RESEARCH

NEWCASTLE

NORTH EAST PROPERTY MARKET REPORT

2017

"The North East has a persuasive message for inward investors. The high calibre of our labour force and graduates provide for current and future staffing, whilst the quality of space both commercial and residential is supportive of an attractive lifestyle."

PETER BOWDEN
Partner, Office Head
Knight Frank Newcastle

FOREWORD

Whilst the EU referendum result has led to an uncertain trading environment, the North East property market continued its recovery in 2016.

Brexit, of course, was just one of many challenges during the year with regional devolution still a hot topic. In the North East there is no clear path ahead, with proposals for a devolution deal alongside an elected regional mayor rejected in September, but reignited by year-end.

Nonetheless, the North East begins 2017 on a positive note. The decision by Nissan to build its new Quasqui and X-Trail SUV models in Sunderland secured not only 7,000 jobs, but also 30,000 in the supply chain. The North East is in fact the only UK region to have a positive trade balance and whilst the falling pound is not good news for all, crucially for the North East, it has helped exports.

In 2016, a market imbalance has developed through rising occupier activity and lack of available space, which has led to the re-emergence of speculative development in the industrial/logistics sector. This is encouraging and illustrates the level of business confidence in the outlook for the region.

Works have now begun at Siglion, a joint venture between Carillion and Sunderland City Council, on the redevelopment of Sunderland's Vaux site. The first building is to be a 60,000 sq ft office block, but the project will encompass both commercial and residential space over a 20-year regeneration period. The theme of redevelopment of former brewery sites continued in Newcastle with further development of Science Central, under a partnership between Newcastle University and Newcastle City Council. In June, Legal & General Capital agreed to partner in the £350m scheme. Such an endorsement from a major fund provides a huge boost for both the project and the wider region.

While the investment market inevitability goes through its varying cycles, investor interest in the North East continued to thrive in 2016. Prime yields held firm throughout the year continuing to offer a relative discount to regional neighbours. Although domestic buyers were most prevalent in 2016, we envisage that the 'buyer pool' will increasingly diversify in the coming year, especially given the favourable exchange rate.

Finally, from a personal perspective it is pleasing that Knight Frank have been active in some of the highest profile and most significant schemes in the region, all of which have created inward investment and jobs in the North East. Knight Frank remains at the forefront of commercial activity and continue to drive regeneration and innovation to support future growth for the region. We are extremely grateful to our clients and fellow professionals who have shared our vision over the past 20 years. I look forward to being part of further successes in 2017 and beyond.

The Rocket, Stephenson Quarter

OCCUPIER MARKET – OFFICES

North East office take-up dipped in 2016, hampered by the uncertain economic environment. Demand has improved in early 2017, leading to a more positive outlook.

Office take-up and demand

Newcastle city centre take-up fell by 15% during 2016 reaching 220,000 sq ft at year-end. Despite this, annual take-up finished marginally below (4%) the long-term average for the city.

Unsurprisingly, Business Services accounted for the largest proportion of city centre take-up in 2016 at 22%. There was also a continued increase in activity in the TMT sector, as the city continues to grow its reputation as a technology hub.

Out of town, total take-up reached 492,000 sq ft, 19% less than in 2015. The North East has attracted an increasing number of 'footloose' occupiers in recent years, but uncertainty in 2016 has meant that projects aimed at furthering inward investment have been delayed.

Key transactions

The 35,000 sq ft letting to Convergys at The Rocket in the Stephenson Quarter was the largest city centre transaction of the year. Developed in partnership by Clouston Group and Newcastle City Council, the building reached practical completion in 2015 and forms part of the first phase of a major mixed-use development.

The most significant deal in the TMT sector was Zerolight's new lease of the entire LiveWorks development on Newcastle Quayside (15,000 sq ft) only months after the building completed.

Out of town, Quorum Business Park secured the largest letting with Sitel taking 47,000 sq ft. Other significant deals included Leeds Building Society moving their regional HQ from Silverlink to Cobalt Business Park and Parseq acquiring 20,000 sq ft at Camberwell House, Doxford Business Park.

Availability

Grade A availability in Newcastle city centre fell by 26% during 2016 to reach 173,300 sq ft at year-end, almost all of which is secondhand space. This total is 23% below the long-term average for the city. The development pipeline over the next two years consists of just 72,000 sq ft split across two comprehensive refurbishment schemes. With the first completion date not until Q4 2017, this means low Grade A availability will continue to be a feature of the market in 2017. The next example of new build space is not due to complete until early 2019, with the planned delivery of 100,000 sq ft at Science Central. Out of town availability is greater with Quorum and Cobalt providing approximately 300,000 sq ft and 260,000 sq ft respectively.

Headline rents

City centre headline rents increased by 5% in 2016 to reach £23.00 per sq ft. This rise followed DAC Beachcroft taking a further 4,500 sq ft at Wellbar Central. Despite the increase, Newcastle still has the lowest prime rent of the major UK regional cities.

Out of town, rents vary between the regional sub-markets. The highest headline rents are at Quorum and Cobalt with £16.00 - £16.50 per sq ft typical.

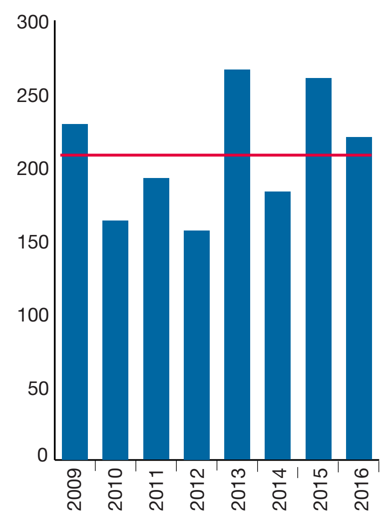
Key leasing transactions 2016

Address	Occupier	Size	Date
Q4 Quorum Business Park	Sitel	47,583	16/Q1
The Rocket, Stephenson Quarter	Convergys	35,000	16/Q2
Cobalt Business Park	Leeds Building Society	20,168	16/Q2
LiveWorks, Newcastle	Zerolight	14,920	16/Q3
Wellbar Central, Newcastle	DAC Beachcroft	4,507	16/Q2

Source: Knight Frank Research

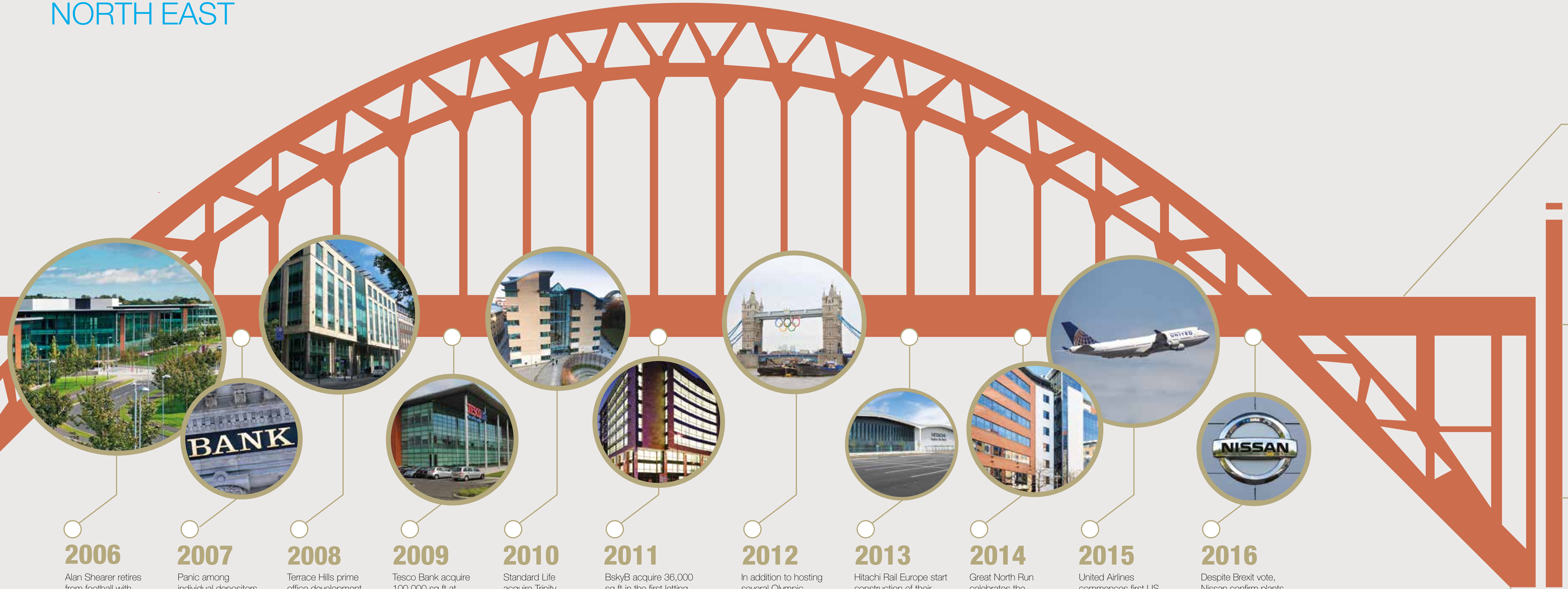
LiveWorks

FIGURE 1
Newcastle city centre office take-up
(000's sq ft)



Source: Knight Frank Research

DEVELOPING THE NORTH EAST



2006
Alan Shearer retires from football with his last game being a 4–1 win at Sunderland. Over 200,000 sq ft of office take-up at Quorum and Cobalt business parks, with occupiers including IBM, EDS and National Grid.

2007
Panic among individual depositors of Northern Rock cause a bank run, the UK's first in 150 years. The bank went into public ownership and is synonymous with the global financial crisis that unfolded in 2008.

2008
Terrace Hills prime office development at Time Central achieves practical completion and is 100% pre-let to Brewin Dolphin & Muckle LLP. Legendary fly-half Jonny Wilkinson leaves Newcastle Falcons for Toulon.

2009
Tesco Bank acquire 100,000 sq ft at Quorum, in one of the region's biggest inward investment projects.

2010
Standard Life acquire Trinity Gardens from the Crown Estate for £50m, in one of the city's largest investment transactions. Modern 40,000 sq ft office at Light House View in Seaham sells for £7.00 per sq ft capital value.

2011
BskyB acquire 36,000 sq ft in the first letting at Moonglade's Wellbar Central office scheme on Gallowgate. The BALTIC Centre for Contemporary Art attracts nearly 150,000 visitors, a record for the Turner prize and heading for double the average attendance in London.

2012
In addition to hosting several Olympic football matches, Olympic related contacts worth £150m were awarded to 42 North East companies. Investment volumes in the North East fall to a cyclical low of only £245m.

2013
Hitachi Rail Europe start construction of their new 470,000 sq ft plant at Newton Aycliffe.

2014
Great North Run celebrates the 1 millionth runner to cross the finish line, and the first edition of the race in 29 years to have a British man, Mo Farah win. 1 St James Gate sold to Aviva investors for £18m.

2015
United Airlines commences first US transatlantic scheduled service from Newcastle International Airport. Newcastle host the Rugby World Cup, hosting games including All Blacks, South Africa and Scotland. First Phase of Stephenson Quarter reaches practical completion.

2016
Despite Brexit vote, Nissan confirm plants to produce the new model of its Qashqai as well as the X-Trail models at its Sunderland Plant. Convergys acquire the Rocket at Stephenson Quarter (35,000 sq ft) whilst L&G confirm their investment partnership in Science Central and Siglion commence construction of the first phase at Vaux in Sunderland.

KNIGHT FRANK VIEW

Offices

The lack of Grade A availability will continue to be the dominant theme in 2017 for Newcastle city centre with only refurbishment schemes set to complete in the next two years. With low supply coupled with an increase in occupier demand, we anticipate prime city centre rents will increase to £24.00 per sq ft by year-end 2017.

The limited supply in central locations is likely to focus occupiers looking for immediate occupation of large floor plates toward out of town locations. The scenario is the same for the wider North East region however, with only Vaux at Sunderland due to complete in the next 24 months. This means that a region-wide supply and demand imbalance will be present in the short-term for Grade A accommodation supporting the negotiating position of landlord's.

Industrial

We anticipate that the continued lack of availability of modern stock will limit overall take-up with the market imbalance creating upward pressure on rents. Despite pressure on margins, the regions manufacturers have maintained a positive stance with an increasing number reporting strong forecasts for new orders in 2017. Combined with evidence of higher rents being achieved this should offer hope to developers that speculative development will become more viable and attract interest. Much will depend of course on a smooth transition through the Brexit negotiations. The strong industrial presence in the North East means that as the government negotiates trade deals, market sentiment may fluctuate through 2017/18 depending on the perceived direction of travel.

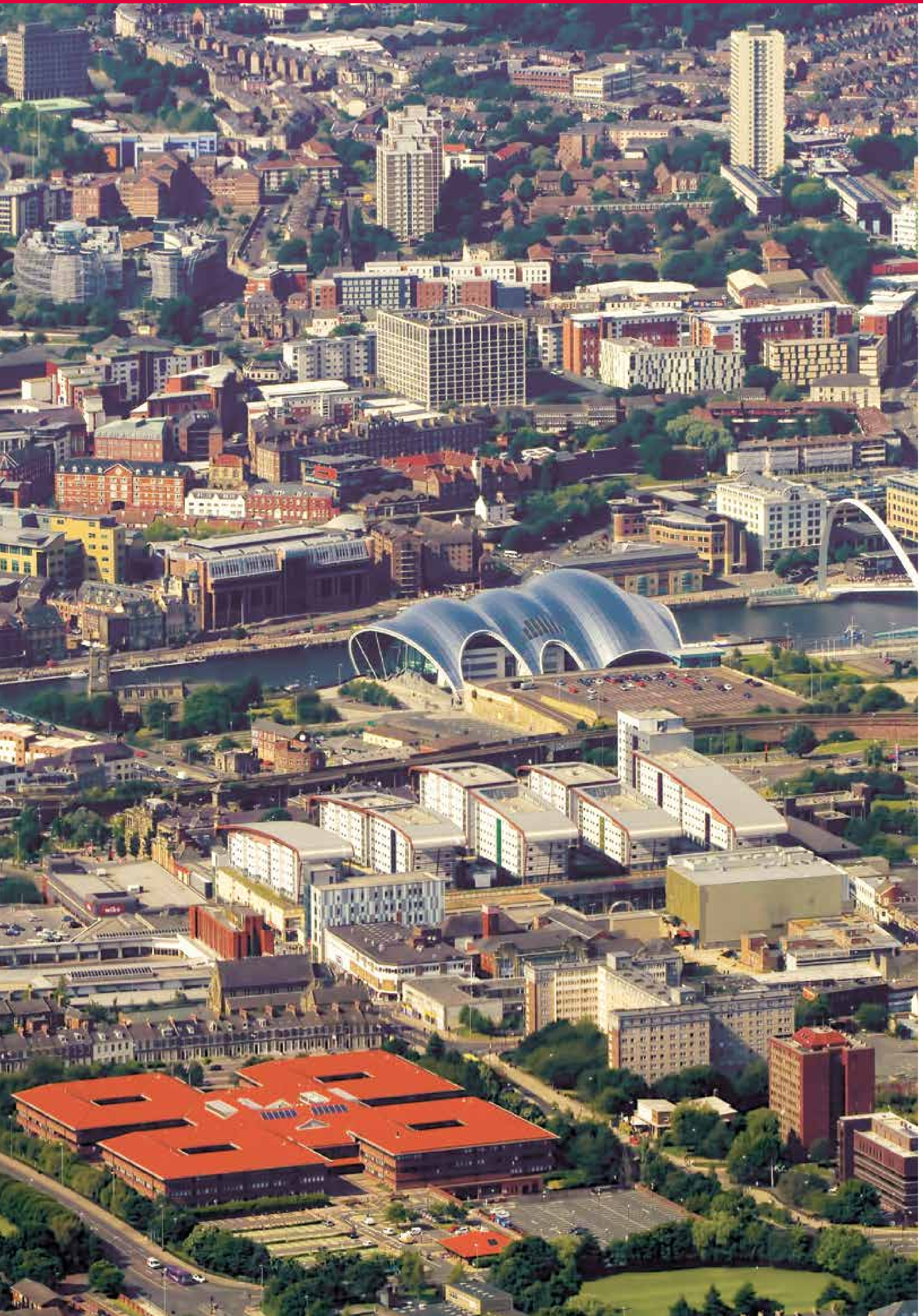
Investment

Given the political and economic events of 2016, it was inevitable that the 'Business Planning Season' at the beginning of 2017 would span all of Q1. Notwithstanding the slow start to the year, the North East Investment market is in a robust state with good prospects for rental growth across the sectors. With this in mind, and the discount on yield from the top six regional centres, we anticipate a strong year in 2017. After two strong years of profit taking, investment volumes are likely to dip slightly however, although a common theme will be the hardening in prime yields as investors continue the flight to prime.

Conclusion

The negotiations related to the UK withdrawal from the EU will be critical to the North East, with a smooth process likely to ensure economic progress in years ahead. With the strong industrial and manufacturing heritage remaining the significant source of employment in the North East, a favourable global trading platform is required to safeguard jobs and in doing so, aid future prosperity.

On the home front, with the prospect of devolution back on the agenda for Newcastle, North Tyneside and Northumberland, the prospect of greater autonomy in spending is growing. This, of course, is not the North East deal that was expected, but would allow the funding of transport and amenity improvements. Fundamentally, connectivity and lifestyle are now a principal consideration for major employers. This means that sustained funding for development in these areas will be vital to maintain a competitive edge.



OCCUPIER MARKET – INDUSTRIAL

Demand slowed before the EU vote meaning take-up remained below historical measure. Confidence recovered by year-end with occupiers revisiting previously shelved investment plans.

Industrial take-up and demand

Take-up of units in excess of 50,000 sq ft totalled only 324,000 sq ft in H1 but more than doubled in the second half of the year with take-up at 795,885 sq ft. In spite of the increased activity, 2016's overall take-up of 1.1m sq ft was less than half the 2015 total.

The EU vote in June served to slow demand overall and raised concerns around the future of Nissan and its supply chain specifically. Importantly, government assurances eased nerves and Nissan gave commitment to build the next generation of Qashqai and X-Trail vehicles at Sunderland.

The fall in oil price also affected the region with a detrimental impact felt by local engineering businesses. Many have consolidated and diversified showing some resilience. OGN Group was one of the largest casualties closing their 465,000 sq ft, 75 acre site albeit acquisition by Smulders has led to a reopening for the manufacture of wind turbine jackets.

At year-end, demand cut across industry sectors. Encouragingly, North East born Etailers are now emerging as a growth area for industrial demand.

Key transactions

The letting of 100,000 sq ft at Cherry Blossom Way in Washington to Amazon at £5 per sq ft was one of the largest transactions and established a new level of rent for a modern second-hand high bay shed in the region.

One of the most significant lettings to establish a new prime rent for the region was the newly built Unit 12, Queens Park on Team Valley (11,614 sq ft). Let to Adept Fasteners, suppliers of components to the aircraft industry, the transaction secured a rent of £8.10 per sq ft.

Availability

At the end of 2016, availability of units in excess of 50,000 sq ft stood at 3.4m sq ft with only 14% of that stock being less than 25 years old.

There remains a shortage of good quality modern units but current rental levels in most areas make development unviable. Currently only one new unit in excess of 50,000 sq ft is scheduled for completion in 2017. Unit L5, Intersect 19 on Tyne Tunnel Estate will deliver 57,425 sq ft with financial assistance secured from the LEP's Local Growth Fund.

Key development sites within Tyne and Wear include Highbridge Properties' 82 acre Indigo Park and Integra 61 at Bowburn in Durham where Citrus Group have outline planning for over 2m sq ft of employment space.

Designated by the UK Government as a nationally significant infrastructure project, the International Advanced Manufacturing Park immediately to the north of Nissan is gathering momentum. Sunderland and South Tyneside Local Authorities have begun the process of procuring a development partner to help deliver the site and the project has secured £42 million in Government funding through the Local Growth Fund.

Headline rents

The lack of modern stock has resulted in upward pressure on rents. The £8.10 per sq ft rent secured on Queens Court, Team Valley represents a new benchmark for a standard B2/B8 unit of between 10,000 and 20,000 sq ft. In the 20,000 – 50,000 sq ft size range UK Land Estates are under offer at £7.45 per sq ft on Team Valley, again setting a new prime rent.

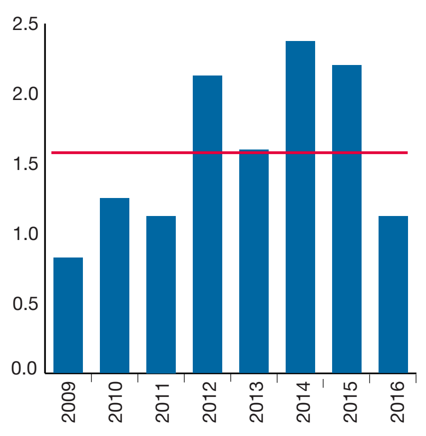
Trade Park rents have recovered slightly with rents at £7 per sq ft plus in well-established prominent locations.

Key leasing transactions 2016

Address	Occupier	Size	Rent/Price	Date
Former Jus Rol premises, Berwick upon Tweed	Countrystyle Foods	157,343	Undisclosed	16/Q4
Coniston Road, Blyth	Tharsus Group	101,347	£10.00	16/Q3
Cherry Blossom Way, Washington	Amazon UK Services Ltd	100,282	£5.00	16/Q2
1 Fiennes Road, Peterlee	Bristol Laboratories	97,778	£3.00	16/Q3
Unit 7 Bentall Business Park, Washington	Timberway Ltd	70,000	£2.15	16/Q1

Source: Knight Frank Research

FIGURE 2
North East industrial take-up
(m sq ft)



Source: Knight Frank Research

INVESTMENT MARKET

The investment market in Newcastle proved resilient in 2016 despite head winds created by the EU referendum and US election. Prime yields held firm and continue to offer an attractive discount when compared to other regional cities.

Offices

Total investment volumes fell marginally (-2%) in 2016 reaching £181m at year-end, 46% above the 10-year average for the city. The completion of two office deals over £50m supported investment volumes in 2016. These two were the first transactions above this threshold since 2010.

The £65m forward funding of Newcastle Science Central (phase 1) between Legal & General Capital, Newcastle City Council and Newcastle University was the largest office investment deal of the year. The £65 million paid is an initial payment and will fund completion of two buildings that, once complete, will offer over 200,000 sq ft of Grade A office space.

The other was the sale of Newcastle University Business School for £60m. Located on a former Scottish & Newcastle brewery site, Aviva Investors acquired the building on behalf of its Lime Property Fund.

UK investors accounted for all office investment during 2016. This represents the highest representation of domestic buyers since 2010. Other domestic deals included the acquisition of Citygate by Ediston Property Investment Company plc for £18.95m reflecting a net initial yield of 6.5% and the sale of Sandgate House by Legal & General for £10.75m which reflected a net initial yield of 5.88% for a new 15 year lease to Ward Hadaway Solicitors.

Sandgate House, Quayside

Prime office yields remained at 6.00% in 2016, now unchanged for three years. At this level, prime yields are 125 basis points above the market peak of 4.75% recorded in 2007 and at a significant discount to other UK regional cities. When one considers the lack of availability of Grade A office space and the supply and take-up dynamics this bodes well for rental growth prospects and confirms Newcastle city centre as a sound location for office investment.

Industrial

Industrial investment volumes in the North East were relatively low in 2016 at £66m. Although this is 54% less than in 2015, the 2016 total is on par with the long-term average. The fall in 2016 however, is symptomatic of a lack of stock available on the market rather than a lack of appetite.

Driving demand is the prospect on future rental growth. Principally, the increased cost of construction is inhibiting any speculative development. This is leading to a significant market imbalance in terms of demand and supply, increasing the pressure on rents.

Notably, yields on single-let units contracted heavily throughout the year with prime yields reducing to 6% for a 10-year term. This is best evidenced by the Knight Frank sale on behalf of Warburg Invest of the Co-op Distribution Centre at Birtley, let to Co-op Group for an unexpired term of 8 years. The purchase price of £17.3m reflected an initial yield of 6.20%.

The multi-let industrial estate sector however, was again the best performing sector on a national basis. The large single ownerships in the North East mean that few estates traded in 2016. Notwithstanding this, this sector of the market remains the most attractive to institutional investors.

FIGURE 3
Newcastle office investment
(£m)

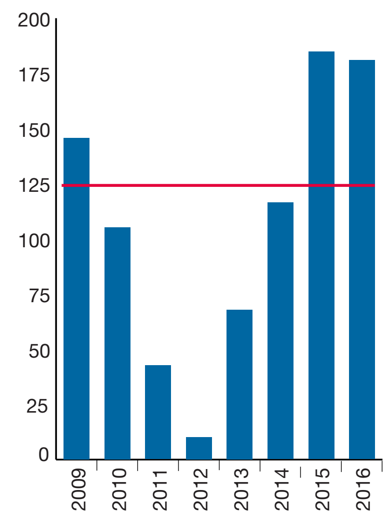
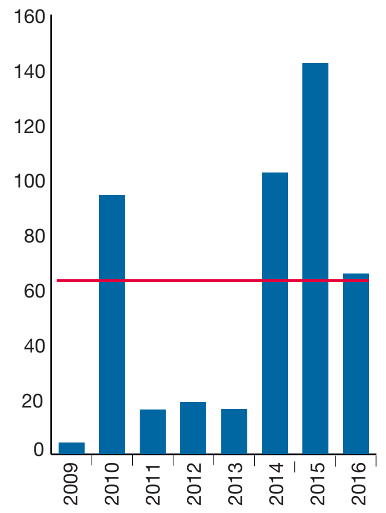


FIGURE 4
North East industrial investment
(£m)



Source: Knight Frank Research / Property data

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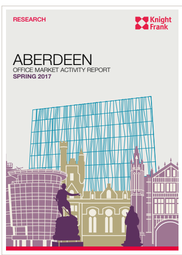

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