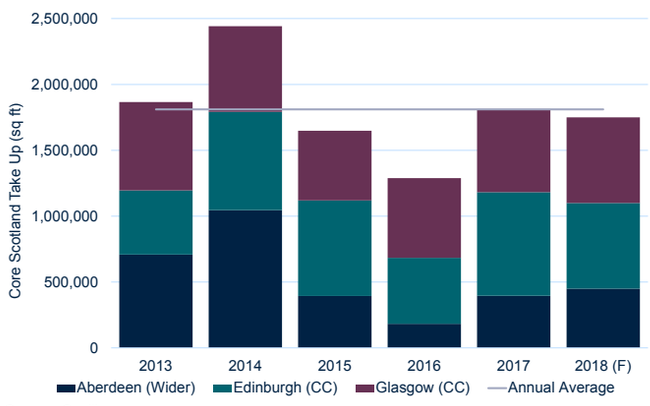
2 Semple Street reaches practical completion at end Q2 2018, whilst The Mint (60,000 sq ft) and Capital Square (122,000 sq ft) are scheduled for completion in Q1 2019 and Q2 2020 respectively, which should ease the shortfall.

Glasgow's city centre lettings soared to 249,483 sq ft during the first quarter of 2018, driven by the Government Property Unit's 187,000 sq ft pre-let at Atlantic Square.

However, besides this deal and Orega's serviced office deal, there were no deals over 7,000 sq ft during the first quarter.

GRAPH 1

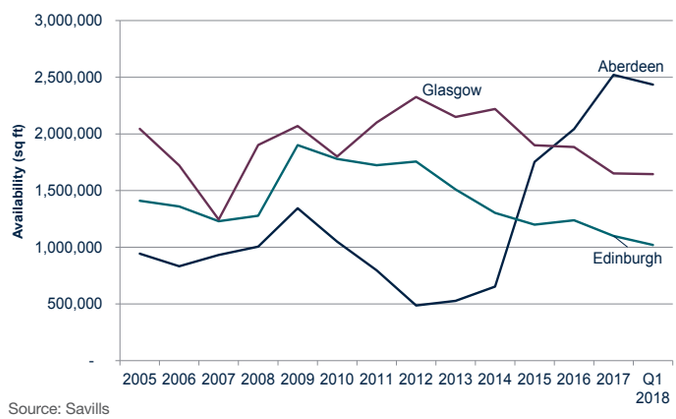
We forecast 2018 take up to reach 1.8 million sq ft for the core Scottish office markets



Source: Savills

GRAPH 2

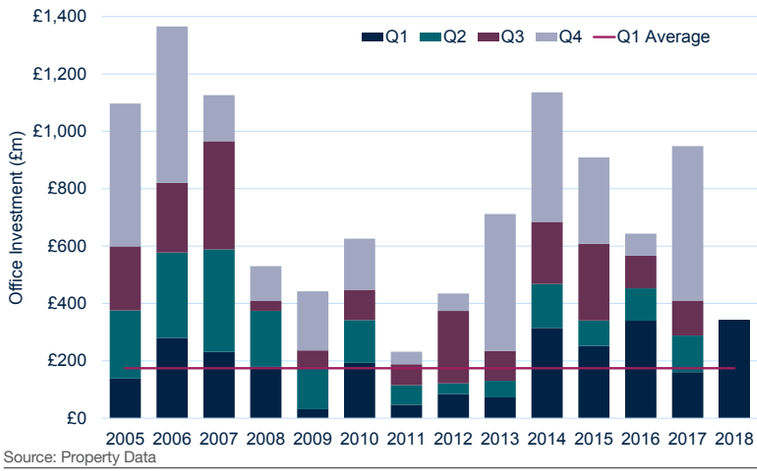
Availability will remain scarce in Edinburgh and Glasgow through 2018



Source: Savills

GRAPH 3

Office investment has started 2018 strongly



Source: Property Data

As announced at MIPIM 2018, FORE Partnership will be bringing forward Glasgow's first speculative office development in the city centre since 2015 and we expect a further 97,000 sq ft of speculative office space at BAM's Atlantic Square to be announced later this year. A shortage of Grade A space will continue to boost top rents which we expect could reach £32.50 by end 2018. Cadworks (pictured cover), will provide 94,000 sq ft of space and will be Scotland's first office allowing cyclists to ride directly into their office upon its completion in 2020.

Over the next five years, Aberdeen, Edinburgh and Glasgow are forecast to see a combined 3.6% office based employment growth, in line with the national average. This indicates a net additional 13,000 office based jobs, or a need for a net additional 1.3 million sq ft of office space across the three cities.

Investment

Scottish office investment transactions continued the strong momentum from last year, with £342 million of transactions recorded in the first quarter of 2018, 96% above the historic first quarter average (Graph 3).

Aberdeen has seen higher levels of office investment during the first quarter of 2018 (£131 million) than in the previous two years. This also marks the strongest year of overseas investment into Aberdeen on record. The headline deal was LCN Capital Partners' £112.5 million acquisition of Aberdeen International Business Park, representing a 6.9% yield.

Investor demand for Glasgow's prime lots remains strong, with Savills acting for L&G LPI Income Property Fund's acquisition of 3 Atlantic Quay at the turn of the year. Hermes also acquired Skypark, Glasgow for an undisclosed sum.

Edinburgh however, saw a fairly modest first quarter of office investment, with only £38 million of transactions, due in part to a lack of openly marketed stock. The key deal was Patrizia Immobilien's acquisition of Apex House for £28 million as German investors continue to favour Edinburgh offices, and have acquired £324 million of the capital's offices since 2016, 37% of the total.

Why we expect yields to harden in Scotland

One of the key determinants of yields in the office market is the political environment. Graph 4 shows that the proportion of people who would vote in favour of Scottish Independence has fallen from 47% immediately post EU referendum to only 37% in January 2018, according to whatscotlandthinks.org. This marks the lowest level since the EU referendum.

Decreasing political risk has provided the UK Institutions in particular, with a boost in sentiment, which has applied downward pressure on prime office yields. Post EU referendum, Scottish office initial yields jumped from 5.8% to 6.1% in July 2016 as the spectre of a second Scottish referendum

BRENT CRUDE RECOVERY AND INFRASTRUCTURE IMPROVEMENTS BOOSTS ABERDEEN

Mike Barnes, Research Analyst highlights his key themes

With the price of Brent Crude oil now hovering around $70 per barrel, we expect oil extraction operators to resume drilling into the North Sea later this year.

2017 marked a number of corporate deals in Aberdeen, a key indication of latent office demand. Private equity backed, Chrysaor, received £1.6bn of funding during 2017 and later last year signed for 48,000 sq ft in the Capitol, expanding from around six employees on inception to approximately 450. The company has been able to benefit from lower operating costs by acquiring capital from major oil and gas companies at a discount.

Whilst many of the multinational oil producers have turned their attention to deploying capital in more cost-effective global locations including Saudi Arabia and Kuwait, this has created an opportunity for smaller engineering companies to acquire North Sea capital. Siccar Point could be among the next fast growth oil and gas companies expanding in the city.

It's not only oil extractors who are considering expansion in Aberdeen. Exploration firms are now weighing up taking on further risk. This will indeed create new demand for office space in Aberdeen which Savills expect to reach 450,000 sq ft this year, 20% above the level recorded last year.

We also expect the number of occupational deals to increase during 2018. Whereas 2017's improved level of take up was in part driven by Total's 108,000 sq ft deal at Westhill, 2018 will see a stronger sub 5,000 sq ft market, largely driven by the oil and gas sector, providing the Aberdeen market with a much needed confidence boost.

Beyond the oil market, Aberdeen is set to benefit from the £745 million Aberdeen's Western Peripheral Route (AWPR), currently Scotland's largest infrastructure project. AWPR is set to complete in Summer 2018 and will provide improved access from the South to the city centre.

Office market fundamentals continue to improve in Aberdeen and as long as the oil price remains stable, the Aberdeen market will continue to benefit from the uptick in enquiries throughout the year.

3.6%
Office Based Employment Growth across Scottish cities over the next five years

1.8m sq ft
Core office take up across Scottish cities forecast for 2018

94,000 sq ft
speculative office space under construction in Glasgow

5.00%
Edinburgh prime office yield

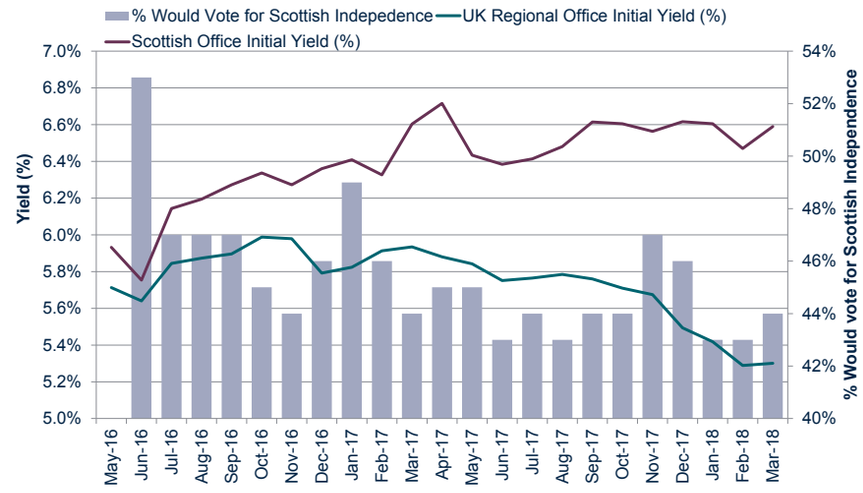
appeared more likely. Average yields continued to rise and peaked at 6.7% in April 2017, and have since hardened only marginally to 6.6% as at March 2018.

As a comparison, UK Regional average office yields peaked at 6% during October 2016 and have continued their downward trend to 5.3% in March 2018 (Graph 4).

The yield spread between Scotland and Rest of UK average yields now stands at 130 bps, the largest spread on record. Savills believe that given a recovery in the price of Brent Crude oil and tightening occupational markets, Scottish offices have become relatively cheap and there is further room for yields to harden during 2018.

GRAPH 4

How would you vote in a Scottish independence referendum if held now?



Source: MSCI, whatscotlandthinks.org

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