Savills World Research
UK Commercial

Spotlight
Regional Office Market Review & Outlook

February 2016

The BBC are relocating their Welsh HQ to Central Square, in Cardiff City Centre, where they will take a new 150,000 sq ft building.

■ After a bumper year in 2015 we expect key regional cities, to once again, exceed their long-term average take-up at the end of 2016. Bristol is expected to see the best growth in 2016, up 45% on 2015.

■ Significant Government led requirements, and an increase in 'northshoring', should start to impact regional take-up figures.

■ The supply versus demand dynamics have been compelling over the last 12 months, with all regional cities significantly below their average years of supply as we move through 2016.

■ Large scale speculative developments have started to materialise. With institutions now having money for funding and with a restored market confidence, we expect this to continue.

■ In the mean time, the lack of office space available in the regional office markets will continue to drive the demand for value-add office refurbishment opportunities as we go through 2016.

"Over the next few years, active Asset Management will be key to maintaining rental growth and creating further capital growth." Jeremy Bates, Head of National Office Agency

Regional investment market

■ Over the last two years the regional office markets have seen a significant increase in investor interest. A combination of relative value against the South East and a recovering occupational market has resulted in yield compression for both prime and good secondary office investments.

■ However, yields are now levelling off, with the average prime yield across all sectors of the market hardening slightly to 4.6%, with the majority of prime yields now at or within 25 basis points of their long-term low.

■ In the past year regional offices prime equivalent yields have moved in by 50 bps to 4.75% and we expect them to stay broadly at this level during the first half of 2016.

■ Regional investment volumes in 2015 were 56% above the 10 year average and 10% above 2007 levels.

■ The proportion being invested in office markets outside London has risen over the last two years, with the proportion standing at 31% in 2015 (regional volumes only made up 16% of total volumes in 2013).

■ Birmingham's Colmore Plaza acquired by Ashby Capital for £140m, its first investment outside London, and 1 Colmore Square which sold for over £87m, well in excess of its initial asking price, demonstrates this regional appetite.

■ 2015 has been a 'happy hunting ground' for the institutions, who made up 35% of volumes in 2015, with deals such as Media City completing in 2015. The landmark sale of a 50% interest in MediaCityUK was sold for £503 million to Legal & General Capital. There was also significant international interest in this opportunity, which highlights the global strength of the regional markets.

■ Overseas buyers, attracted by the relative safety of investment in the regional office markets without the Central London price tag, have made up 31% of regional office investment volumes in 2015.

■ 2015 saw some very high profile sales such as Deutsche Asset & Wealth Management's acquisition of 2 St Peter's Square, Manchester, from Mosley Street Ventures, for £100m. The building is due for completion this year, with Ernst and Young already secured as future tenants. We expect this overseas interest to continue as we go through 2016.

■ Deutsche Asset & Wealth Management also bought 110 Queens Street, Glasgow at the end of 2014, again, before it had completed construction, showing the improved confidence in the speculative market, as well as overseas interest in regional assets.

■ Arguably, UK funds, who are most comfortable with understanding the regional office market dynamics, have increased their appetite across the UK.

■ With institutions now having money for funding and with a restored market confidence and positive sentiment, large scale speculative developments have started to materialise.

■ Fund appetite for speculative development become apparent with Mountgrange's 143,000 sq ft One West Regent Street, and BAM's 163,000 sq ft 110 Queen Street in Glasgow completing in 2015. Other cities are now following suit. These include:

■ Central Square, Leeds, funded by M&G is a 220,000 sq ft development due for completion summer 2016, with significant pre-lets already in place.

■ The third phase of Ballymore Properties highly successful Snowhill scheme is another example. The first two phases have already drawn on occupiers including: Barclays, KPMG and Wragge Lawrence Graham & Co. We expect the third phase, which will provide Grade A office space of approximately 400,000 sq ft, to attract similar interest. We understand this is currently under offer.

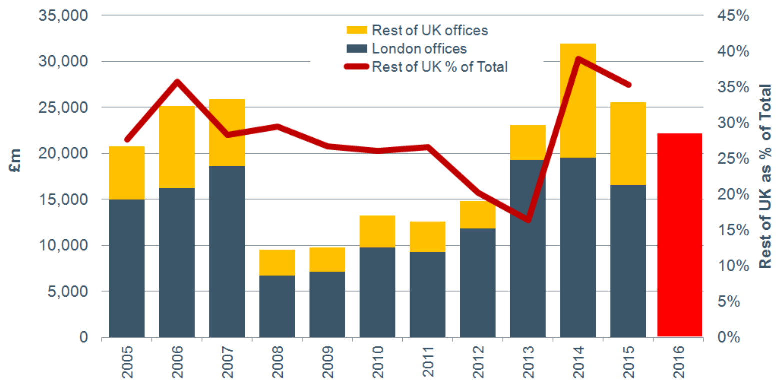
■ As more institutional prime stock is developed out, the increased critical mass will widen the investment appeal to both UK Funds and more overseas investors.

■ There has also been a continued pick-up in investor demand for secondary assets in strong locations, where a successful refurbishment will lead to rental growth and significant increase in values as rent difference between new and refurbished has become marginal. A recent example of this is Circle Property's, acquisition of one of Birmingham's key office refurbishment opportunities, Somerset House from M&G for circa £7.8m.

■ There has been a more pronounced depth of investment demand within the regional office sector, with healthy demand for well let Grade A stock, asset management opportunities further up the risk

GRAPH 1

Regional investment volumes are 56% above the 10 year average



Graph source: Savills/Property Data

Redevelopment of New Street Station, Biirmingham

curve and, more recently, speculative development.

■ As we go through the first quarter of 2016, with inflows at a more manageable pace, we expect the funds to start focusing on their own portfolios, which is likely to bring more stock to the market.

■ In terms of investment volumes we expect 2016 to end the year above the long-term average but below the level achieved in 2015.

■ The 2016 investment market will be driven by the smaller end of the market rather than the larger trophy assets, as has been the case over the last two years. The next big opportunity may be to package up groups of smaller assets to create high quality regional portfolios, which are large enough to satisfy investment requirements.

■ For UK property investment, at present, there is a higher degree of uncertainty, which may drag on the investment volumes during the first half of this year. However, there will be a desire amongst investors to capture the upswing in the regional leasing market, particularly as capital value growth prospects begin to slow.

■ We believe the early phase of recovery is now ending and we are now moving into the phase of the cycle where the majority of the total return will be driven by income return and rental growth, rather than just capital value growth.

Regional occupational market

■ Demand for prime office space in key regional cities has increased dramatically during 2015. This has been driven by local businesses, start-ups, and the rise in northshoring, where rising rents in London has driven further relocations to regional markets.

■ 2015 take-up was 16% higher than the previous year (43% including the M25). Restored confidence and positive market sentiment has resulted in a considerable spike in demand for certain cities.

■ Manchester, Birmingham Cardiff and Edinburgh have seen increases of 39%,105% 41% and 44% respectively, on the ten year average, with Birmingham and Cardiff finishing the year with the best take-up figures ever recorded. Going forward, Bristol is expected to see the best growth in 2016, up 45% on 2015.

■ Looking forward to the end of the year, we expect year-end figures to be 12% down on 2015, but 21% above the long term average. We expect key cities, to once again, exceed their long term average at the end of 2016.

■ There is a rising trend in corporates in the UK to move away from Central London to major regional cities such as Birmingham and Manchester, bringing increased inward investment to these regions.

■ Cost issues has been a major contributor to moves away from the London over the past few years, with a search for more affordable secondary locations in which to locate 'back office' operations.

■ Deutsche Bank's move to Birmingham has been discussed at length in the past, however, more recently, HSBC agreed a significant deal to forward purchase 210,000 sq ft at Birmingham's new development, 2 Arena Central, in a move that allows it to bring its UK personal and business banking operations to Birmingham.

■ Around 1,000 head office roles will move from London to Birmingham before the end of 2018. This deal is particularly important, as it has shown that the Deutsche Bank deal wasn't an anomaly, but has actually set the tone for things to come.

■ With all regional cities now below their average years of supply, we estimate that the total Grade A availability in regional cities is now 18% down on its 2007 levels.

■ Tenant demand is recovering in the majority of key regional cities, and there are increasing opportunities for developers going forward. Indeed, speculative development in the regions has started to pick up pace, with levels up 129% since the same time last year.

■ The confidence shown in speculative office development underway in the regions is already paying dividends with a number of significant pre-lets completed and more due to be announced in the first quarter 2016. Global law firm Squire Patton Boggs, who have agreed a pre-let on 27,500 sq ft at Allied London's No.1 Spinningfields in Manchester city centre is the most recent example.

■ At the end of 2015, there was c3.5 m sq ft in the regional pipeline, with almost a million sq ft of this already pre-let (28%). We predict that there should be an appetite for more speculative development to be considered in prime locations as we go through 2016.

Slowing Capital Value Growth will drive a hunt for rental growth opportunities as we go through 2016

■ Supply levels are still way below long-term average in the majority of key regional cities. The average take-up for all regions is 4.6m sq ft, so there is in fact under one years worth of new Grade A supply coming into the figures over the next three years.

■ With new build development likely to peak in 2017/2018, and with limited Grade A stock remaining, refurbishment opportunities will be vital in satisfying occupier demand in the short-term.

■ We have seen the lack of office space available in the regional cities drive the demand for value-add office refurbishment opportunities. UK commercial developers indicated that refurbishment work continued to expand in January marking a 41-month sequence of increases.

■ Refurbishment opportunities are attractive given their speed to market and their ability to 'plug the gap' while the market waits for developments to complete. Buildings such as No.1 Colmore Square in Birmingham, 11 Portland Street in Manchester, 191 West George Street in Glasgow and Pithay in Bristol, will be delivered to the market from 2016 onwards.

■ A lack of Grade A new build accommodation has seen corporate occupiers consider existing buildings for their possible relocations; this includes Pinsent Masons, PwC and Deloitte amongst others.

■ The lack of supply in these city centres is forcing some occupiers to look at wider locations such as the business parks. This has been evidenced in Birmingham where the vacant stock of Birmingham Business Park has fallen from 75% to 15% over the last 12 months.

Outlook

■ As we move through 2016, it is apparent that amenity-rich and well-connected workplaces are the key to regional cities growth as business locations for both indigenous occupiers and inward investment.

■ Occupiers of offices will continue to question their overall office costs and we expect regional cities to start to feel the 'northshoring effect' more strongly this year, as companies look to capitalise on the relatively low property costs and higher quality of life which certain regional cities can offer in comparison to London.

■ The Northern Powerhouse, will also continue to be a 'buzz word' as we go though 2016. Frustratingly vague, it is looking to reshape the economic geography of the UK, with the aim to attract new businesses to the North of England. Key policies include upgrading infrastructure to better connect the urban areas to each other and the South.

■ The potential inward investment associated with HS2 has been another hot topic throughout 2015 and we expect this to gather momentum in 2016.

■ Going forward, job creation in the UK will be concentrated in the private services sector, particularly the strongly expanding professional and support business services. These two sectors alone are forecast to create an additional c.900,000 jobs in the UK by 2025.

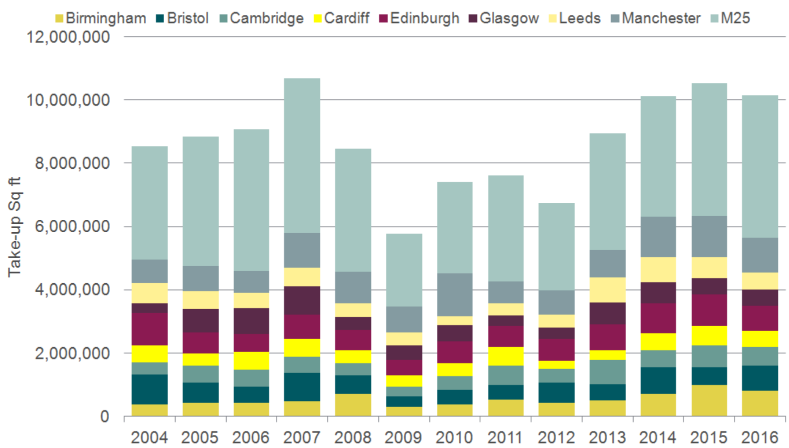
■ UK wide activity also points to additional and increasing demand from sectors such as TMT which is estimated to see a c.700,000 of jobs created in the regions over the next 10 years. We expect places such as Bristol to capitalise on this, with developments such as 'Pithay' geared towards this sector.

■ More office requirements from GPU and Central Government are expected going forward, with the Government looking to create more efficient space and rationalisation of the estate. This will save costs in the long-run but will result in some significant government led requirements throughout the UK, which should impact take-up figures from 2017 onwards.

■ Rental growth has already become a reality. The markets that saw the biggest growth in rents at the end of 2015 were the M25, driven by the M4 corridor, with an impressive 10% rental growth.

GRAPH 2

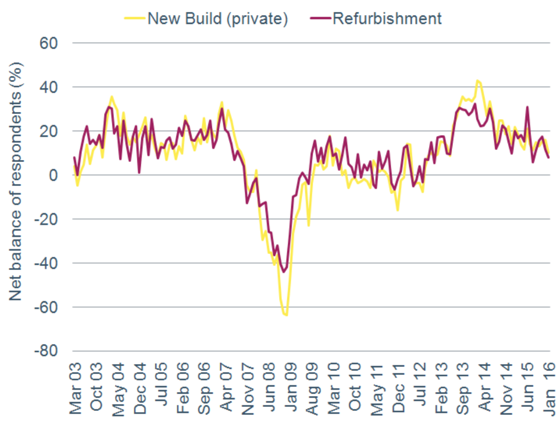
2015 take-up levels were the best since 2007



Graph source: Savills Research

GRAPH 3

Refurbishment activity continues to increase



Graph source: Savills Research

The Pithay, Bristol, which is about to under go extensive refurbishment

■ Outside the South we saw the biggest growth in Manchester at 6% and Leeds at 4%. This was due to improving occupier demand for certain office product and new developments commanding higher rents. Glasgow also broke the £30 per sq ft barrier for the first time in 2015.

■ Going forward through 2016, we expect the best rental growth to be in Bristol, which could see a 12% growth in 2016, alongside Cardiff, which is predicted to see 9%.

■ Competition for the best quality refurbished stock has significantly narrowed the gap between refurbishments and new build rents. Cities such as Leeds and Bristol are seeing quoting rents on refurbished space at a similar level to new builds.

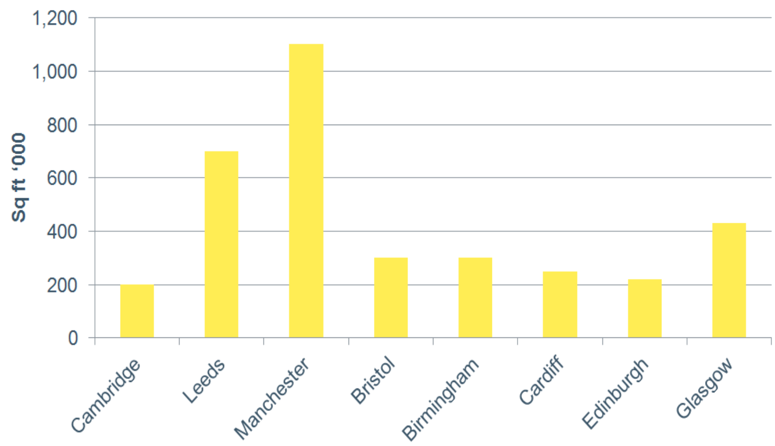
■ We believe this will change as we go through 2016 as more developments becomes available and start to re-rate the market.

■ Whilst the key drivers of demand for space are still important, other issues such as security, amenities and clustering are becoming increasingly significant. Of over 200 finance directors surveyed by recruitment consultant Robert Half, 38% saw staff retention as a major issue.

■ Regional cities must offer the right blend of working environment, infrastructure and amenity. In many of the regional cities, public spending infrastructure is hitting the right note with the metro and Grand Central in Birmingham and the Leeds Arena bringing further positive momentum to the city.

GRAPH 4

Regional development starts have increased



Graph source: Savills Research

Property Investment Overview - 2016

■ UK businesses are performing well amid a growing business consensus that UK economic growth is stabilising.

■ However, while these signals are encouraging, businesses are increasingly cautious, with investment intentions slowing down with much of the focus on cost-cutting and rationalisation to achieve efficiencies.

■ This is hardly surprising given the concerns over the state of the global economy, but also amid growing concerns over global economic uncertainty, with the risk of an EU exit weighing heavily on business confidence.

■ Depite corporates having record levels of cash on the balance sheet, companies will remain cautious in how they invest this, especially in the face of rising employment costs and wage growth expectations.

■ In terms of investment volumes, we expect 2016 to end the year above the long term average but below the level achieved in 2015.

■ The 2016 investment market will be driven by the smaller end of the market rather than the larger trophy assets.

■ In the past year regional offices prime equivalent yields have moved in by 50 bps to 4.75%.

■ Regional investment volumes in 2015 were 56% above the 10 year average and 10% above 2007 levels.

■ The proportion being invested in office markets outside London has risen over the last two years, with the proportion standing at 31% in 2015 (Regional volumes only made up 16% of total volumes in 2013).

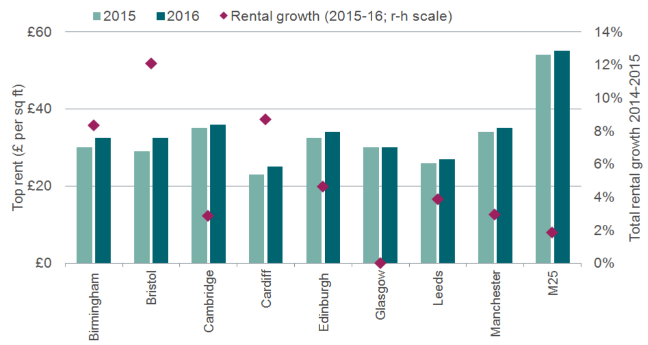
■ Overseas buyers, attracted by the relative safety of investment in the regional office markets without the Central London price tag, have made up 31% of regional office investment volumes in 2015.

■ 2015 has been a 'happy hunting ground' for the institutions, who made up 35% of volumes in 2015.

Key Charts

GRAPH 5

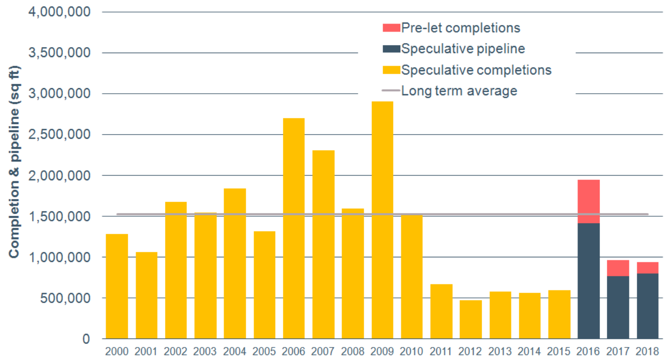
Rental growth is a certainty in most cities



Graph source: Savills Research

GRAPH 6

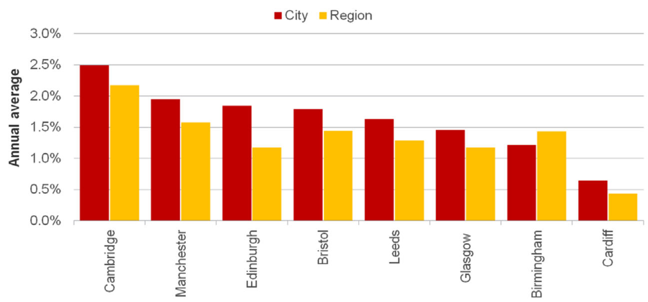
Spec development in the regions has started to pick up pace with 28% already pre-let



Graph source: Savills Research

GRAPH 7

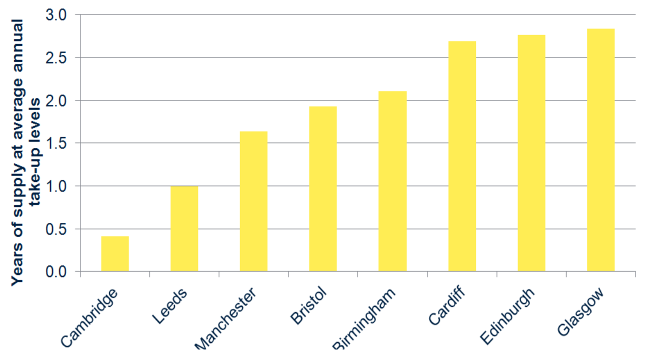
There is predicted positive office-based employment growth over the next five years



Graph source: Savills Research

GRAPH 8

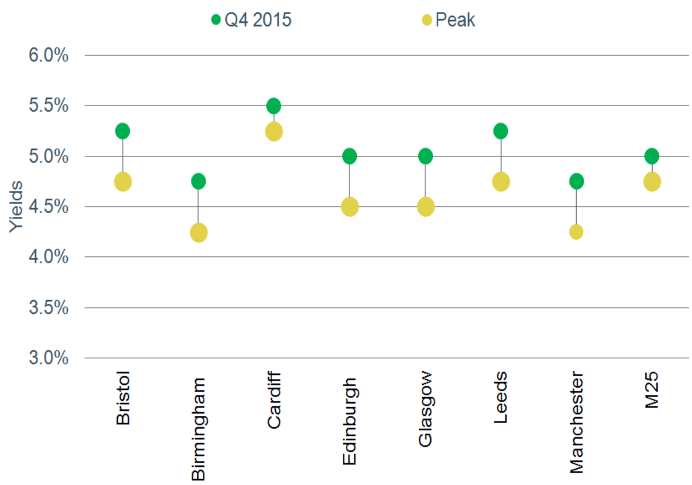
The big regional office markets are all looking under-supplied



Graph source: Savills Research

GRAPH 9

Have prime yields come in as far as they can go?



Graph source:: Savills Research

TABLE 1

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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