

Spotlight Regional Office Market Report

April 2014



Academy House, Cambridge. 30,763 sq ft due for completion in 2015

■ With the UK economic recovery firmly on track, we believe the regional property markets are the next beneficiaries of the ripple of recovery outwards from London and the South East.

■ After a 32% growth in take-up in 2013, Savills predicts that take-up in 2014, will be 13% above the 10 year average.

■ Strong cities to watch are Cardiff with a 107% increase expected, and Manchester and Birmingham, although more modest, are still predicted to see a 26% and 14% rise in take-up respectively.

■ Overall supply has fallen 12% over the last 12 months (14% if you include the M25). The city who saw the biggest supply fall was Leeds, with a 31% decline.

■ The constrained supply levels have inevitably placed upward pressure on office rents with Seven of the UK cities covered (eight if you include the M25) expected to see growth in 2014.

■ UK institutions and overseas investors are becoming more dominant, with investors starting to look more closely at key regional cities.

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“Sustained levels of occupier demand combined with the decreasing availability of Grade A office supply will be a catalyst for rental growth as we go through 2014.” Jeremy Bates, Head of National Office Agency
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➔ ■ With the UK economic recovery firmly on track, we believe the regional property markets are the next beneficiaries of the ripple of recovery outwards from London and the South East.

■ According to Deloitte, perceptions of economic uncertainty are at a three-and-a-half year low and risk appetite among big corporates are at a six-year high. Revisions to the business investment data show it has now increased at a relatively punchy rate for four consecutive quarters to stand 8.5% up on a year ago.

■ For the UK economy, to make up the ground lost over years since the recession, it is vital that growth spreads out from London and into the regions. The key towns and cities which have healthy and robust local economies, are well placed to support growth and provide opportunities for businesses to expand.

Regional investment market

■ Looking specifically at the investment market, there has been a steady drift of investor aspirations away from the desire to protect income and towards the recovery-focused aspiration of finding higher returns with a degree of letting risk.

■ In our last report we suggested that the tone of prime yields in the regional office markets were around 5.75%, and that this was going to trend downwards due to rising investor interest in both the regional cities and the differential between London and the top regional cities.

■ Although we don't expect yields to come in at the rate they did in 2013 (50bp since March 2013), we expect prime yields to move to 5.5% in key regional cities as we go through the year. The national average prime yield is now well down from its 2009 peak of 7% and now stands at 6%.

■ There is still a limited desire to sell, however, investor appetite for regional offices is increasing and investors are looking more closely at the regions as available space reduces, with limited speculative space being developed, which could fuel investor interest and subsequent pricing as we move into 2014.

■ This intensity of demand has resulted in some transactions achieving above their asking price as seen with SWIP's £34.5m purchase of Sunlight House in Manchester, originally marketed at £28.5m.

■ We have also seen assets which would have struggled to sell 18 months ago acquired off market below their previous marketing yield. Helical Bar purchased Churchgate House and Lee House in an off-market transaction for £34m (21m 2.5 years ago) from a joint venture between Angelo Gordon and Dunedin Property. There is currently circa 35% vacant, providing Helical with a number of Asset Management opportunities.

■ Towards the end of 2013, we also started to see a pick-up in investor demand for secondary assets where the yield has over corrected on the back of the last few years of heightened risk-aversion. Hodge House in Cardiff is a prime example of a well let office building in a secondary location, with Grade A specification. The 143,000 sq ft building was purchased by L&G from Aberdeen Asset Management, it was acquired for £18.87 million representing an NIY of 9%. A similar building would have achieved well over 10% only 12 months earlier.

■ This mounting demand saw office transaction volumes reach a six year high of £23bn in 2013. This was 55% up on 2012 and only 10% off 2007 peak levels. Although the proportion of office investment in the regions was down on 2012, the actual volume of

investment was up 26%. We expect this figure to increase in 2014.

■ UK institutions are becoming more dominant in the regional cities and are starting to look more closely at key regional cities. They made up 33% of volumes in 2013 compared to 18% in 2012.

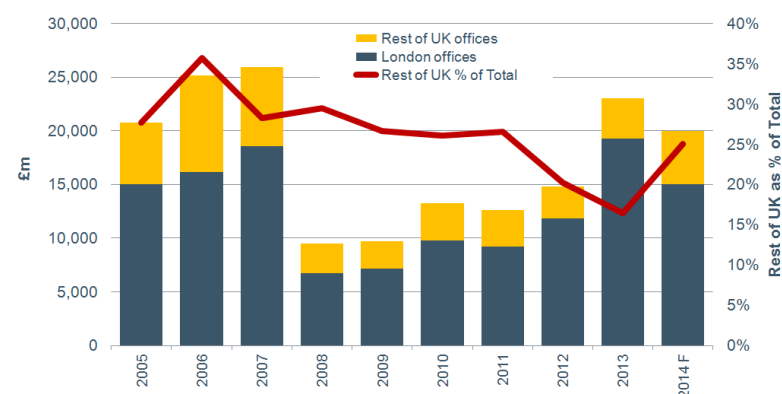
■ While risk-averse international investors will continue to be heavily biased towards London, the more risk-embracing investors will be looking to capitalise on the wide spread between London and regional yields, as well as the even wider spread between prime and secondary. Overseas investors accounted for 48% of volumes in 2013, a sharp increase on their 2012 share of 23%. A prime example of this is the sale of one Snowhill to Union at the end of 2013. This sold for £125m with an equivalent yield of 6.1%.

■ 2014 is likely to see sustained levels of demand for prime stock, but a significant lack of stock due to increased levels of activity in 2013. This level of demand is being driven by the weight of money looking to be placed into the sector chasing yield and stability that is not available in other asset classes, and in some instances to rebalance asset allocations for some who saw strong performance in equity markets in 2013.

■ For the top regional office markets falling vacancies and recovering tenant demand, coupled with little or no speculative development activity, will fuel a rental recovery. The yield spread compared to London offices should

GRAPH 1

Office investment volumes continue to recover, but the proportion that is outside London remains low



Graph source: Property Data

entice further investment driving capital value growth.

Occupational market

■ 2013 represented a real step-change for the UK office markets, with demand increasing across all of the key markets, representing a significant growth in take-up levels, while in many cities, office rents for regional commercial property have returned to growth in 2013. The falling availability of Grade A supply is now a key theme across the regional markets. Overall, Grade A supply has more than halved from its peak in 2009.

■ A survey by the CBI/Accenture found that just over half of the British companies surveyed (51%) expect to create new jobs over the next year - with Yorkshire, Humberside and the East Midlands the regions with the most positive views. This positivity started to translate into office take-up in 2013 and has continued into 2014.

■ With an increase in larger lettings over the second half of 2013, the major regional office markets saw a 32% growth in take-up in 2013 in comparison to 2012 (33% if you include the M25). This is the best year since 2007. Cities which performed particularly strongly were: Leeds, who saw an impressive 97% growth, with a number of large lettings signing through 2013. Cambridge and Glasgow also saw strong growth at 88% and 87% respectively.

■ We expect take-up to end 2014 at 13% above the long-term average. Strong cities to watch are Cardiff with an exceptional 107% increase expected, and Manchester and Birmingham, although more modest, are still predicted to see a 26% and 14% rise in take-up respectively.

■ Larger occupiers, such as PwC, BBC, Addleshaw Goddard and KPMG will still be active in the market as we go through 2014, however, following London's lead, mid size tenants will become much more active off the back of improving business confidence and a tightening supply pool in this size bracket.

■ Take-up for the first quarter of 2014 is estimated to be 4% up on the same time in 2013, with particularly strong

cities being Cardiff with 210% growth and Manchester with a 48% growth.

■ Towards the end of 2012, economic data started to indicate that the level of regional employment had increased in 'office-based' sectors, which has heralded a renewed optimism in the regions. More recently data from CBI and PwC point to a further 15,000 positions hired in the first quarter of 2014, which would be the fastest growth since the study began in 1989.

■ There is also evidence that the regional markets will increasingly benefit from relocations out of London to more affordable locations; a number of footloose requirements have been publicised over the last few years. A good example being Deutsche Bank's, expanding by 1,000 jobs in Birmingham as part of plans to decentralise some of their back and front office functions.

■ Currently, Birmingham's top rents are still 14% down from their peak of 2008, compared to the City of London where rents have already beaten their peak by 17%. Many regional cities are at a point in the cycle where it has the capability to become the 'value for money' alternative to London.

■ We estimate that 20% of available space in our key office markets is Grade A. Within this figure there is even less 'large floorplate' newly built space, and this is the trend that is starting to stimulate a rising interest in speculative office development in the regions.

■ Overall supply has fallen 12% over the last 12 months (14% if you include the M25). Due to a number of larger lettings, Leeds saw the biggest supply fall, with a 31% decline.

■ However, if we are looking solely at Grade A supply, the majority of cities are edging towards a severe supply shortage. Will these cities have the space that growing companies need?

■ From a supply perspective, the continuing erosion of Grade A supply across the region is now likely to trigger enquiries from a number of occupiers, as they become aware of the increasingly limited pool of

Expert view

Simon Lister, Director, Leeds Investment, highlights his key themes

There is currently a positive outlook within the regional markets, with a good economic picture to back this up. In general the property market had good 2013 with a slightly higher number of deals done outside London. Lenders and funds are increasingly looking at the regions as a target for their investment strategy.

There are very high expectations for total returns in 2014, with forecasts at an average of 16% (Savills holds a more conservative at just below 14%). Some asset allocators believe that property is currently the most attractive asset class and could remain so for the next two years.

Prime equivalent yields have hardened in all sectors over the past 12 months with downward pressure on a number of sectors. This yield hardening has been evidenced by a collection of key regional office transactions summarised as follows;

Union Investments acquired One Snowhill, Birmingham which struggled to get to 7% in early 2013, but subsequently achieved equivalent yield of 6.1%, with a good depth of market.

SWIP have recently acquired Sunlight House, Manchester for £34.5m, way in excess of asking price of £28.5m and reflecting a net initial yield in the order of 6.50%.

BBC Pension Scheme reportedly purchased Time Central in Newcastle for £24.70m reflecting a net initial yield of 6.2%.

There is downward pressure on yields to reflect the anticipated rental growth and continued levels of office take-up. Correspondingly yields have moved dramatically since March 2013, but the key regional cities still look like good value when compared with London and the south east. Investor appetite for regional offices is increasing and investors are looking more closely at the regions as available space reduces and limited speculative space is being developed.

Regional markets have however recovered more slowly than London, which is to be expected and Investment volumes are also increasing but the proportion that is outside London remains low.

Speculative funding is still very difficult to secure, but we will see some funding of part pre-let schemes as stock levels remain scarce and occupational demand continues to improve.

“Speculative funding is now firmly back in London and the South East and inevitably this will follow in the regions. Currently the regional markets are fully open to part speculative schemes off the back of a pre-let and we expect speculative development to be fully back in the regions within the next 9-12 months.” Jonathan Holmes, Head of funding

suitable product. Going forward, there are also a significant proportion of lease events coming up during the next five years, in the key regional markets. This bodes well for a healthy level of future office demand.

■ With limited Grade A floorplates, some of this demand will involve a pre-let. Indeed, occupiers with lease events coming up in the next three years, will need to start looking now to make sure they secure the best deal.

■ Due to shortage of stock, Leeds was one of the first cities to see the return of the pre-let in 2013 and the recent announcement of global pharmaceutical firm, Astra Zeneca, relocating their UK 850,000 sq ft headquarters, establishes Cambridge's position as a leading UK office market.



1 Capital Square, Rightacres. 130,000 sq ft speculative office building. 26,000 sq ft pre-let to Blake Morgan (Morgan Cole)

■ Regional city vacancies are falling, and the development pipeline is only equivalent to 0.8% of stock (Graph 6). With this in mind, regional office locations are now starting to respond to the changing market demands and are at varying stages of seeking to attract office development back in the city centres. The take-up and supply balance looks attractive in key locations such as Manchester, Leeds, Birmingham and Edinburgh, however, office rents need to grow in many Tier 2 locations to make development viable without public sector pump-priming.

■ Given the renewed demand in the regions, against the improving economic conditions, there are great opportunities ahead for those investors and developers with well located sites. Indeed, the growing confidence in regional office markets, with growing demand and limited supply, is a catalyst for developers to act sooner rather than later.

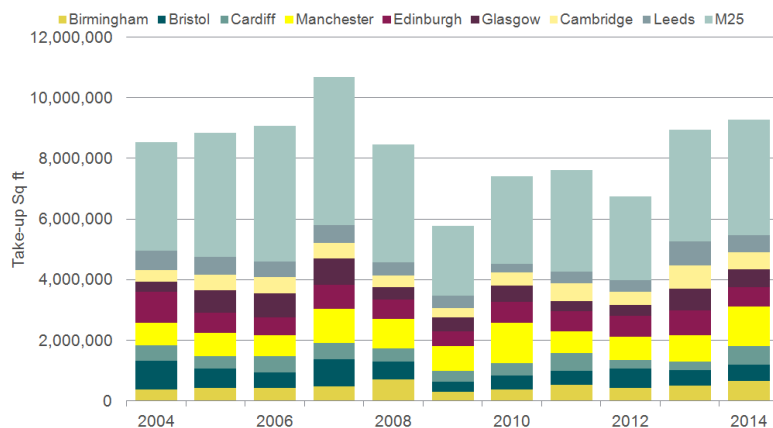
■ Encouragingly, according to Savills PMI survey (Graph 3) the UK total commercial projects rose at the sharpest rate in the survey history during February with growth of private office activity remaining robust.

■ In our last report we reported that 10 schemes are underway in Bristol, Cardiff, Manchester, Edinburgh, Cambridge and Glasgow (c.1 million sq ft in the pipeline outside the South due to complete in 2014/15). Although this figure hasn't changed significantly since the last report, what has changed is the expectation that a number of new schemes will start on site within the next 6 - 12 months.

■ Although availability of funding remains an issue for speculative development, attitudes to funding part pre-lets in the regions has now fully recovered. The percentage needed for a pre-let has also decreased over the last few years, down from 60% at Two Snowhill, Birmingham to Wragges to

GRAPH 2

Take-up continues to increase

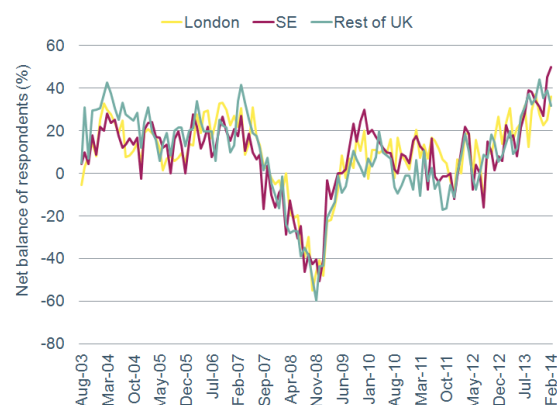


Graph source: Savills Research

2014 forecast

GRAPH 3

Development activity remains robust



Graph source: Savills Research

24% at St Peter's Square, Manchester to KPMG.

■ 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 cities such as Manchester and Birmingham will also see substantial growth in the private sector.

■ Which sectors will provide the impetus for growth as we go through 2014?

■ The largest growing sector over the last twelve months was the Professional sector, accounting for around a third of the total jobs growth. Going forward the Professional and administrative services are predicted to be the key driver for growth over the next decade, with a 11% growth forecast in both sectors over the next five years.

■ Employment growth in these sectors will help to negate the job losses expected in manufacturing, and in public services as further austerity measures take hold.

■ Despite an economically challenging few years, we are of the belief that the regional markets are now at a turning point, with the regions being well placed to take advantage of the improving occupational markets, with some locations faring better than others.

■ The sustained levels of occupier demand combined with the decreasing

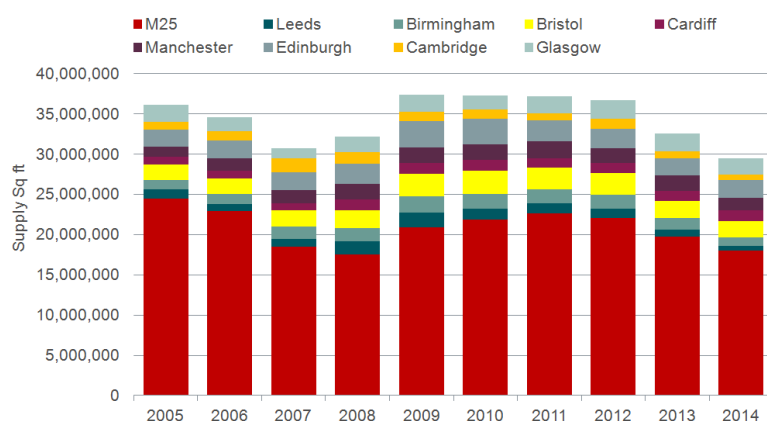
availability of grade A office supply has also been a catalyst for rental growth in the majority of regional office markets. As we go through 2014, as the economic recovery really starts to take shape and new developments provide a step change in rents, we expect rental growth for prime space will continue on an upward curve in the majority of the regional cities.

■ Seven of the UK cities covered are expected to see growth in 2014 (eight if you include the M25) (Graph 8). Savills predicts a notable rise moving forward in Manchester and Edinburgh where rents are likely to see a 7% increase going from £30 per sq ft to £32 per sq ft. Cambridge and the M25 are close behind at 6%, moving from £34 per sq ft to £36 per sq ft and £41 per sq ft to £43.50 per sq ft respectively, over 2014.

■ Away from the prime end of the market, we expect rental growth to remain subdued with high levels of second-hand space still on the market.

■ With supply being a determining factor in this cycle, the lack of development finance will keep supply restricted, however investors should start to move up the risk curve and start backing speculative development in the regions as we move through 2014.

GRAPH 4
Overall supply in most cities continues to fall



Graph source: Savills Research

2014 forecast

Expert view

Nick Gregori, Analyst, Residential Research, gives his view on the regional residential market

Residential property prices are recovering across the regions, with price growth now extending out beyond London and the South East, according to the latest figures from the Nationwide, Halifax and Land Registry house price indices. These all show positive trends for a strong majority of the regions, but a more detailed analysis of key local markets shows that some cities are significantly outperforming others.

Manchester and Cardiff are two city markets showing particularly strong improvement, with Land Registry figures (Jan 14) showing year-on-year price growth of 3.6 and 5.6% respectively.

Evidence from local surveyors in the RICS Residential Market Survey (Feb 2014) suggests that these rises are in part due to a lack of supply, with new instructions remaining at low levels.

The Land Registry transaction level data lends some further evidence to this theory, with the number of transactions still only a fraction of their pre-financial crisis peaks, down over 50% in Manchester and almost 30% in Cardiff.

Areas exhibiting lower growth include Glasgow and Leeds, with annual price changes of 0.0% and -0.5% respectively, according to the most recent Land Registry and Registers of Scotland data. Some of last year's quarterly figures showed strong growth in both locations though, so it is perhaps the case that the recovery in prices is simply arriving later in these areas.

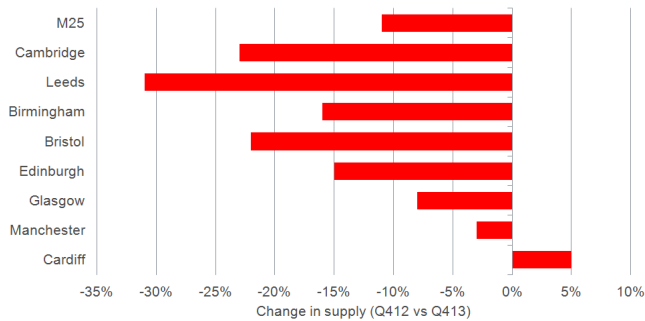
When combined with strong demand from first-time buyers and increasing mortgage availability, the lack of supply across the regional markets means that prices are predicted to continue rising through 2014.

Unlike London and some of the prime South East locations, prices are still significantly below their previous peak in much of the rest of the country, so there is perhaps better value to be found in certain regions – our five-year forecasts suggest that both the South West and the East of England will outperform London significantly.

Key Charts

GRAPH 5

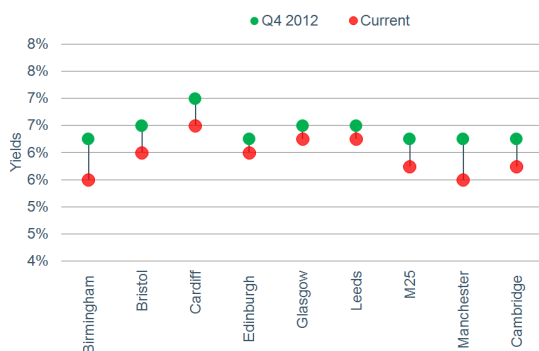
Leeds has seen the biggest supply squeeze over the last 12 months



Graph source: Savills Research

GRAPH 6

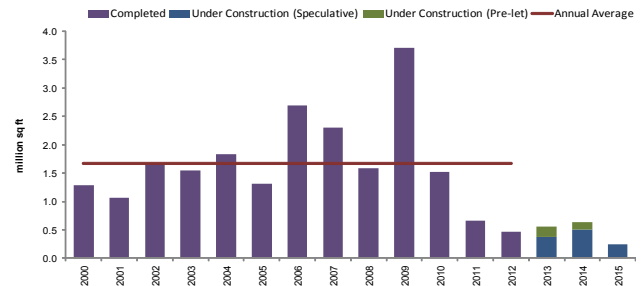
Regional yields continue to move in



Graph source: Savills Research

GRAPH 7

The development pipeline is only equivalent to 0.8% of stock

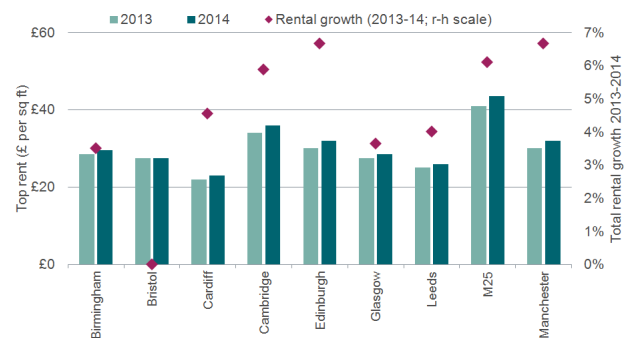


Graph source: Savills Research

2013/14 forecast

GRAPH 8

Rental growth will pick up pace in 2014



Graph source: Savills Research

TABLE 1

Regional Economic Indicator - 2014

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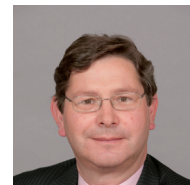
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