RESEARCH

SPRING 2012

ABERDEEN

Office market activity report

Knight Frank

HIGHLIGHTS

- Aberdeen saw record office take-up of 773,175 sq ft in 2011, with occupier demand fuelled by high oil prices and renewed commitments to invest in North Sea oil. Aberdeen's performance also stands out when compared with the UK's other key office markets, few of which recorded above average take-up in 2011.
- Strong occupier demand and an acute shortage of available Grade A space has combined to exert strong upward pressure on headline rental levels. Prime headline rents reached a new record level of £31.50 per sq ft in 2011, and are expected to rise further in 2012, potentially to £34.00 per sq ft by the year-end.
- Aberdeen's buoyant occupier market has prompted a strengthening of investor demand in the city. However, limited availability of prime stock weighed down on transactional activity, with 2011 volumes of £95m almost exactly in line with the 2010 level.

Economic overview

The 'granite city', as Aberdeen is known, is proving to be a particularly appropriate name amid challenging conditions in the wider UK economy. As the energy capital of Europe, Aberdeen is reaping the benefits of the buoyancy of the North Sea oil industry, with high oil prices prompting investment and business expansion. While it could be argued that the city is overly exposed to a single sector, its long term prospects have been boosted by news that £10bn will be invested in the exploration of oil fields at Clair Ridge, to the west of Shetland, which will effectively guarantee oil production until at least 2030.

Aberdeen was also recently placed among a group of five UK towns and cities with the best prospects for private sector investment and economic growth. In its 2012 Cities Outlook report, leading thinktank Centre for Cities revealed that Aberdeen was the only city in the UK to witness net growth in business creation, while the city boasts one of the highest proportions of residents educated to degree level, at 43.5% of the working age population.

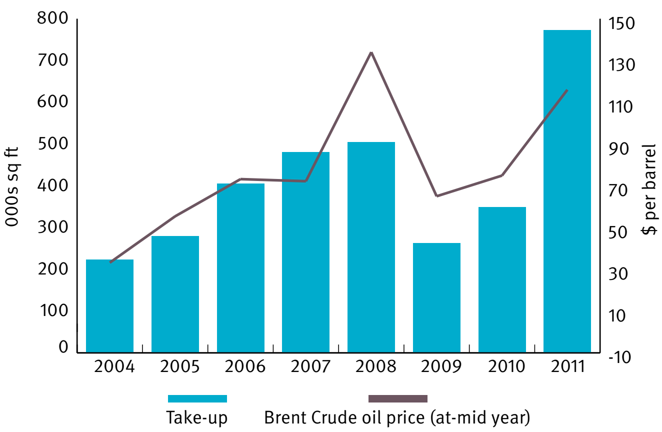
Table 1
Aberdeen: key economic indicators and UK ranking

Criteria	Aberdeen	Rank (out of 64 UK cities)
Economic output per head p.a.	£40,600	1
Business start-ups (per 10,000 pop)	47.7	5
Business stock (per 10,000 pop)	339.0	7
Business churn (per 10,000 pop)	1.0	1
Patents (per 10,000 pop)	15.7	5
High level qualifications	43.5%	5
Employment rate	76.5%	6
Private to public sector employment ratio	3.05	9
Knowledge intensive jobs	17%	14
Claimant count	2.2%	3

Source: Centre for Cities 2012

In 2011, AMEC sub-leased 94,000 sq ft at Seafield House, Hill of Rubislaw, from Shell UK Limited. Knight Frank represented Shell UK Limited.

Figure 1
Aberdeen city centre take-up and oil prices



Source: Knight Frank Research / Thomson Reuters

Office occupational market

Take-up in Aberdeen totalled 773,175 sq ft in 2011, easily surpassing the previous high of 2008 and more than double the 2010 total (Figure 1). The result is all the more impressive considering the performance of the UK's other key office markets, with the majority recording below average levels of activity in 2011 (Figure 2). Aberdeen's office market is unique in the UK for the dominance of the energy sector which, in 2011, accounted for around 70% of take-up.

Almost three quarters of 2011 take-up occurred in the first half of the year, boosted by several large deals in the city core exceeding 50,000 sq ft. In January 2011, Wood Group and Centrica leased 66,584 sq ft and 58,339 sq ft respectively at iQ, Justice Mill Lane. Since March 2011, AMEC has sub-leased a total of 94,000 sq ft at Seafield House, Hill of Rubislaw, from Shell UK Limited, albeit agreed over three separate deals.

Aberdeen continues to command the highest prime headline office rent of any of the UK's 11 key regional markets outside the South East. Prime headline rents are also rising in the city; in November 2011, law firm McGrigors' 16,110 sq ft deal at Queens House in the West End set a new record headline rent of £31.50 per sq ft, surpassing the previous high of £31.00 per sq ft set in Q1 2011 by Centrica's lease at iQ.

Incentive packages are also less generous in comparison with other UK office markets (Figure 3). The discount from headline to net effective rent, which takes into account the incentives offered by landlords to tenants, stands at 5% or under for Grade A space in the city centre, equivalent to a maximum of six months rent-free on a

10-year lease. Recent market evidence also indicates that rent-free incentives stand at just seven months for 15-year leases.

This upward pressure on rental levels reflects the acute shortage of available Grade A space in the city. At the time of writing, Grade A supply stands at a record low of just 9,433 sq ft and is confined to a single building, Dee Bridge House, Leggart Terrace.

Despite the strength of occupier demand, the difficulty of obtaining development finance continues to stifle speculative construction in the city core. Indeed, the only city centre development currently underway comprises Knight Property Group's 6,262 sq ft extension to Queens House, while the last sizeable scheme to be delivered was iQ, which completed in Q1 2011.

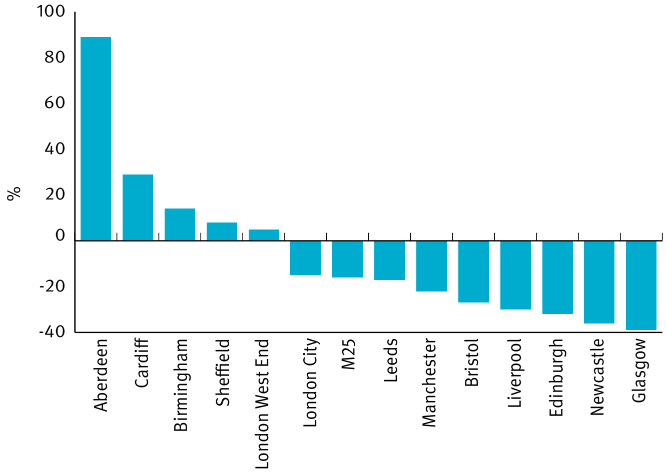
An increasing lack of choice in the city core has diverted more activity to Aberdeen's out-of-town markets, which in 2011 saw seven leasing transactions in excess of 10,000 sq ft. At Westhill, schemes by Knight Property Group and Gladman have attracted occupiers to West Point and Abercrombie Court respectively, with lettings agreed to Kongsberg (25,950 sq ft) and Fairfield Energy (25,504 sq ft).

The Dyce and Bridge of Don areas have also capitalised on the shortage of accommodation available in the city centre with, for example, Schlumberger leasing 25,000 sq ft at Pavilion 1, Aberdeen Business Park, Dyce, and ITS Testing Services leasing over 40,000 sq ft at AWG's Northpoint, Aberdeen Energy Park.

ABERDEEN CONTINUES TO COMMAND THE HIGHEST PRIME HEADLINE OFFICE RENT OF ANY OF THE UK'S 11 KEY REGIONAL MARKETS.

Figure 2

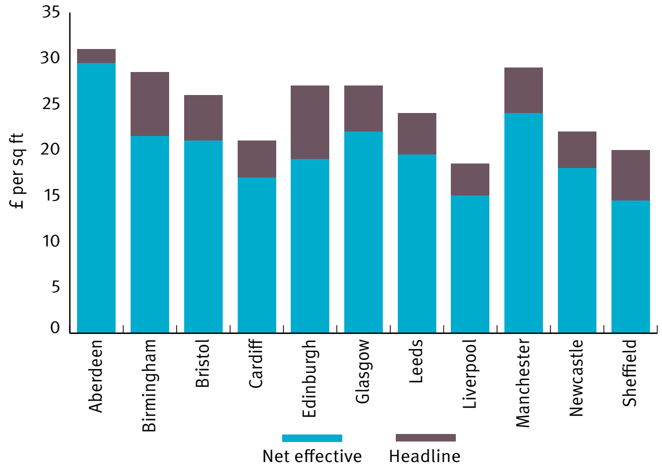
2011 office take-up vs 10-year average



Source: Knight Frank Research

Figure 3

Prime headline and net effective rents



Source: Knight Frank Research

Table 2

Key office transactions in 2011

Address	Tenant	Size (sq ft)	Rent (£ per sq ft)	Date
iQ, Justice Mill Lane	Wood Group	66,000	£25.00	Jan-11
iQ, Justice Mill Lane	Centrica	59,500	£31.00	Jan-11
Pavilion 3, Aspect 32, Arnhall, Westhill	Technip UK Ltd	24,205	£19.00	Feb-11
Seafield House, Hill of Rubislaw	AMEC	94,151 *	£21.25	From Mar-11
Pavilion 1, Aberdeen Business Park, Dyce Drive	Schlumberger Oilfield UK plc	24,798	£15.12	Apr-11
Northpoint (formerly Excel Centre), Aberdeen Science & Energy Park	ITS Testing Services	40,369	£12.00	Aug-11
Gordon House, 27 Rubislaw Den North	Sterling Resources	12,540	£30.00	Oct-11
Pavilion 7, Westpoint, Arnhall, Westhill	Kongsberg Maritime Ltd	25,950	£19.00	Oct-11
Queens House, 13 Queens Road	McGrigors	16,110	£31.50	Nov-11
Abercrombie Court, Westhill	Fairfield Energy	25,504	£17.50	Dec-11

Source: Knight Frank Research *Take-up in three separate tranches

Table 3
Selected schemes in the pipeline

Scheme	Size (sq ft)	Owner/Developer
Pilgrim House, Old Ford Road	20,944	Miller Cromdale
Triple Kirks, Schoolhill	72,600	Stewart Milne Developments
The Pinnacle, Shiprow	100,000	Ardent Group
Aberdeen Gateway Business Park,Cove	150,000	StocklandMuir
Ardent House, North Esplanade West	173,460	Miller Cromdale
St Nicholas House, Broad Street	200,000	Aberdeen City Council
Phase1, Primefour, Kingswells (Nexen, Apache, Transocean)	296,795	Drum Property Group
Aberdeen Energy & Innovation Parks	700,000+	Buccleuch Property
Axcess, Portlethen	750,000	Stewart Milne
D2 Business Park, Dyce	800,000+	Miller Developments

Source: Knight Frank Research

With development finance remaining highly restricted, strong occupier demand has prompted an increase in pre-letting activity. In Q3 2011, NEXEN, Apache, and Transocean agreed to relocate to Phase 1 of Drum Property Group's Prime Four Business Park, Kingswells. Taken together the deals will amount to c.300,000 sq ft of take-up once full planning permission is granted, expected in Q2 2012. GDF Suez is also rumoured to have pre-let 45,000 sq ft at a proposed redevelopment of Riverside Business Centre, at a record headline rent for the Harbourside area of £29.50 per sq ft.

There is currently over 1m sq ft of office space in the pipeline within Aberdeen's city centre, and a significant 3.2m sq ft outside the city (Table 3), over half of which is attributable to two schemes. Miller Developments' D2 Business Park, Dyce has potential for c. 800,000 sq ft, while Aberdeen Energy and Innovation Parks, where Buccleuch Property is the new Joint Venture partner with Scottish Enterprise, has potential for over 700,000 sq ft.


A computer generated image showing the proposal at Triple Kirks, Schoolhill. Image supplied courtesy of architects Halliday Fraser Munro.

KNIGHT FRANK VIEW

- While the UK's occupier markets are expected to see at best average levels of activity in 2012, another strong year lies ahead for the Aberdeen market, backed-up by a number of major outstanding oil-led enquiries. We also anticipate that prime headline rents will increase to a new record of up to £34.00 per sq ft, reflecting the acute shortage of Grade A space in the city centre.
- New build speculative development is likely to remain muted in 2012 given banks' general aversion to financing development. Consequently, strong occupier demand in the city is likely to manifest itself in a notable increase in pre-letting activity.
- The medium to long-term market prospects have also been boosted by BP's commitment to oil exploration at Clair Ridge which should deliver consistent supply for another thirty years. Local transport infrastructure is also improving, with the recent completion of the Aberdeen Airport Extension, and a positive decision expected on the Aberdeen Western Peripheral Route (AWPR) due in the Spring.


In 2011, Centrica and Wood Group leased 59,500 sq ft and 66,000 sq ft respectively at iQ. Aerium also purchased iQ for £50.1m, the largest investment transaction of 2011.

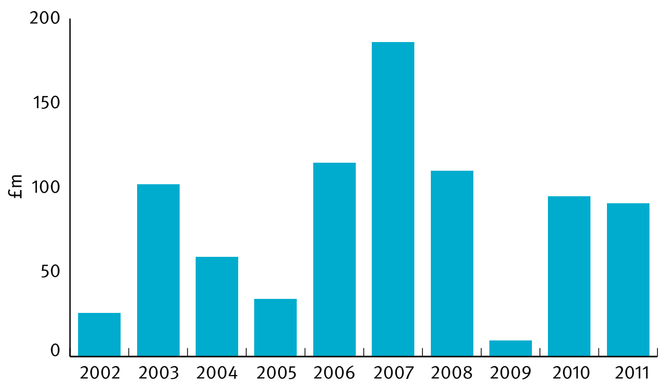
Investment market

Investor demand for Aberdeen offices increased in 2011, with funds and institutions attracted by the relative strength of the city's occupational market and a perception that the market represents good value in comparison with the UK's other regional cities. However, the number of deals concluded was below the peak of 2007, owing to a lack of buying opportunities at the prime end and a divergence in pricing expectations for secondary product.

Investment volumes amounted to £95m in 2011, almost identical to the 2010 level, with five deals accounting for 95% of the total. Over half was accounted for by a single transaction, Aerium Finance's £50.1m purchase of iQ from Hazeldene, reflecting a net initial yield of 6.70%. The 125,000 sq ft new-build was let to Centrica and Wood Group on 15-year leases with fixed rental uplifts at review.

While the market for secondary product remains generally challenging in the UK's regional centres, investors have shown relatively more confidence in Aberdeen's secondary market, with four higher yielding assets changing hands in 2011. As with elsewhere, a marked pricing disparity is evident between prime investments and those that do not possess all the necessary institutional criteria, but where potential exists to add value through asset management.

Figure 4
Office investment transactions



Source: Knight Frank Research/Property Data

For example, Freedom House, let to Aker until August 2014 was purchased by CBRE Global Investors for £6.77m reflecting a net initial yield of 9.0%, while Riverside House, multi-let to three tenants with an average unexpired term of approximately five years, was purchased by Rockspring Property Investment Managers for £11.5m, reflecting a net initial yield of 7.95%. Both transactions had strong imminent reversions due to the continued upward pressure on rental levels.

Out-of-town, the greatest levels of investment activity continue to be seen at Westhill. This was home to 2011's second largest deal, Knight Property Group's sale of three office pavilions and forward funding of a car park at Westpoint Business Park to Invista for £18.7m, reflecting a net initial yield of c.8.5%. The offices were let to TAQA on three separate leases, ranging from two and nine years to break/expiry. In addition, the second phase of Gladman's Abercrombie Court scheme continued to see active interest from private investors looking for sub-£1m lot-sizes.

KNIGHT FRANK VIEW

- We anticipate a stronger level of investment turnover in 2012, with investors attracted to the relatively expansive nature of Aberdeen's oil-driven occupier market compared with the more challenging market conditions evident elsewhere in the UK.
- Prime office stock is also likely to trade in greater quantities, as developers secure pre-lets for office HQ buildings on 15+ year leases to strong covenants, a trend not prevalent in many other regional office markets at present. This is already being seen, with the anticipated forward funding sales of the three Prime Four investments at Kingswells.
- While there is limited openly-available secondary stock on the market, we are aware of a number of buildings available 'off market'. With the occupier market set to remain both buoyant and tightly supplied, we expect more investors to enter the market for good quality, secondary properties with strong reversionary potential and/or asset management opportunities.

Table 4
Key investment transactions in 2011

Property	Size (sq ft)	Price (£ millions)	Net initial yield (%)	Purchaser
Freedom House, Old Ford Road	31,706	6.77	9.00	CBRE Global Investors
Cromarty House, Regent Quay	23,000	3.57 *	8.70	CBRE Global Investors
iQ, Justice Mill Lane	124,923	50.10	6.70	Aerium
Riverside House, Riverside Drive	52,745	11.50	7.95	Rockspring Property Investment Managers
TAQA offices, Westhill	145,840	18.70	c.8.50	Invista

Source: Knight Frank Research *Apportioned price as part of portfolio acquisition

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