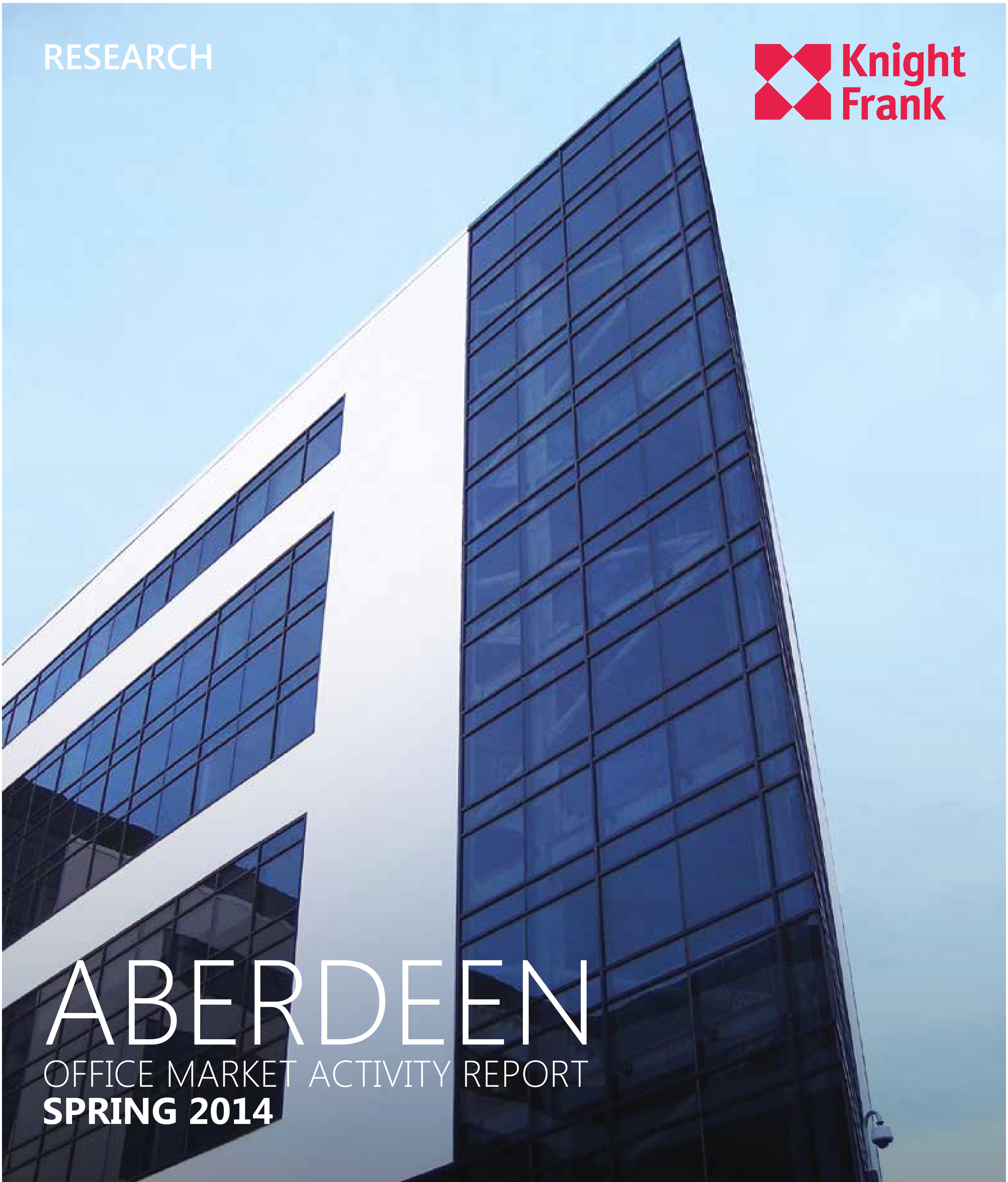
RESEARCH



ABERDEEN
OFFICE MARKET ACTIVITY REPORT
SPRING 2014

HIGHLIGHTS

Underpinned by record levels of investment in the North Sea oil and gas industry, Aberdeen recorded a third consecutive year of impressive office take-up, reaching 740,000 sq ft in 2013.

Reflecting developer confidence in the market, a host of schemes are set to be brought forward speculatively within the city core during 2014.

The investment market enjoyed another record year of turnover in 2013, backed by its thriving occupier market and fuelled by substantial capital inflows among the UK funds.

ECONOMIC OVERVIEW

Amid a long and difficult period for the wider UK economy, the relatively strong performance of Aberdeen's own economy in recent years has been intrinsically linked to the fortunes of the North Sea oil and gas industry.

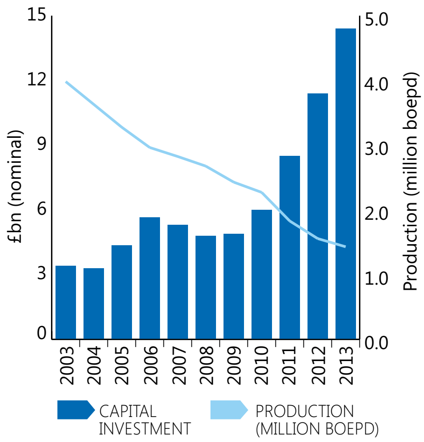
"The future of North Sea oil and gas is one of the key campaign battlegrounds ahead of the Scottish independence referendum."

The city's economy is currently benefiting from a wave of fresh investment into the sector, which in 2013 reached £14bn, the highest annual total in real terms since the mid-1970s.

The investment has been stimulated by UK Government fiscal measures, including tax allowances on mature oil fields and tax relief for decommissioning costs. This is absolutely critical in increasing the viability of extraction and boosting levels of production, which has fallen by 38% since 2010. The Government also plans to implement the key recommendations set out in the Wood Review, which argues that greater collaboration across the industry is required in order to maximise the potential of the North Sea's remaining reserves over the next 50 years.

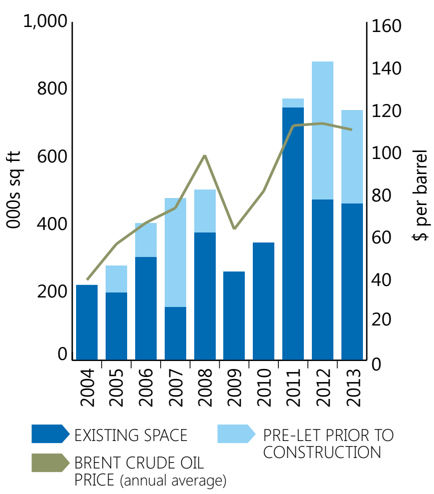
The future of North Sea oil and gas is one of the key campaign battlegrounds ahead of the Scottish independence referendum in September 2014. There are understandably concerns that the uncertainty surrounding the outcome of the referendum may delay key decisions on investment, relating to the oil industry and the wider economy more generally. Regardless of the outcome of the vote, above all investors are seeking certainty and clarity.

FIGURE 1
North Sea oil and gas: Production and Investment



Source: Oil & Gas UK

FIGURE 2
Aberdeen office take-up and oil prices



Source: Knight Frank Research / Thomson Reuters

The occupier market's largest deal in 2013 was EnQuest's 120,000 sq ft pre-purchase of The Grande, Palmerston Road. The development is under construction and will be ready for occupation in Q1 2015.

OCCUPIER MARKET

Unprecedented levels of investment in the North Sea oil and gas industry resulted in a third consecutive year of impressive take-up in the Aberdeen market, reaching 740,000 sq ft in 2013. The energy sector has dominated occupier activity in each of the last four years, and in 2013 accounted for almost 80% of all the space transacted.

With an ongoing shortage of existing supply, pre-committed space featured prominently among the larger transactions. 2013 saw seven pre-let / pre-sale agreements, which combined accounted for a significant 43% of 2013's total take-up. However, not to underplay the importance of smaller occupiers in driving the market, 65% of 2013's 85 deals were below 5,000 sq ft.

The largest deal of 2013 took place in the North Dee Business Quarter (NDBQ), where EnQuest agreed to pre-purchase 'The Grande' from Drum Property Group, a new HQ building totalling 120,000 sq ft. Another of Drum Property Group's developments also attracted a significant pre-commitment in 2013, with Premier Oil agreeing to pre-let 63,000 sq ft at Phase 2, Prime Four, Kingswells.

Reflecting the strength of demand, a significant proportion of new speculative development has attracted occupiers prior to practical completion. Last year, AMEC acquired two pavilions at Knight Property Group / M&G's City View Business Park, West Tullos, totalling 33,500 sq ft, and is presently understood to be under offer on a third pavilion of 35,500 sq ft at the site.

An acute shortage of supply remains a persistent theme in the market, and it is notable that space previously shunned by occupiers has now been taken up. For example, in Q3 2013, Aberdeen Appointments Agency acquired 9,400 sq ft at Dee Bridge House, Leggart Terrace, a building which, owing to its relatively off-pitch location, had remained vacant for four years following completion.

Total current office availability in Aberdeen equates to a vacancy rate of only 3.5%, which is lower than any of the UK's key office markets. Aberdeen is also unique among the UK's office markets in that there is – at the time of writing – no Grade A space available in units above 10,000 sq ft in the market.

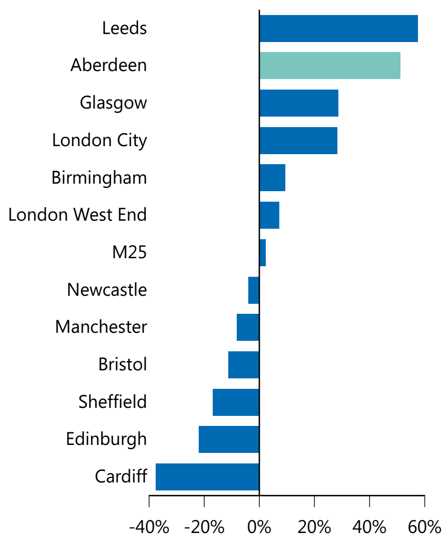
"Current office availability in the city equates to a vacancy rate of only 3.5%, which is lower than any of the UK's key office markets."

TABLE 1
Key office transactions in 2013

Address	Tenant	Size (sq ft)	Rent (£ per sq ft)	Date
Pavilion 4, Prospect Park, Westhill	Proserv	23,358	£23.50	Apr-13
Phase 2, Prime Four, Kingswells	Premier Oil	63,180	£27.75	May-13
Kirkgate House, Upperkirkgate	Atkins	17,638	£24.00	May-13
Aberdeen Gateway Business Park	Ensco	25,000	£20.25	Oct-13
The Grande, Palmerston Road	EnQuest	120,000	Purchase	Oct-13
Pavilion 1 & 2, City View Business Park	AMEC	14,090 / 19,339	£24.00	Oct-13 / May-13
Grampian House, Union Row	Dana Petroleum	45,543	£21.95	Nov-13

Source: Knight Frank Research

FIGURE 3
2013 office take-up vs 10-year average



Source: Knight Frank Research

"Underlining developer confidence in the market, a host of schemes are also set to be brought forward speculatively during 2014."

At £31.50 per sq ft, Aberdeen continues to command the highest prime headline rent of any office market outside London and the South East. Ironically, despite the strength of the market, it has remained unchanged at this level for the past two years, a situation which reflects the dearth of new supply in the city core and a consequent absence of any transactions to confirm pricing. That said, at the time of writing, 9,000 sq ft is under offer at 20 Queens Road in the West End, at a rent rumoured to be at £32.00 per sq ft.

Rental growth has nonetheless been more clearly evident outside the city core, with occupiers opting to relocate out-of-town in order to satisfy their requirement for new-build space. Headline rents in Westhill and Kingswells have increased by over 25% during the past two years, to stand at £24.00 and £27.75 per sq ft respectively, eroding much of the price differential that traditionally existed between the city core and out-of-town locations.

Landlords in the city also continue to benefit from extremely limited incentives, regardless of location. Generally, a maximum of just three months is offered on a fifteen year FRI term, although in many instances no rent free period has been seen. While evidence suggests that incentives are starting to harden in the UK's other regional office markets, they typically range between 24 and 36 months for an equivalent term, quite unlike the situation in Aberdeen.

Two out-of-town developments have come forward speculatively during 2013, namely City View, West Tullos and Kingshill Business Park, Westhill, although this has hardly been sufficient to address the city's acute shortage of supply. However, this situation is set to change dramatically. According to figures from Aberdeen City Council, 873,500 sq ft of office space was awarded detailed planning consent in 2013, a six-fold increase on 2012's figure.

Underlining developer confidence in the market, a host of schemes are set to be brought forward speculatively during 2014. Moreover, c.525,000 sq ft is set to commence construction within the city core, and this will undoubtedly redress the supply issue in 18 to 24 months (details of key schemes provided overleaf).

Notably, however, SWIP and Manse's 48,500 sq ft refurbishment of AB1, Huntly Street is set to be the only "New" space delivered in the city core during 2014. The timing of the scheme means it is well-placed to capture the strong pent-up demand for space in the city core.

SWIP and Manse's 48,500 sq ft refurbishment scheme, AB1, Huntly Street, is the only development set to be delivered in the city core during 2014.

KNIGHT FRANK VIEW

- Substantial investment in the North Sea oil and gas industry will continue to drive strong levels of office demand. With several major pre-let commitments already confirmed, we are confident that 2014 will be another record year for the market, with take-up surpassing 2012's previous high to reach an impressive c.1m sq ft.
- The revival of speculative development represents a fundamental change to the market, particularly within the city centre which has long been starved of new Grade A supply. The increased appetite for development risk reflects developers' confidence that strong occupier demand will be sustained, with expectations that occupiers will take space prior to completion.
- Despite the likely arrival of several developments two years from now, the demand for space in the city is likely to push headline rents to a new high. We expect prime rents to reach c. £34.00 per sq ft during 2015, following the completion of the key city centre schemes.

KEY CITY CENTRE DEVELOPMENTS

The Silver Fin, Justice Mill Lane

Titan Investors
132,000 sq ft (speculative)

The Capitol, Union Street

Knight Property Group
74,000 sq ft (speculative)

AB1, Huntly Street

SWIP & Manse
48,500 sq ft (speculative refurbishment)

Pilgrim House, North Esplanade West

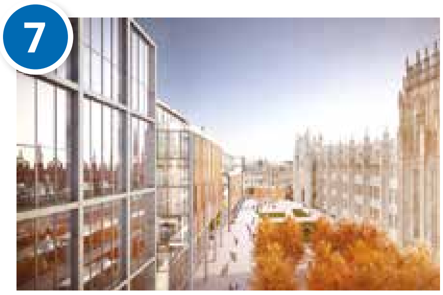
Miller Cromdale
27,094 sq ft (50% pre-let to Food Standards Agency)

The Grande, Palmerston Road

Drum Property Group
120,000 sq ft (pre-sale to EnQuest)

The Point, Schoolhill

Dandara
78,000 sq ft (speculative)



Marischal Square, Broad Street

Muse Developments
c.200,000 sq ft (speculative)

Ardent West, North Esplanade West

Miller Cromdale
47,198 sq ft

INVESTMENT MARKET

Aberdeen enjoyed another record year in 2013, backed by its thriving occupier market and fuelled by substantial capital inflows among the UK funds. Volumes reached £254m for the year, eclipsing 2012's high by 23%.

"With its active pre-let market, Aberdeen has provided a key UK foothold for investors looking to source long-income stock let to strong covenants."

Despite a welcome return of investment demand across the UK's regional office markets, Aberdeen was the only city to see a record level of office investment during 2013. Activity was dominated by the funds, a number of whom made their debut purchase in the city. Within the national context, Aberdeen accounted for 43% of Scotland's total volumes in 2013, set against a ten-year average of 20%.

With its active pre-let market, Aberdeen has provided a key UK foothold for investors looking to source long-income stock let to strong covenants. For example, Technip undertook a 20-year sale and leaseback of their new HQ at Westhill, a deal which is rumoured to have received eight offers at the closing date prior to selling.

However, 2013's largest transaction was for medium-term income, where Legal & General purchased Union Plaza from Stewart Milne for £54.82m, equating to a yield of 6.30%. The 100% occupied multi-let building carried a weighted unexpired lease term of c.7.5 years.

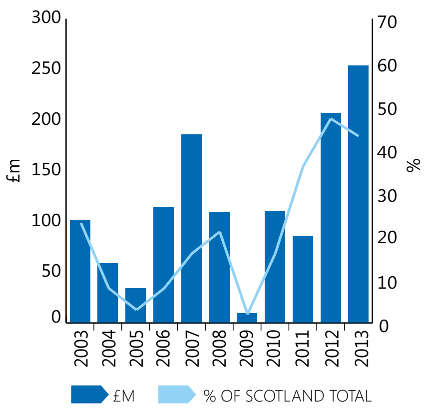
Nevertheless, with prime stock in short supply relative to demand, it is telling that 2013 also saw two prominent deals to forward-fund two speculative developments on Union Street, namely The Silver Fin and The Capitol, which together amounted to £100m. These deals underline investors' determination to 'buy into' the city on the back of its strong occupier market.

Prices for regional offices have increased significantly since the middle of 2013, driven by an influx of capital and a desire among investors to seek the better value that the regions are perceived to offer compared with London and the South East. While most markets lacked the prime stock to confirm pricing, Aberdeen saw enough evidence to confirm that yields for prime 15-year income hardened by 50bps in H2 2013 to stand at 6.00%.

Notably, five of Aberdeen's nine transactions in excess of £10m were located out-of-town. While institutional investors have traditionally lacked the confidence to invest here, the recent trend for occupiers to relocate from the city core has firmly established it as a mainstream investment location among institutional investors.

The proliferation of large deals has been central to Aberdeen's record year of

FIGURE 4
Office investment transactions



Source: Knight Frank Research/Property Data

In December 2013, Knight Frank advised Legal & General over their £54.82m purchase of Union Plaza. The transaction was one of the biggest deals in the UK's regional markets during 2013.

turnover. However, buyers for smaller sub-£2m lot-sizes have been left frustrated by a severe lack of buying opportunities. Gladman's Abercrombie Court, Westhill is in fact the only new-build investment opportunity to arrive in this segment of the market in recent years.

With a shortage of willing sellers and an affluent local population, there is strong pent-up demand from private investors and small property companies for this type of product. Moving forward, however, schemes such as Dandara's City South should help to satisfy some of this demand.

"Buyers for smaller lot-sizes have been left frustrated by a severe lack of buying opportunities."

TABLE 2

Key office investment transactions in 2013

Address	Size (Sq ft)	Price (£m)	Net initial yield (%)	Purchaser
Union Plaza, Union Row	122,012	£54.82	6.30	Legal & General
Premier Oil HQ, Kingswells	63,180	£27.40	6.05	Royal London Asset Management
Technip HQ, Westhill	61,424	£22.50	5.75	Blackrock
The Exchange, Market Street	82,172	£21.00	7.49	Hermes Real Estate
Silverburn House, Bridge of Don	146,340	£17.56	10.05	Carisbrooke
GDF Suez House, North Esplanade West	40,375	£16.10	7.27	Tritax
Atmosphere One, Prospect Park, Westhill	53,427	£13.84	7.25	Standard Life
Riverside House, Riverside Drive	52,760	£13.75	8.30	Aston Property Ventures
Aspect 32, Arnhall Business Park, Westhill	48,357	£13.50	6.94	CCLA Investment Management

Source: Knight Frank Research

KNIGHT FRANK VIEW

- The strong outlook for Aberdeen's occupier market is expected to continue to attract investors, particularly those who as yet lack any exposure to the market. However, with renewed investment appetite for regional offices more generally, Aberdeen will undoubtedly face greater competition for flows of capital from other cities as the UK's economic recovery becomes more entrenched.
- The record level of activity seen in 2013 suggests that investors have so far been relatively unperturbed by Scotland's forthcoming vote on independence. However, the market is watching closely to see what effect the approaching referendum will have on institutional demand, and whether growing investor caution will switch the focus of attention more towards England's core cities.
- To the detriment of smaller private investors, recent development activity has focused on larger buildings aimed at satisfying larger requirements. Positively, speculative developments which are either underway or forthcoming will provide smaller lot-size opportunities for private investors when they are completed and let over the coming years.

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RESEARCH

Oliver du Sautoy Associate
Head of Regional Research
+44 20 7861 1592
oliver.dusautoy@knightfrank.com

ABERDEEN

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

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

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

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

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

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

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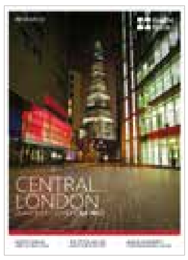

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