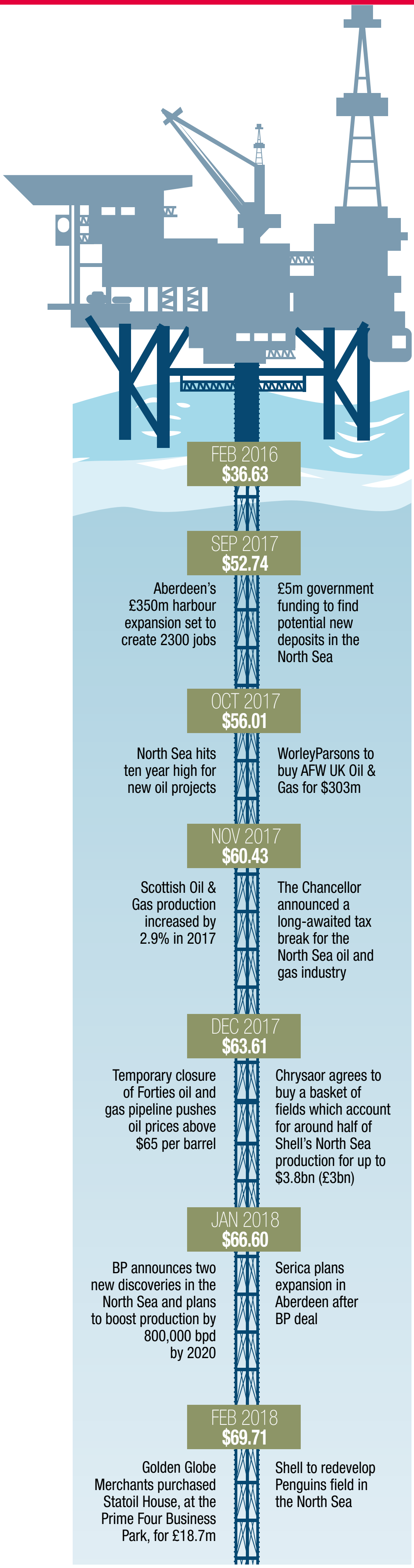
RESEARCH

Knight Frank

ABERDEEN

OFFICE MARKET REPORT

SPRING 2018



Source: Knight Frank Research
Spot price 1st of each month

ECONOMIC OVERVIEW

The Aberdeen economy enters 2018 with cause for guarded optimism.

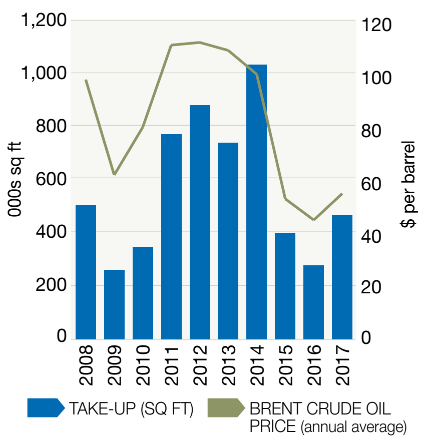
Oil is the city's main growth driver, and in early March, Brent crude was trading at around the US$64.00 a barrel mark, up by 16% on a year earlier. A recent poll of 37 oil market analysts conducted by Reuters suggests that prices by the end of the year are expected to be around the present level. Price stability would offer certainty to oil firms operating in Aberdeen, and allow them to plan for the future. This improves the chances that companies with upcoming lease expiries might initiate searches for new office space.

The uncertainty surrounding Brexit presents a significant headwind for the UK economy. Oxford Economics are forecasting UK GDP to expand by 1.5% in 2018, marginally down on the 1.7% figure recorded for 2017.

Contrary to press reports, new economic opportunities for Aberdeen are emerging, particularly in regard to the task of decommissioning the first generation of North Sea oil platforms. Construction has begun on the harbour extension at Nigg Bay that will allow the city to claim a share of this new business. Also, the University of Aberdeen and Robert Gordon University (RGU) are co-operating to offer the world's first Masters degree in decommissioning, while RGU has built a simulator to allow oil company workers to practice well plugging. The degree course and the simulator show Aberdeen is further expanding as a centre of expertise for the oil industry, which allows the city to export specialist knowledge to other global oil markets.

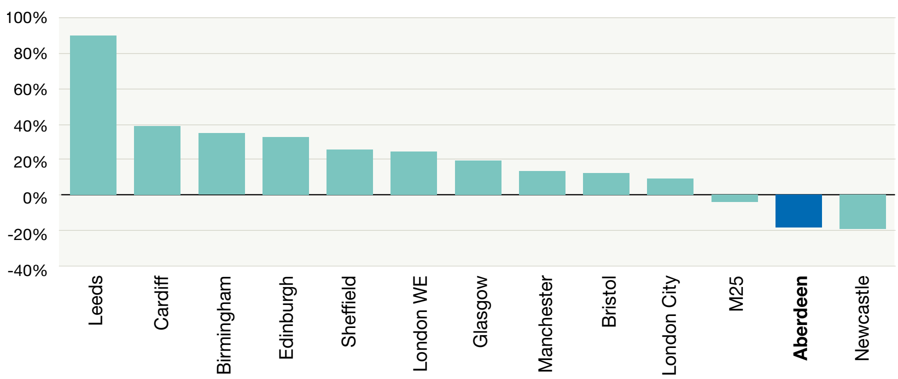
The city should also see reduced traffic congestion, as the new £745 million Aberdeen Western Peripheral Route is expected to open this year. Over the medium to long-term, new investment will support the city's leisure economy, with plans for a new Aberdeen FC stadium, and the new £333m Aberdeen Exhibition and Conference Centre, which is scheduled to open next year.

FIGURE 1
Aberdeen office take-up and oil prices



Sources: Knight Frank Research / Thomson Reuters

FIGURE 2
2017 take-up vs 10 year average



Source: Knight Frank Research

Aberdeen 10-year average: 569,699 sq ft

OCCUPIER MARKET

With the worst of the Oil & Gas downturn now past and most rationalisation programs seemingly complete, occupier activity showed steady improvement in 2017.

As with previous Oil & Gas cycles, once the oil price starts to increase and projects are reviewed with the prospect of ramping up production again, this leads to new employment, which in turn leads to new requirements for office space.

Office take-up reached 468,000 sq ft by year end, a total that, although 18% below the 10-year annual average, reflects a 68% increase when compared to 2016.

The reported rise was underpinned by three large deals. The largest of which saw 138,500 sq ft taken by Total E&P UK at West Campus, Westhill. Although agreement was reached in March 2017, the energy firm only moved into the property in Q4 2017 following refurbishment of the building.

The second largest letting saw Somebody Cares relocate to another large secondary office in Aberdeen. The charity agreed terms on a new lease of 51,000 sq ft at John Wood House.

In May, Chrysaor Holdings Limited, took over 47,700 sq ft at The Capitol on Union Street for their North Sea Operations HQ. Since opening in 2016, 85% of available space has now been let in the £30m award winning redevelopment of the former cinema. Other tenants in the building include Price Waterhouse Coopers (PWC) and Dentons UKMEA LLP.

Many occupiers took advantage of "the tenant friendly" market conditions throughout 2017 to re-negotiate the terms of their existing lease with their landlords (nervous about potential long void periods and large empty rates bills) on more favourable terms in return for extending or renewing their lease duration after first circulating requirements in order to "test the market". This lead to a number of requirements being later withdrawn from the market.

The number of active requirements at the end of 2017 stood at 50, although the vast majority (39) of these were for sub 5,000 sq ft. However, we have seen a small number of larger requirements of 10,000 sq ft and above return to the market following recent positive announcements from operators in the Oil & Gas sector regarding contract wins and new exploration.

In terms of supply, levels have remained at over 2.5 million sq ft over the course of the year with no signs of this figure reducing significantly in the short term. City Centre offices continue to dominate supply, accounting for 43% of the market allocation. Marischal Square was the last of the new developments to reach practical completion in December 2017. We are seeing healthy enquiry levels for Grade A city centre offices that will "soak up" some of the new build and refurbished stock. The bulk of the Grade 'C' space (over 558,000 sq. ft) is no longer "fit for purpose" and should be considered for re-development or alternative use.

A combination of development completions and 'grey space' coming back to market meant a further rise in vacancy was recorded in 2017. Grade 'A' availability increased to 753,800 sq ft during the year, a total twice that of the long-term average. This is the highest level on record for the city, but this total, should represent the peak in vacancy with the development pipeline consisting of proposed schemes only at this time.

In 2017, prime headline rents held firm at £32.00 per sq ft, albeit occupier incentives remain particularly attractive. Rental values are expected to come under pressure in 2018 driven by a continued supply and demand imbalance.

The Capitol

TABLE 1 **Key office transactions in 2017**

Address	Tenant	Size (Sq ft)	Rent (£ per sq ft)
Office & Leisure Building, West Campus, Arnhall Business Park, Westhill	Total	138,535	£21.00
John Wood House	Somebody Cares	51,153	Nominal rent
The Capitol, Union Street	Chrysaor Holdings Ltd	47,657	£32.00
395 King street	TuaRx Therapeutics Ltd	12,386	All-inclusive rent
H1, Hill of Rubislaw	Siccar Point Energy Ltd	7,730	£23.00

Source: Knight Frank Research

INVESTMENT MARKET

Following a subdued market in 2016, the gap between buyer and seller expectations finally began to close in 2017. Office investment volumes for the year were £98.8m, the highest total achieved since 2014.

In the run up to the 'snap' general election in June the market contended with what has unfortunately become normal political uncertainty. However with the possibility of a second Scottish Independence Referendum having abated there have been notable signs of increased confidence in the market and investor sentiment towards Scotland as a whole. The most tangible signs have generally been in the Central Belt, however during M&G's sale of the West Campus at Westhill, we saw the price quoted for the asset increase as a direct result of the election result as UK Funds increased their valuations of Scottish assets. The investment was originally marketed for £38.75m (8.01%) in March and sold in November for £39.38m (7.88%) with an unexpired term of 11 years.

The Aberdeen market did witness an increase of 419% when compared to the cycle low of 2016, albeit it was propped up by one sale, which was driven from a pre-let agreed prior to the oil price crash in 2014. This was the 105,594 sq ft office let on a 15 year lease to Lloyds Register by developer Drum Property Group at Prime Four Business Park. This sale, together with the subsequent sale in January 2018 of the Statoil office (also 15-year lease) at Prime Four has shown the continued success of the Park to attract investors and the demand for well-let high quality stock. The last six months have also seen two of the largest property investments for Aberdeen come back to the market – the Aker HQ, Dyce for £114.9m (6.75%) and City Park (Sir Ian Wood House), Altens for £81.20m (6.75%).

Prime office yields remained at 6.50% in 2017, meaning prime assets in Aberdeen still offer a considerable discount when compared to other regional centres. Notably, at this level, yields are 100 basis points above the market peak of 5.50% recorded in 2007. Despite some improvement in sentiment, pricing is expected to remain stable in the coming 12 months

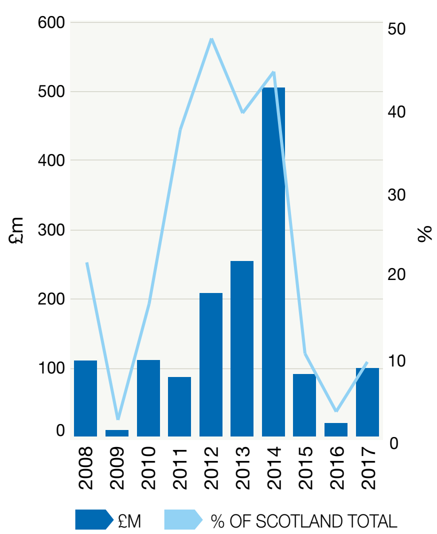
Secondary pricing on the other hand is highly variable. As buyer and sellers expectations began to converge, we did see a limited number of transactions with short to medium term income take place. The purchases by FCFM Group of Quattro House and Trafalgar House, both in Altens, showed the true differential in pricing for some assets, which had short/medium term income and tenants not in situ. Over the longer term, the removal of a number of secondary office buildings from the market can help occupancy rates and market recovery. The sale of Denburn House on Union Terrace within the City Centre for conversion to a hotel / aparthotel is one of the early examples of such with an expectation that as sellers reduce their price expectations further redevelopment of offices will become viable.

TABLE 2
Key office investment transactions in 2017

Address	Size (Sq ft)	Price (£m)	Net initial yield (%)	Purchaser
Lloyds Register, Prime Four, Kingswells	105,594	£41.28m	6.68%	LCN Purchasers
West Campus, Westhill	211,773 (113,951 office)	£39.38m	7.88%	Gulf Islamic Investments (GUI)
Quattro House, Altens	44,996	£7.70m	12.22%	FCFM Group
Ensco House, Gateway Business Park	25,802	£6.5m	7.34%	Private Investor
Trafalgar House 1&2, Altens	95,661	£4.00m	30.48%	FCFM Group

Source: Knight Frank Research

FIGURE 3
Aberdeen offices investment volumes



Source: Knight Frank Research/Property Data

West Campus, Westhill was the subject of the largest letting and second largest sale of 2017

KNIGHT FRANK VIEW

Occupier market

- Sentiment in the industry is cautiously optimistic, however despite the oil price reaching a high of $67.00 per barrel at the close of December 2017, there will inevitably be a significant time lag before we witness a tangible improvement in the occupational market.
- Early indications for 2018 are encouraging with many occupiers seeing the current imbalance of supply over demand being a great "buying" opportunity. Trend for the year is likely to be a continued interest by occupiers in new space in the City Centre.
- The bulk of the Grade 'C' space is no longer "fit for purpose" and should be considered for re-development or alternative use.

Investment market

- The offer of favourable pricing when compared to regional competitors, in addition to signs of an improving occupier market, is slowly beginning to fuel renewed investor interest.
- Despite an upturn in sentiment by UK Funds to Scotland, we expect overseas investors to continue to dominate the market.
- As the market begins to recover, we would expect to see greater numbers of investments traded compared to the past couple of years.

RESEARCH

Lee Elliott Partner
Head of Commercial Research
+44 20 7861 5008
lee.elliott@knightfrank.com

Darren Mansfield Associate
+44 20 7861 1246
darren.mansfield@knightfrank.com

ABERDEEN

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

Matthew Park, Senior Surveyor
Disposals & Acquisition
+44 1224 415 951
matthew.park@knightfrank.com

Chris Ion Partner
Investment, Disposals & Acquisitions
+44 1224 415 969
chris.ion@knightfrank.com

Richard Evans Partner
Valuations & Lease Advisory
+44 1224 415 952
richard.evans@knightfrank.com

Grant Hendry Associate
Building Consultancy
+44 1224 415 963
grant.hendry@knightfrank.com

Malcolm Campbell Associate
Planning
+44 1224 415 949
malcolm.campbell@knightfrank.com

Fiona Alsop Associate
Management
+44 1224 415 944
fiona.alsop@knightfrank.com

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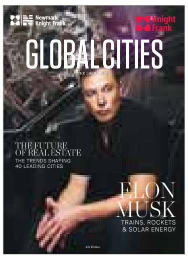

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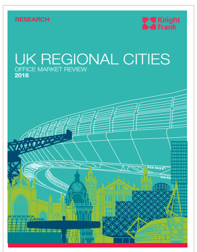

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