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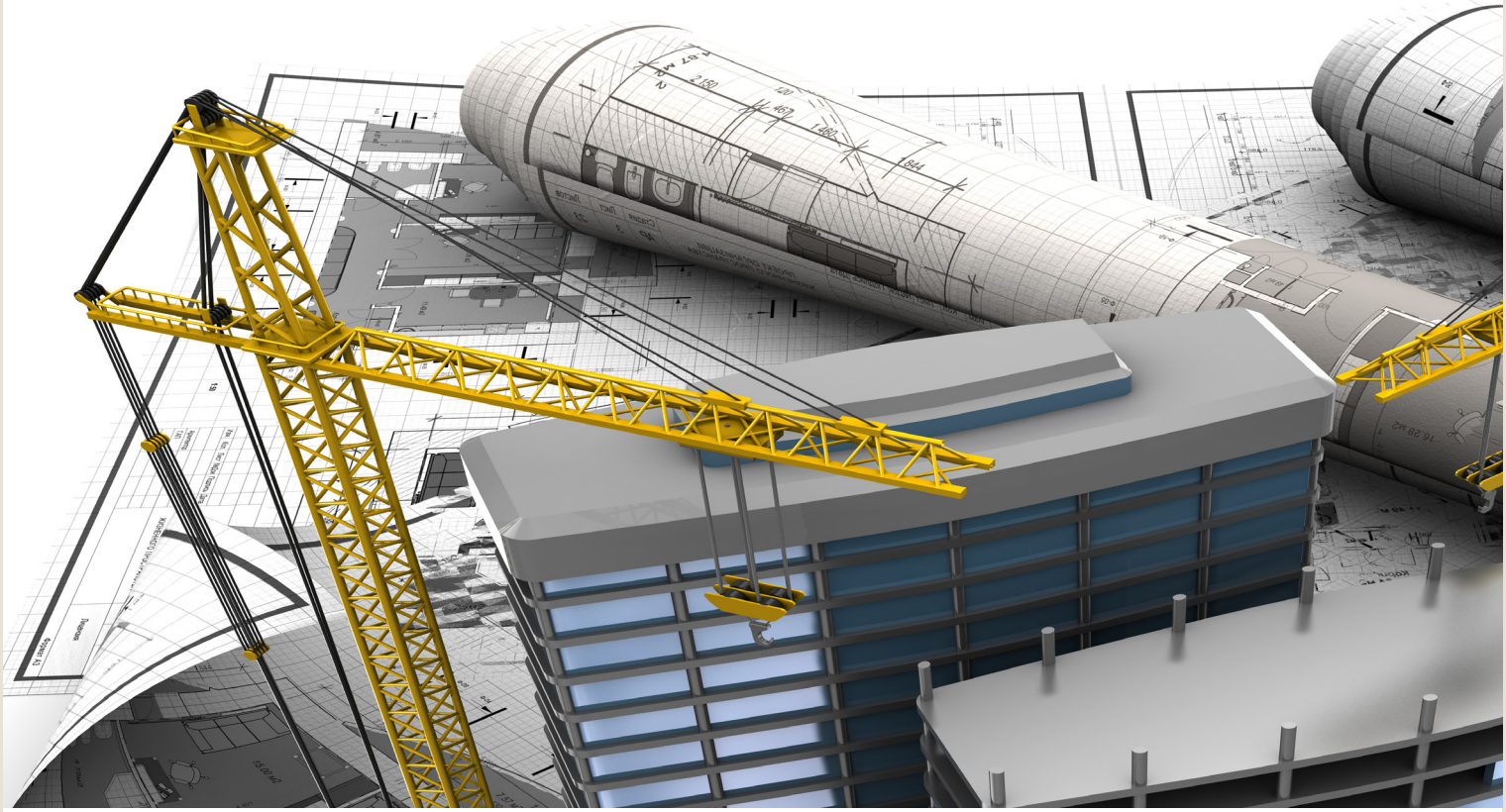
Savills World Research
UK Commercial

Spotlight
Regional Office Market Report

October 2013



SUMMARY

- The first three quarters of 2013 saw a marked rise in investor interest in the UK regional cities.
- With 134,000 sq ft of space rumoured to have let in the second quarter, Birmingham has seen the biggest uplift in take-up, with a 128% increase on the same time last year.
- The current UK vacancy rate across all grades stands at 12.3%, down from its peak of 15.8% in 2009.
- All of the key cities have seen a supply fall over the last 12 months, with Leeds seeing a fall of 29%, the largest of any of the regional cities.
- The regional office markets are predicted to see a 11% rise in take-up by the end of 2013. However, we expect take-up levels to increase more dramatically in 2014, with a 17% uplift forecast, as the economic recovery really starts to pick up pace.

"With positive business sentiment increasing, investors are becoming more comfortable with buying into key regional office markets as Grade A supply shortages give rise to positive rental growth."

Jeremy Bates, Head of Office Agency

Regional Investment Market

■ The first three quarters of 2013 saw a marked rise in investor interest in the UK regional cities, driven by the expectation of an imminent rental recovery in some of these strong regional cities, combined with improving confidence, and the record wide yield gap between London and the regions.

■ The proportion of investment in commercial property that was outside London fell to nearly 40% in 2012, well down on its normal level of around 60%. However, with a renewed interest in the regional office markets, the first half of 2013 has seen the proportion of investment,which is outside London, rise by 14% on the same time last year, with the level of investment outside London now making up almost 50%.

■ With the weight of money continuing to pour into London and the South East markets and therefore the associated stock and pricing implications this creates, investors are having to look in to the regions for both product and its relative "value."

■ Certainly the rationale for investing in the regional markets is starting to look more attractive. Oxford Economic's recent analysis looking at a composite regional economic health indicator for the UK regions (Table 1), based on a blend of unemployment, house prices, and employment data, shows the unsurprising fact that London has been the strongest region over the last year.

■ However, it is the rest of the ranking that brings some surprises, with the North West coming second (ahead of the southern regions), and the West Midlands coming equal fourth with the South East.

■ The yield gap between prime London offices and prime regional offices is now 225 basis points, furthermore, the regional office markets, in particular, are beginning to show signs of imminent under supply, with only c.1 million sq ft of speculative office developments underway outside London and the South East at present.

■ The focus in the regional investment market continues to be on 'Prime' stock and with this in mind, yields in the UK's key regional markets continued to strengthen during the first three quarters of 2013.

■ The scarcity of investment stock, coupled with increasing demand levels, has seen firmer pressure on yields. Additionally, more institutions are back in the market and this has resulted in yields falling on prime and good secondary product.

■ Prime yields have fallen by around 25-50 basis points in the majority of the regional office markets in the last six months. The national average prime yield is now well down from its 2009 peak of 7% at 6.1%.

Are some investors Beginning to shift along the risk curve?

■ As we come to the end of 2013, we are starting to see more of a pick-up in investor interest in secondary assets where the yield has over corrected on the back of the last few years of heightened risk-aversion.

■ There is increasing excitement about Grade B, and 'value add', indeed, the growing shortage of grade A office space, particularly in the regions, has seen a number of investors acquire assets for refurbishment.

■ Hines and Moorfield's purchase and subsequent refurbishment of Five Brindleyplace in Birmingham is a prime example, as are 100 Barbirolli Square and Bauhaus in Manchester, all of which represent a move up the risk curve towards fundamentally good, well located assets, with shorter leases and future refurbishment plans.

■ Considering that Savills refurbishment activity index (PMI) rose in August at the second-strongest rate in the survey history. We expect this to continue for some time. The net balance increased from +28.3% in July to +30.8% (the highest since February 2004).

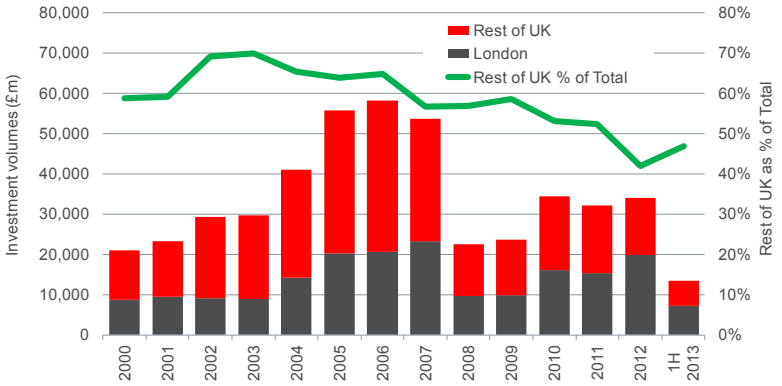
■ There has been a pick up in investor confidence with improving market depth and liquidity in regional UK commercial property markets. This is being led by domestic funds being priced out of London and looking to regional properties, attracted by higher yields but still demanding strong tenant covenants.

■ Larger investors in the market have access to capital through equity and bond issuances, however bank debt remains scarce. UK occupational markets have become more stable by a severe lack of new development, over the last five years.

■ With positive business sentiment increasing, investors are more comfortable with buying into key markets. However, they need to ensure that investment prices are not pushing ahead of the occupational markets again.

GRAPH1

The proportion of investment that is outside London is rising



Graph source: Property Data

■ These opportunities will start to diminish as an acceptance of the arrival of the recovery becomes more prevalent outside London. However, for the next 12 months pricing will often reflect an overly pessimistic view of regional recovery prospects, and therein lies the opportunity for the canny investor.

Regional occupational market

■ With summer behind us, attention returns to market performance and what the future holds for UK regional office markets. There is finally a reason to be optimistic, with take up for the first half of the year 10% up on the same period in 2012 (28% if we only look outside the South East).

The return of the larger letting

■ In most markets, activity over the last few years, has been characterised by a high frequency of small deals, typically for second-hand refurbished space, with 73% of regional lettings in 2012 being for secondhand space. However, it appears that the desire to control property costs is starting to give way to a focus on growing the business, witnessed by an increase in the larger Grade A letting in many regional cities as we go through 2013 and into 2014.

■ With 134,000 sq ft of space rumoured to have let in the second quarter, Birmingham has seen the biggest uplift in take-up, with a 128% increase on the same time last year. Boosted by three deals over 50,000 sq ft, Leeds also saw an impressive increase of 107%. Manchester, Bristol and the M25 also saw a growth of 43%, 31% and 10% respectively.

■ Surprisingly, not only have a number of large requirements moved forward but a number have also been resurrected in the regional office markets. Furthermore there has been a marked increase in the number of discussions involving the magic word, “growth”. We expect requirements will continue to increase, while the developments and refurbishments in the pipeline start to entice potential occupiers.

■ We predict that the regional office markets will still see a respectable 11% rise on year on year take-up levels by the end of 2013, with expected take-up levels to increase more dramatically in 2014, with a 17% uplift forecast, as the economic recovery really starts to pick up pace.

■ Examination of existing occupiers gives us an indication of the type of businesses likely to be attracted to the regions. The more traditional occupier types, like the Professional sector, is showing some bounce back in the regional office markets, with the best increase observed in the North West where the professional services grew by an impressive 9.1% over the last 12 months, overtaking London, which saw a growth of 6.9%.

■ However, the Technology, Media and Telecoms sector (TMT), which is exceptionally strong in Central London, accounting for over a third of take-up in 2012, has also gained momentum in the regions during 2013. Oxford Economics predicts that employment in the technology sector, in the UK is forecast to grow by 9% over the next five years. This is a clear sign that the regional office markets will continue to benefit from the growth of the TMT sector in the coming years.

■ The burgeoning TMT sector very often want unconventional space on unconventional terms. Landlords and their buildings will need to evolve to capture such tenants. Equally more traditional stock must provide leasing terms that allows tenants to move now but provide "up sizing" opportunity to accommodate potential growth in the early stages of an economic recovery.

■ With the development pipeline continuing to be restrained, supply is now falling in all major cities with a 11% decrease across the UK over the last 12 months. The current UK vacancy rate is at 12.3%, down from its peak of 15.8% in 2009. With increased take up and minimal developments coming on stream (c.550,000 sq ft between now and the end of 2014), we expect the vacancy rate to fall to 11.5% by the end of 2014.

Expert view

Andrew Bull, Director, Birmingham Investment, highlights his key themes

The key regional office markets outside of London have already witnessed a resurgence of interest from both UK and overseas investors during 2013, with strong demand for prime office stock. This is set to continue for the foreseeable future in our view.

Foreign and UK based investment interest in the regions has increased, evidenced by recent deals such as One Brindley Place in Birmingham acquired by Spanish Investors, Terra Nova (circa £30m - 6.3%). Epic also recently acquired Quartermile One in Edinburgh for circa £40m reflecting a net initial yield of 6.5%. Savills now consider prime equivalent yields in the regions now to be 5.75%. Further encouragement came from IPD's latest quarterly returns.

All UK Retail and Industrial joined Offices in Q2 in reporting a growth in capital values, the first since Q3 2011. Much of this was driven by growth in the wider South East, however, those segments still experiencing value decline saw this slow in Q2. This is good news for those looking at good quality secondary outside the South East, which is an ever increasing number, as scarcity of prime continues. This improving sentiment could see the definition of 'secondary' widen.

For the UK funds, who are back in the market, this may mean a move up the risk curve. For example, we have already seen interest in development opportunities in core regional markets such as Palmer Capital's purchase of the majority stake in the £100m debt secured against the mixed use Finzels Reach scheme in Bristol city centre.

Despite the increasing interest in secondary, the appetite for prime remains unabated. However, there is a significant shortage of prime stock forcing investors up the risk curve and out of London into the regional markets. The yield improvements that had been restricted to prime properties is now being experienced across the quality and geographical spectrum.

Considering that the pressure on UK funds to buy has intensified, as we head into the final quarter, combined with improving confidence, regional yields are now estimated to be in the region of 5.75%, where they are likely to remain as we go into 2014.

■ All of the key cities have seen a supply fall over the last 12 months (see graph 5) with Leeds seeing a fall at 29%, the largest of any of the regional cities. With only 1.9 years of supply available (3.1 years in 2009), Leeds vacancy rate now stands at 5.4%, the lowest vacancy rate outside Central London. The lack of large Grade A floorplates in the city has led to the re-emergence of the pre-let market, with KPMG's 60,000 sq ft pre-let at 1 Sovereign Square, the most notable.

Outlook

■ With a significant volume of lease events coming up over the next 36 months, one of the big questions concerning the regional markets is whether they will have enough 'suitable space' to accommodate this potential demand.

■ With Grade A availability accounting for less than a quarter of availability in our key markets, pointing to a very real shortage of Grade A supply, will this see the revival of speculative development?

■ While regional development is less likely to be speculative than in London, the mere fact that 10 schemes are underway in Bristol, Cardiff, Manchester, Edinburgh and Glasgow (c.1 million sq ft in the pipeline outside the South) is a vote of confidence in the prospects for the regional office markets.

■ However, the markets continue to face significant challenges in terms of financing new developments. Without the comfort of a significant pre-let, options are limited, despite a compelling supply argument. Schemes with the benefit of a detailed planning consent are more likely to generate increasing interest, particularly if the potential returns significantly out weigh those available further south. Inevitably the general lack of new development will fuel more detailed appraisals of refurbishment opportunities, as they may be a quicker way to deliver supply into greater market demand.

St Peter's Square, Manchester

■ Landlords are in a prime position to take advantage of a clear 'window of opportunity'. Therefore, with the lack of Grade A stock and continued lender caution, we envisage seeing a continued rise in refurbishment activity in the regional office markets as we go through the latter part of 2013 and beyond.

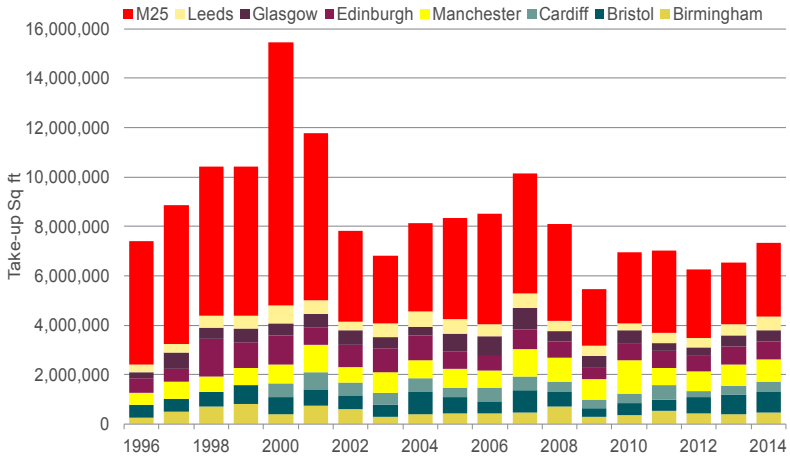
■ Although there is a limited amount of Grade A supply, with second-hand available space currently accounting for 77% of availability (up from 70% at Q4 2012) in our key markets, there is still a question mark over what will be done with this steadily increasing space?

■ We remain of the view that as the leasing market starts to recover we will see more of this 'non-prime' office space being refurbished to absorb increased demand. However, change of use is also another possibility. Student accommodation is one route, with over a 100,000 sq ft of older buildings in Cardiff for example, recently gaining consent for conversion.

■ That said, the temporary removal of 'red tape' around the conversion of offices to residential use, driven by the Government's desire to speed up housing delivery and tackle high

GRAPH 2

Take-up is predicted to increase by 12% in 2014

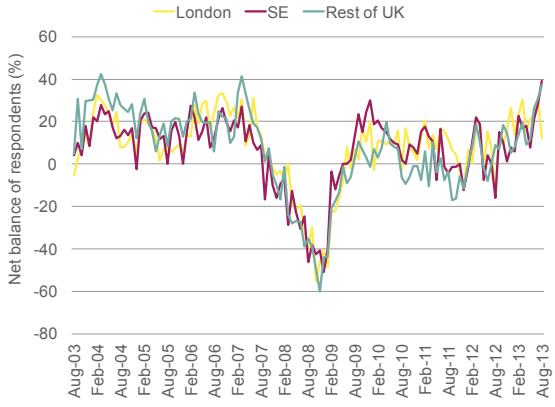


Graph source: Savills Research

2013/14 forecast

GRAPH 3

Development continues to increase outside the South East



Graph source: Savills Research

office vacancy rates in some parts of the country, has created a 'window of opportunity' for developers (See Expert View).

■ The medium term outlook is for an additional 1.8 million net jobs in the Financial and Business Service sector, to be created over the next ten years. Although London and the South East are likely to lead in terms of job growth, with these areas being dominated by the private sector. Key cites such as Manchester and Edinburgh will see substantial growth going forward.

■ Corporate profitability has been surprisingly robust during the past 12 months and according to the Office of National Statistics, Private Sector employment grew by almost 400,000 jobs, between June 2012 and June 2013.

■ The most successful regional office markets will still be the strong private sector towns and cities where public sector cuts are less relevant. The largest increase in private sector employment in the year outside London, were seen in Yorkshire and The Humber (82,000; 4.3%) and Scotland (62,000; 3.3%).

■ Although all northern regions have seen public sector job losses, interestingly, private sector employment growth has nearly four times offset the c.100,000 jobs the public sector have lost and this will continue to support the occupational markets going forward as businesses become more confident to spend.

■ Has 2013 seen the return of office rental growth? The markets predicted to see the biggest growth by the end of 2013 are the M25, driven by the M4 corridor, with an expected 8.6% growth. Outside the South we expect to see the biggest growth in Edinburgh at 9% and Manchester at 3%, which will largely be driven by a shortage of Grade A stock and improving occupier demand for certain office product.

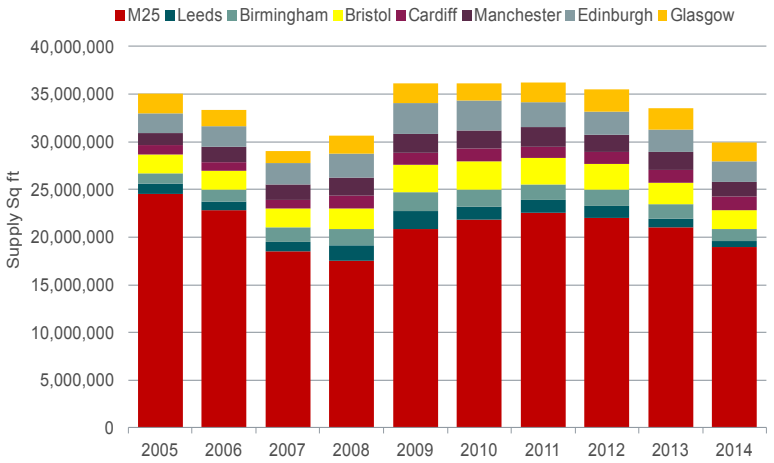
■ Whilst we won't see any drastic improvements in rents during 2013 in many of the regional cities, as the economic recovery really starts to take shape, we expect rental growth for prime space will continue on an upward curve, driven by the lack of Grade A space in key locations, as we go through 2014.

■ Lack of Grade A supply will result in prime rental growth in some of these strong regional cities, with rents recovering in the strongest cities (2012-2016 average), with Bristol & Birmingham seeing a growth of 1-2% per annum. Manchester & Leeds, 2% per annum, with Edinburgh & Glasgow seeing a 2-3% growth per annum.

■ Away from the prime end of the market, we expect rental growth to remain subdued due to the high level of second-hand space currently on the market.

GRAPH 4

Overall supply in most cities continues to fall



Graph source: Savills Research

2013/14 forecast

Expert view

Susan Emmett, Director, Residential Research, looks at commercial to residential conversions in more detail

Projects seeking approval under the new permitted development procedure started pouring into planning authorities from the beginning of June. Activity has been recorded in London and the south east as well as northern cities and the Midlands. Cities where there is an oversupply of office space such as Birmingham have been earmarked for potential conversions. We have also seen interest in Solihull and Edgbaston.

However, obstacles still exist. Certain areas within 17 local authorities (most of them London boroughs) have been exempted from permitted development including the City of London, the whole of the Royal Borough of Kensington and Chelsea and the Manchester city centre core. There are further exemptions in parts of the Vale of White Horse, Stevenage, Sevenoaks, Ashford and East Hampshire.

Savills research earlier this year revealed that the difference between residential values and office values varies largely across the country and is not always as great as might be assumed. Conversion therefore may not always be economically viable.

The research considered the decision facing a landlord or developer on what to do with a hypothetical 10 storey, steel-framed second-hand office building situated in an area suitable for residential use. Should the building be refurbished for office use or converted for residential purposes?

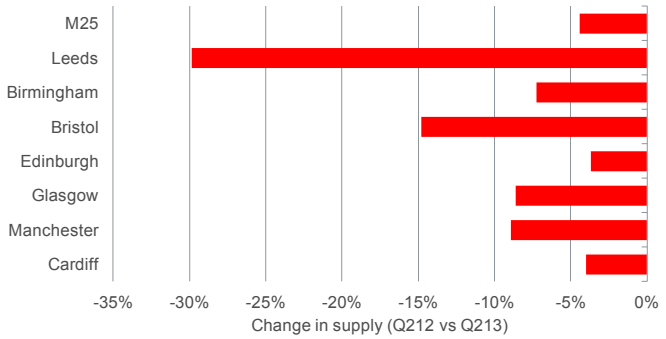
We found that while the potential uplift in capital value in prime central London could be as high as £1,000 per sq ft, in Manchester the differential might shrink to £5 per sq ft. Variations means each scheme must be considered on its own merit, particularly as the residential market picks up. Our experience tells us that even without the need to go through a traditional planning process, you need to factor in at least £100 per sq ft for basic office to residential conversion.

Permitted development might allow developers to bypass Section 106 requirements to provide affordable housing. In central London, where conversion is already viable, exemption from Section 106 could almost double the potential uplift. That said, developers must satisfy themselves that this applies to their individual case and that other charges such as Community Infrastructure Levy (CIL) are not triggered. As the permitted development right only applies to the principle of use, schemes that require material external physical alterations are still subject to planning permission.

Key Charts

GRAPH 5

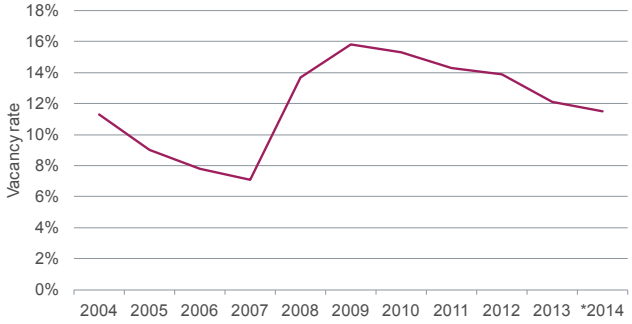
Leeds has seen the biggest fall in supply in the last 12 months



Graph source: Savills Research

GRAPH 6

The UK vacancy rate falls to its lowest levels since 2008

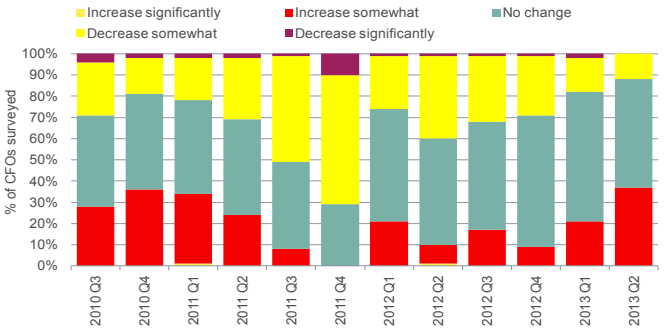


Graph source: Savills Research

2013/14 forecast

GRAPH 7

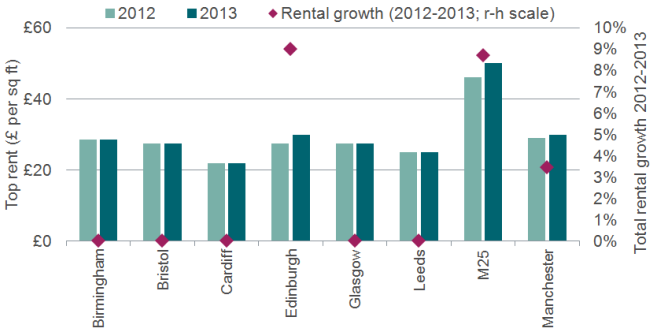
CFO view on hiring during next 12 months looks positive



Graph source: Deloitte

GRAPH 8

Are we seeing the return of sustainable rental growth?



Graph source: Savills Research

TABLE 1

Economic Indicator

Rank	Region
1	London
2	North West
3	South West
4=	South East
4=	West Midlands
6	Scotland
7	Yorkshire & Humber
8	North East
9	East Midlands
10	Wales
11	East
12	Northern Ireland

Graph source: Oxford Economics

TABLE 2

Definitions

Definitions	
Property criteria	Transactions and supply recorded for units in excess of 1,000 sq ft.
Top rent	Highest rent achieved in one or more transactions in the given period.
Grade A	All new development (including speculative schemes reaching practical completion within six months, plus major refurbishments).
Grade B	Space previously occupied, completed or refurbished in the last 10 years.
Grade C	Space previously occupied, completed or refurbishment more than 10 years ago.

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