RESEARCH

SPRING 2010

# ABERDEEN

## Office market activity report

Knight Frank

## HIGHLIGHTS

- Aberdeen's office market saw very low levels of occupational activity in 2009, with only four transactions in excess of 10,000 sq ft. Annual take-up was just 262,400 sq ft, 30% below the city's medium-term average.
- Despite the downturn in letting activity, and in contrast to other major regional cities, rents have held up well. The city's prime headline office rent has been reconfirmed at £30.00 per sq ft and the discount from headline to net effective rents, which is an average of 20% in other regional markets, equates to only 5% in Aberdeen city centre.
- Investment transaction volumes have also been low in the last year. However, the December sale of the slightly off-pitch BBC Scotland premises at a net initial yield of 6.47% indicates that prime office yields have moved in notably in recent months, and are currently estimated at 6.25%.

# IN CONTRAST TO OTHER MAJOR REGIONAL CITIES, PRIME HEADLINE RENTS IN ABERDEEN HAVE HELD UP WELL.

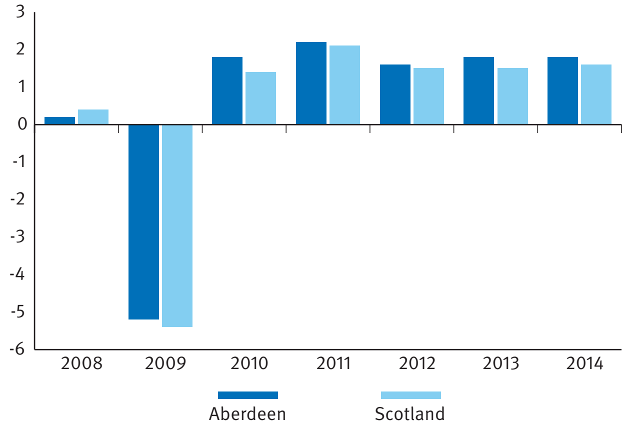

Carlton Rock's letting of 28 Albyn Place to BG Group achieved a prime headline rent of £30.00 per sq ft

## Economic overview

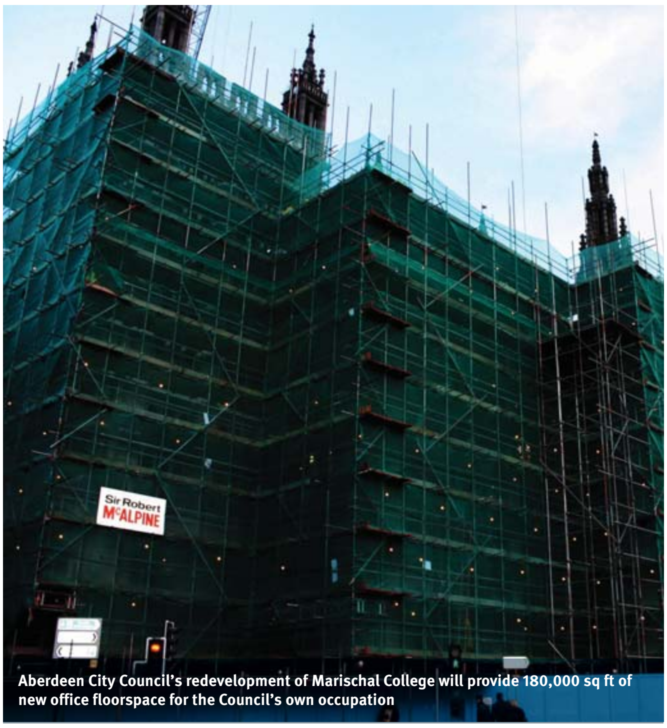
Aberdeen has not been immune from the UK's economic downturn of the last 18 months. However, as the centre of Europe's oil and gas industry, it remains a key driver of the wider Scottish and UK economies and continues to offer opportunities for future growth. Besides oil and gas, the wider city region's key industry sectors include construction, engineering, professional services, education and transport.

Aberdeen's economy is forecast to increase by an average of 1.9% per annum over the next 5 years, or by 9.6% in total during the period 2010 to 2014 inclusive. This is faster than the growth forecast for Scotland as a whole, which is anticipated to be an average 1.6% per annum or 8.3% in total, despite the exclusion from regional output figures of the economic contribution made by offshore oil and gas extraction.

Figure 1
**Forecast GDP growth**
**(% pa)**




Source: Experian Business Strategies



Aberdeen City Council's redevelopment of Marischal College will provide 180,000 sq ft of new office floorspace for the Council's own occupation

## Office occupational market

The high oil prices sustained throughout the majority of 2008 initially protected Aberdeen from the worst impact of the wider economic downturn, and 2008 saw strong cycle-high levels of take-up in the city area of over 505,000 sq ft.

When the fortunes of oil prices reversed in late 2008 and then only partially recovered, this combined with the recessionary environment to produce extremely low transactional activity throughout last year. Only four transactions in excess of 10,000 sq ft were completed in 2009. Activity was instead focused on the smaller size bands and consequently total take-up was 48% down on that achieved in 2008, at just 262,400 sq ft. This is 30% below the medium-term average for Aberdeen of 370,000 sq ft per annum.

Despite the downturn in letting activity, and in contrast to other major regional cities, rents have held up well. The prime headline office rent of £30.00 per sq ft achieved in 2008 was reconfirmed by Carlton Rock's letting of 28 Albyn Place to BG Group in May 2009, following major refurbishment. The 15 year lease incorporated five-yearly break options in the tenant's favour, which is indicative of the changing marketplace. Similarly, Miller Cromdale's letting to Aker Offshore Partner (AOP) of the newly developed Freedom House at Old

Ford Road is for only a five year term, with a tenant's option to extend for a further five years.

Nonetheless, most regional office markets are seeing a discount from headline to net effective rents, which take into account the incentives offered by landlords to tenants, of around 20%. This rises to as much as 33% in over-supplied markets such as Birmingham. In Aberdeen city centre, not only have prime headline rents been maintained at a time when most markets have experienced falling rents, but this has not come at a cost of significant incentives, with a typical city centre deal still offering incentives equating to only a 5% discount, or the equivalent of six months' rent free on a ten year lease.

## THERE IS OVER 1.5 MILLION SQ FT IN THE DEVELOPMENT PIPELINE, BUT ONLY THREE SCHEMES ARE UNDER CONSTRUCTION.

Development completions during 2008 and last year have impacted on the overall supply of office space, with around 656,000 sq ft available at the end of 2009, although only 28% of this space is centrally located. The majority of available office space is in out-of-town locations such as Westhill, Dyce, Bridge of Don and Tullos. As forecast in our 2009 report, this has resulted in a substantial oversupply in Aberdeen's out-of-town markets. By the end of 2009, the vacancy rate for the wider Aberdeen area had risen slightly to 17.5% after a substantial jump in 2008 to 16.0%. In December 2007, the vacancy rate had stood at just 10.4%.

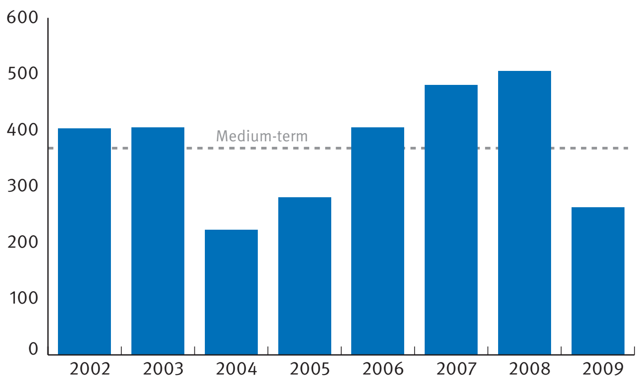
The terms offered by banks for commercial development borrowing remain, generally, unattractive and in many cases make development financially unviable. Consequently most proposed developments have been put on hold and indeed the majority of the core development pipeline detailed in our 2009 report remains unchanged. Given the prevailing lending environment, nearly all are reliant on securing a pre-let and so an upturn in development activity is unlikely until the occupational market improves significantly.

**Xodus took 14,500 sq ft at Princewall House, 50 Huntly Street at a headline rent of £27.50 per sq ft**

Figure 2

**Aberdeen city centre take-up**

**(000s sq ft)**




Source: Knight Frank Research

Table 1

**Key office transactions**

| Address | Tenant | Size (sq ft) | Rent (£ per sq ft) |
|---|---|---|---|
| 28 Albyn Place | BG Group | 13,954 | £30.00 |
| Princewall House, 50 Huntly Street | Xodus Group | 14,500 | £27.50 |
| Freedom House, Old Ford Road | Aker Offshore Partner Ltd | 31,012 | £21.00 |
| 1 Minto Drive | Sword UK Ltd | 12,375 | £16.00 |

Source: Knight Frank Research

Table 2

**City core development pipeline**

| Scheme | Size (sq ft) | Developer | Estimated completion date |
|---|---|---|---|
| City Wharf, Virginia Street | 27,785 | Kenmore (now in administration) | Spring 2010 |
| IQ Aberdeen, Justice Mill Lane | 125,000 | Hazledene | May 2010 |
| Marischal College | 180,000 | Aberdeen City Council | Easter 2011 |
| Triple Kirks | 85,000 | Stewart Milne Developments | Requires pre-let |
| New Horizons House, Waterloo Quay | 53,500 | Waterloo Quay Properties | Requires pre-let |
| Rockwater House, Stoneywood Park, Dyce | 50,913 | Rockwater Property Partnership | Requires pre-let |
| 140 Causewayend | 37,000 | Private Client | Requires pre-let |
| Pilgrim House | 20,382 | Miller Cromdale | Requires pre-let |
| Crathie House, Holburn Street | 18,000 | C&L Properties | Requires pre-let |
| Oakbank School, Midstocket Road | 160,000 | Carlton Rock | Planning consent pending |

Source: Knight Frank Research

At present, there is over 1.5 million sq ft of office schemes in the development pipeline, but only three schemes are under construction. Kenmore's City Wharf is expected to be the first to complete, delivering 27,785 sq ft of new office floorspace to the market in Spring 2010. Hazledene's 125,000 sq ft IQ scheme at Justice Mill Lane is expected to complete in May this year. Finally, construction has begun on the City Council's substantial 180,000 sq ft redevelopment of Marischal College.

Approximately half of the development pipeline is located out-of-town, most of which is comprised of Stewart Milne Developments' Axcess Business Park which is scheduled to provide 750,000 sq ft of office floorspace. The only major new office application submitted during 2009 relates to the development of the former Oakbank School site at Midstocket Road. Carlton Rock intends to provide 160,000 sq ft of new Grade A office space, which will help to redress the balance of city centre offer relative to the large supply of available out-of-town floorspace.

## KNIGHT FRANK VIEW

- 2010 has started positively, with a substantial rise in city centre enquiries. Following the success of 28 Albyn Place, were further newly refurbished West End space to be released in 2010 we would expect prime headline rents to be preserved at £30.00 per sq ft. With none in the pipeline, it may be left to the IQ scheme, currently quoting a headline rent of £27.50 per sq ft, to set the rental tone this year.
- Occupational activity in Aberdeen is dependent on oil, the price of which will need to show sustained recovery for confidence to return. With all pipeline schemes requiring a pre-let, once IQ is let there will be a marked shortage of new space within the city centre core.
- Not so for the out-of-town markets, which remain very over-supplied. We expect these to continue to struggle throughout the year, both in terms of activity and rental levels.

Figure 3

**Regional office prime headline rents**

**(£ per sq ft)**

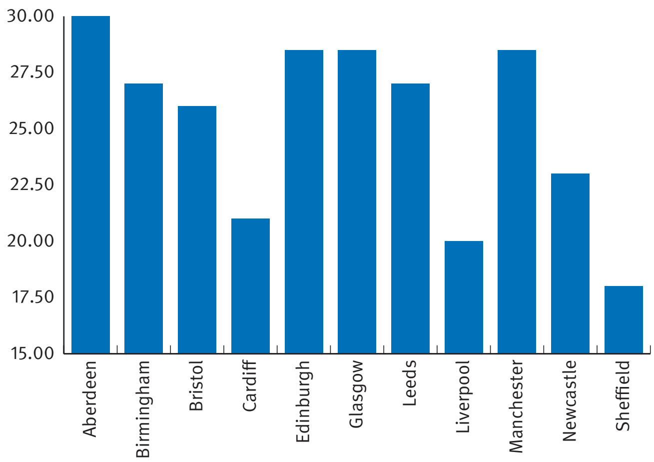
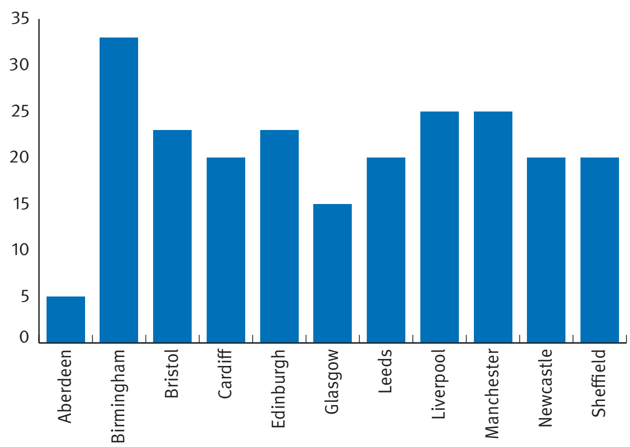



Figure 4

**Regional office discounts to net effective rents**

**(%)**




Source: Knight Frank Research

## Investment market

The UK investment market has improved substantially in recent months, particularly for investors with access to equity, but at the same time fewer assets are now being marketed. Activity remains highly selective and focused on good quality tenure, lease terms and occupier covenant. The scarcity of bank funding has severely hampered activity on riskier assets, although smaller lot sizes are still attractive to cash buyers requiring less funding. Consequently, the differential between prime and secondary yields continues to widen.

Reflecting the lack of demand in the first half of 2009 and the lack of stock in the second half, Aberdeen has seen few notable office investment transactions in the last year. Although not a straight investment transaction, in October 2009 4 Queens Terrace in the city's West End was the subject of a sale and leaseback by Sovereign Oilfield Group on a 10 year FRI lease, and sold for £1.575m and a net initial yield of 7.2%. Had the covenant been stronger, this transaction could potentially have achieved a sub-7.0% net initial yield.

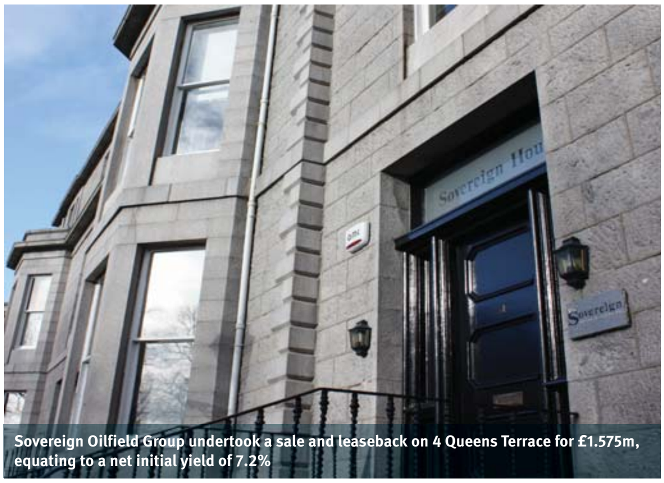
Just two months later, BBC Scotland's premises sold at auction in December 2009 for a capital value of £188 per sq ft. Although the Beechgrove Terrace property is off-pitch, the lease has in excess of 10 years unexpired and the sale achieved a net initial yield of 6.47%. This indicates that prime yields for Aberdeen city centre offices currently stand at around 6.25%.

Out-of-town, key transactions included the National Oilwell Varco (NOV) occupied new-build development at Aberdeen Gateway Business Park, which Stockland Muir Ltd sold in November 2009 for £9.35m. This reflected a net initial yield of 7.75% and it was subsequently re-sold at an improved yield. In February 2010, Stewart Milne sold Acergy's HQ in Westhill to M&G Property Portfolio for £36.0m, a yield of 7.1%.

There has been greater activity at the smaller end of the market, principally out-of-town and driven by local investors. Five units at Gladman's Abercrombie Court, Westhill, have sold or are under offer at yields ranging from 8.25% to in excess of 9.5%, depending on lease length. In January 2010, Unit 8 Abercrombie Court, let for 10 years to a NHS-contracted dentist, sold for £595,200 and a net initial yield of 7.77%, reflecting the longer lease term and good covenant.

The average capital value in 2009 dropped further from its 2008 level of £249 per sq ft to £190 per sq ft. This reflects the dual impact on Aberdeen of the decline in oil prices during late 2008 and early 2009, combined with the wider economic and property recession. Now, and despite the resurgence in the investment market at the end of last year, the key restraint on activity is the lack of stock available to purchase in Aberdeen.


BBC Scotland's premises achieved a net initial yield of 6.47% at auction in December 2009



Sovereign Oilfield Group undertook a sale and leaseback on 4 Queens Terrace for £1.575m, equating to a net initial yield of 7.2%

## KNIGHT FRANK VIEW

- Demand for prime stock will remain strong, with city centre yields stabilising or potentially even hardening marginally from their current level of 6.25%. Smaller lot sizes in out-of-town locations will also continue to see activity from local investors.
- With strong interest from buyers and debt funding available for prime transactions, further price improvement is now principally dependent on supply. However, lending remains restricted where lease terms and covenant strength are less than prime and terms are very stringent even for good quality properties, and so we expect the margin between prime and secondary yields to widen further.

Table 3
**Key investment transactions**

| Property | Size (sq ft) | Price (£ millions) | Net initial yield (%) | Purchaser |
|---|---|---|---|---|
| Acergy HQ, Westhill | 210,500 (116,000 offices) | 36.0 | 7.10 | M&G Property Portfolio |
| NOV, Aberdeen Gateway BP | 40,970 (33,470 offices) | 9.35 | 7.75 | HKIP LLP |
| BBC Scotland, Beechgrove Terrace | 9,135 | 1.72 | 6.47 | Private client |

Source: Knight Frank Research

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**Research**

**Claire Higgins** Partner
Head of Commercial Research
+44 (0) 207 861 1246
claire.higgins@knightfrank.com

**Aberdeen**

**Eric Shearer** Partner
Development & Investment
+44 (0) 1224 415 948
eric.shearer@knightfrank.com

**Katherine Monro** Partner
Disposals & Acquisitions
+44 (0) 1224 415 962
katherine.monro@knightfrank.com

**Allan Rae** Partner
Planning
+44 (0) 1224 415 961
allan.rae@knightfrank.com

**Douglas Garden** Partner
Building Consultancy
+44 (0) 1224 415 940
douglas.garden@knightfrank.com

**Richard Evans** Partner
Valuations & Rent Reviews
+44 (0) 1224 415 952
richard.evans@knightfrank.com


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