RESEARCH

NEWCASTLE

NORTH EAST PROPERTY MARKET REPORT

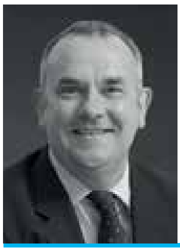
2018

CONTENTS

Please refer to the important notice at the end of this report

FOREWORD

Opportunities still shine through the Brexit fog.



"Well if Ian Dury was writing his lyrics now to "Reasons to be Cheerful, Part 3" he would probably include – Economic growth is still positive – and there are still opportunities to be had."

PETER BOWDEN
Partner, Office Head
Knight Frank Newcastle

How is the North East market going to react and adapt to the challenges of a slow economy, Brexit and the lack of prime space in the region? Well if Ian Dury was writing his lyrics now to "Reasons to be Cheerful, Part 3" he would probably include, economic growth is still positive, and there are opportunities to be had.

Our economic growth forecast for 2018 is 1.5% which, although below the 20-year average of 2% is still progressive. Yes, there's uncertainty around Brexit. Inevitably this brings caution into the market. But, there is still demand from the growth sectors, and combined with a lack of good quality office and industrial stock, rents are under pressure to rise.

The smart landlords are refurbishing their offices to meet the rapidly changing requirements of occupiers, inspiring, contemporary spaces are leading the way. Landlords are realising the need to provide amenity rich, highly serviced spaces, which together with the occupiers fit-out, serve to aid talent attraction and retention. The refurbishment of Earl Grey House and Barclays House on Grey Street, are prime examples.

Speculative industrial development is back on the agenda encouraged by the prospect of rising rents. Nissan's current tendering for suppliers also has given some hope to developers and owners of large factories that 2018 could be a good year. Although of course, we have yet to see how many of these companies eventually secure contracts and take space, but still another reason to be optimistic.

And finally, our region remains a prime location for inward investments projects. Our competitive cost base, skilled labour pool, and strong universities are all key ingredients, particularly to compete for "North Shoring" opportunities.

From a personal perspective. I would like to add a huge thank you to our clients, for their continued support over the last 12 months, and to the outstanding individuals and teams I work with, which combined to make the last 12 months our most successful year ever, Reasons to be Cheerful, Part 4!

Earl Grey House

OCCUPIER MARKET – OFFICES

Despite wavering sentiment, occupier demand levels are rising. Availability is at a 10-year low creating a market imbalance supportive of rental growth.

Demand

Despite 2017 take up being 12% below the long term average, there was a strong start to 2018 in the office sector with total North East take-up in Q1 standing at 71,943 sq ft, an increase of 38% from Q4 2017. Encouragingly, both the level of new enquiries and the number of viewings has also increased pointing towards a continuing positive picture for 2018.

Within Newcastle city centre, Professional Services accounted for the largest percentage of let space in 2017 at 30%. This has continued in Q1 2018 with the sector accounting for 29% of city centre take up. With several deals currently under offer in the city involving high profile professional firms, the sector looks set to feature strongly again throughout 2018. Demand from the Technology, Media and Telecoms (TMT) sector also continues to build, with a further four city centre lettings in Q1 2018 including the letting at Schroder's newly refurbished Earl Grey House to Tangent plc (1,986 sq ft) which set a new headline rent for Grey Street of £21.50 per sq ft.

There is real evidence of a 'flight to quality' in the market, with the majority of demand focusing on the prime Grade A stock as occupiers are increasingly looking beyond total occupation costs and focusing on amenity rich properties and locations.

Despite the out-of-town market finishing 2017 with a similar take-up to 2016, it remained 21% below the five-year average. However, the out-of-town market bounced back strongly in Q1 2018 with 45 transactions completing and a total of 132,749 sq ft of take-up. Deals at Quorum Business Park accounted 20% of out-of-town transactions with new lettings including 13,333 sq ft let to Utility Alliance, 6,600 sq ft let to Zoopla and 5,646 sq ft let to TSG Group.

Availability

Whilst fluctuating during the year, Grade A availability in Newcastle city centre finished 2017 at 175,000 sq ft. This total being 15% below the 10 year average, but more notably none of this is made up of new buildings. With a further raft of city centre lettings due to complete in the coming months, supply will therefore come under increased pressure. The development of 107,000 sq ft at Newcastle Helix remains the only committed scheme in the city, although completion is not due until Q4 2019.

The only new construction currently underway in the region is at Vaux Sunderland which will deliver a new city centre Grade A building of 60,000 sq ft delivered in at the end of 2018.

Out-of-town supply is dominated by Cobalt Business Park and Quorum Business Park, both having single buildings of over 100,000 sq ft immediately available making them attractive options for inward investment projects. Due to the current challenges in funding new speculative development, the development pipeline in the region is dominated by schemes that are either being, or are likely to be, funded by way of local authority intervention.

Key transactions

The 21,300 sq ft lease at 2 St James Gate taken by Eldon Insurance was the largest city centre transaction to complete in 2017, whilst region wide the largest transaction was the 33,600 sq ft purchase of 6 Admiral Way, Doxford Business Park by Durham police. The most notable letting deal in Newcastle city centre in Q1 2018 was Turner and Townsend's 5,200 sq ft relocation to Time Central, whilst out-of-town the pre letting at Durhamgate to Learning Curve (16,000 sq ft was the largest of quarter.

Headline rents

Prime headline rents increased by 2% in 2017 to reach £23.50 per sq ft. This rise followed HSBC taking 4,562 sq ft at Central Square South. Despite this increase, Newcastle continues to have the lowest prime rent of the major UK regional cities, which should attract inward investment. Out-of-town there is still a significant variance in headline rents depending upon location, but the highest headline rents continue to be at Quorum and Cobalt with £16.00 - £16.50 per sq ft.

Key leasing transactions 2017

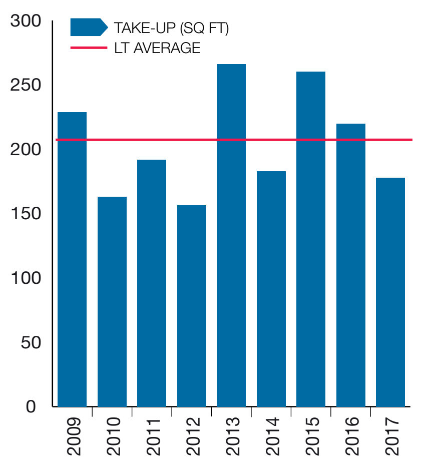
Address	Occupier	Size	Date
6 Admiral Way, Doxford	Durham Police	33,600	17/Q1
No. 2 St James Gate, Newcastle	Eldon Insurance	21,300	17/Q1
St Nicholas Building, Newcastle	Frank Recruitment Group	19,200	17/Q1
Durhamgate, Durham	Learning Curve	16,000	17/Q1
Eldon Court, Newcastle	Trinity Mirror	12,500	17/Q3

Source: Knight Frank Research

FIGURE 1

Newcastle city centre office take-up

(000's sq ft)



Source: Knight Frank Research

OCCUPIER MARKET – INDUSTRIAL

A lack of stock continues to hamper occupier activity. Speculative development remains limited, although recent deals may renew interest.

Demand

Take-up of industrial space in the North East for 2017 totalled 4.4m sq ft, down from 6.7m sq ft in 2016 and well below the 5-year average of 7.1m sq ft. The number of actual transactions totalled 491 again down significantly on 2016's total of 602 and below the 5-year average of 540.

There is no doubt that these figures have been affected by the general lack of good quality available stock, but also highlight the gradual slowdown in activity in anticipation of Brexit.

Of the 2017 total, 3.2m sq ft (395 transactions) was let with the balance of 1.2m sq ft (96 transactions) being sales. The amount of sales as a percentage is only 27% also down on the 5-year average that stands at 39%. We believe this is a reflection of owners retaining and leasing assets to benefit from attractive returns when measured against saving rates and alternative forms of investment.

Take-up of units over 50,000 sq ft across the North East region totalled 1.2m sq ft in 2017, which is broadly similar to 2016, but significantly down on figures for 2014 & 2015, which exceeded 2m sq ft.

Availability

The North East continues to suffer from a lack of good quality industrial stock. The statistics show that there is around 4.2m sq ft currently available, however only 485,000 sq ft of that space can be considered modern. Significantly, there is no new stock above 20,000 sq ft available although Hellens are close to completing a development of three units of 31,524 sq ft, 15,900 sq ft and 10,577 sq ft on the Monkton Business Park, Hebburn.

The only other new build space is UK Land Estates remaining two units in the Dukesway Central scheme which comprise 20,112 sq ft and 12,276 sq ft. In terms of land supply, the International Advanced Manufacturing Park (IAMP) proposed for land north of Nissan (150 ha/370 acres) has cleared most of the planning hurdles and Henry Boot has been chosen as the preferred developer by Sunderland and South Tyneside Councils. There remain some questions on the land ownership and in particular, a key part of the site is in the hands of a rival developer intent on bringing forward their own proposals. This will not necessarily conflict with the Council's ambitions but it may divert control away from them.

In the south of the region at Newton Aycliffe, Durham County Council has announced Richardson Barberry as the preferred developer for their Forrest Park site of 160 acres adjacent to Junction 59 of the A1(M). The scheme has been awarded funding of £13m from the North East LEP towards infrastructure costs and works on the servicing is now largely complete in readiness for the first phase development.

Key transactions

The stand out transactions during 2017 were the sale of the former Visage Clothing warehouse in Washington totalling 187,659 sq ft to Ashworth & Parker Ltd and the letting of Hadrian Yard in Wallsend to Smulders comprising 461,128 sq ft on a site of 75.16 acres.

The letting of L5 Intersect 19 on the Tyne Tunnel Trading Estate in North Shields was notable for the fact that it went under offer within the first month of construction. The unit comprises 57,404 sq ft and was let to Pryme Group and as the building works were in their early stages it allowed the tenant to have a bespoke fit out to satisfy its production needs including an uprated power supply and additional office & welfare space.

Headline rents

Prime headline rents have remained stable at £8.10 per sq ft, which was established in 2016 for a letting on a new build 11,000 sq ft unit on Team Valley, and subsequently £7.45 sq ft for a 26,000 sq ft unit.

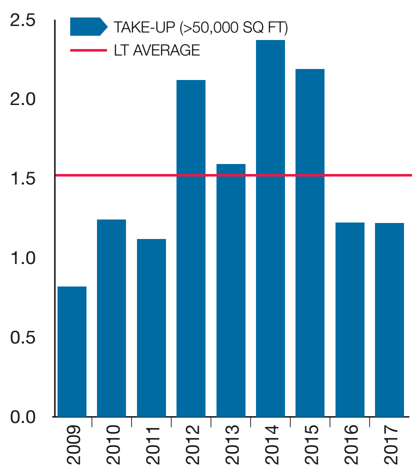
Arguably, the letting of UK Land's new build 57,000 sq ft unit on Tyne Tunnel Trading Estate is more of a landmark as it was let at a rent of £6.00 per sq ft, which established a new rate for this size in North Tyneside.

Key leasing transactions 2017

Address	Occupier	Size	Date
Unit 11 Follingsby Park, Gateshead	Ikea	62,778	Dec-17
Hadrian Yard, Hadrian Road, Wallsend	Smulders	461,128	Feb-17
Unit L5, Intersect 19, North Shields	Pryme Group	57,404	Sep-17
Former Visage Premises, Parsons Road, Washington	Ashworth & Parker	187,659	Aug-17
Units A3 – A5 Benfield Business Park, Newcastle	Card Tricks Ltd	69,162	Aug-17

Source: Knight Frank Research

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



Source: Knight Frank Research

INVESTMENT MARKET

Investor interest in the North East, particularly toward industrial stock, remains at a high level. Availability however, continues to restrict investment volumes.

Offices

Following a relatively strong 2016 in terms of trading activity, the reluctance of landlords to bring assets to market in the absence of suitable alternative opportunities meant overall volumes suffered. Investment turnover for the year reached £50m in the city centre, 49% below the 10-year average for the city. Interestingly, actual deal number was up when compared to 2016, but it was the absence of higher value sales that meant investment volumes remained below the long-term trend.

Arising from the all issued share purchase of SM Newcastle, the acquisition of 1-3 St James Gate by Palace Capital PLC for £20m was the only sale to complete over £10m in 2017. The mixed use development comprises of a 61,000 sq ft office and two retail units. The purchase price reflected a net initial yield of 8.25%.

In August, Watkin Jones Group, via their SPV Planehouse Ltd purchased Keel Row House from Aviva Investors for £8.85m. The 23,794 sq ft property is fully let to Ward Hadaway until 2030. Notably, the deal reflected a net initial yield of 5.57%, a record low for the city in this cycle.

Maya Capital LLP extended their portfolio in the North East in September, with the acquisition of Bede House at All Saints Business Park for £4m. The 38,000 sq ft property is multi-let, with tenants including Wealth Management Systems Ltd, Turner & Townsend Group Ltd, Ingeus UK Ltd, and London & Country Mortgages. Assets already owned by Maya Capital include, units 9 and 15 B&C at Cobalt Business Park, both bought in 2015.


Royal Mail Sorting Office

In a year of few transactions, domestic money continued to dominate activity. UK buyers accounted for 87% of investment in 2017. The only sale to an international buyer was the acquisition of Maybrook House to Chinese firm TusPark for £5.65m.

Following the Keel Row House sale, prime yields moved to 5.75%. At this level, prime yields are 100 basis points above the market peak of 4.75% recorded in 2007. Yields for good quality, well located secondary stock were around 8.25% at year end.

Industrial

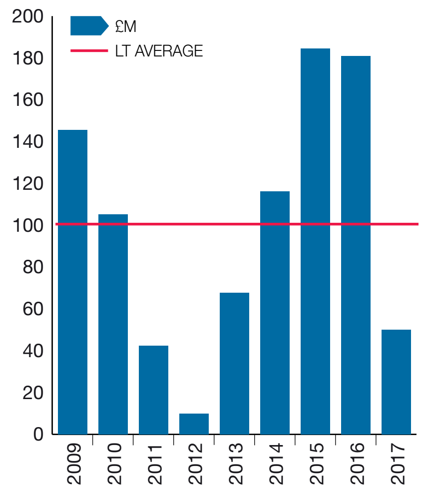
The industrial market continues to go from strength to strength. Transaction volumes in 2017 were £110m, an increase of 69% on 2016 and an indication of the underlying demand in this sector.

The sale of the Royal Mail Sorting Office on Team Valley at £16.15m reflecting an initial yield of 5.22%, was the lowest investment yield for an asset of this nature on record, and suggests that prime yields have reduced by 50 bps to 5.50% for a 10 year term.

Multi-let estates were also in demand and the sale of the UK Land Estates portfolio for £41.79m reflected a yield of 7.27% and consisted of 10 non-core multi let assets. This is a 200bps change from where these assets were trading five years ago.

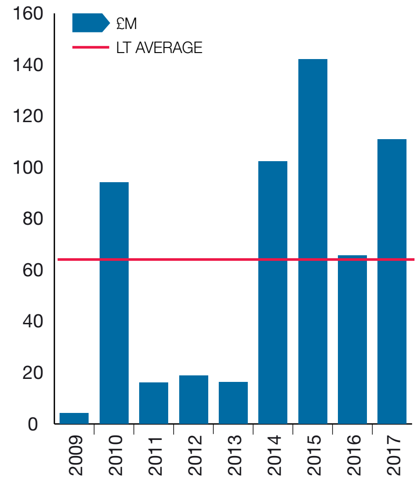
The multi-let industrial estate sector however, was again the best performing sector on a national basis. The large single ownerships in the North East mean that few estates traded in 2016. Notwithstanding this, this sector of the market remains the most attractive to institutional investors.

FIGURE 3
Newcastle office investment
(£m)



Source: Knight Frank Research

FIGURE 4
North East industrial investment
(£m)



Source: Knight Frank Research

KNIGHT FRANK VIEW

PATRICK MATHESON
PARTNER

The strong start in Q1 is expected to continue through the rest of 2018, with continued upward pressure on prime rents due to the lack of supply in the market, particularly in central locations. Occupiers will continue to be focused on the higher quality Grade A space as the 'flight to quality' continues. Landlords providing the right, high quality and amenity rich space will no doubt be the beneficiaries.

Whilst the co-working revolution is yet to fully reach Newcastle, there are a number of major operators who are starting to circle the market, looking to benefit from the flourishing tech scene and change in what occupiers need and desire from their office space. Much will depend upon the right buildings being available for them, which is certainly a challenge, but the city and the region is certainly ready to embrace this new product and culture.

SIMON HAGGIE
PARTNER

Demand is strong for larger units between 50,000 sq ft and 150,000 sq ft, which is partly being fuelled by Nissan's launch of Nissan's next Qashqai replacement vehicle in 2020. Interestingly in anticipation of Brexit, Nissan is encouraging many of its suppliers into the region to avoid potential duties on its parts post Brexit. The market is otherwise proving to be resilient. We expect to see continued enquiries in the sub 10,000 sq ft range, but less activity in the mid-range size between 15,000 sq ft to 35,000 sq ft. We believe that there will continue to be steady demand for larger modern units in the 50,000 sq ft to 150,000 sq ft size range but fewer enquires for buildings in excess of 150,000 sq ft.

PETER BOWDEN
PARTNER

It's always interesting to look back and see what we said previously for the year ahead. Last year we talked about the lack of Grade A office space and the potential for rental growth, probably not hard to predict. This proved correct and this continuing market imbalance looks set to push rents passed £25 per sq ft. We will see more developers adapting their buildings and design for management to improve quality and amenity, in pursuit of tech sector occupiers.

For industrial, we reviewed the growth in rents which was encouraging the return of speculative development, but it was also the speed at which UK Land's 57,000 sq ft new build at Tyne Tunnel went under offer in the first month after construction started, which should give further encouragement in that market.

Because of the prospects of further rental growth in our markets, and despite Brexit, we remain more than confident about next year's investment market, provided product is available.

DICKON WOOD
PARTNER

The market has shrugged off the initial concerns regarding Brexit and yields continued to harden throughout 2017 and new flows of global capital maintained pressure. We expect to see an increase in corporate activity in 2018 and believe that office yields in the city centre still have some way to go.

Rental growth continues to provide comfort to investors in the office and industrial sectors and assets such as final mile logistics and collaborative working hubs will continue to appeal to investors looking to future proof their portfolios.

COMMERCIAL RESEARCH

Lee Elliott
Partner, Head of Commercial Research
+44 207 861 5008
lee.elliott@knightfrank.com

Darren Mansfield
Associate
+44 207 861 1246
darren.mansfield@knightfrank.com

NEWCASTLE OFFICE

Peter Bowden
Managing Partner
+44 191 594 5003
peter.bowden@knightfrank.com

OFFICES

Patrick Matheson
Partner
+44 191 594 5015
patrick.matheson@knightfrank.com

CAPITAL MARKETS

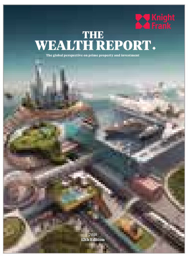
Dickon Wood
Partner
+44 191 594 5036
dickon.wood@knightfrank.com

INDUSTRIAL

Simon Haggie
Partner
+44 191 594 5009
simon.haggie@knightfrank.com

Knight Frank Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, funding organisations, corporate institutions and the public sector. All our clients recognise the need for expert independent advice customised to their specific needs.

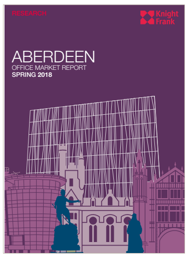
RECENT MARKET-LEADING RESEARCH PUBLICATIONS



The Wealth Report 2018

Regional Offices Year End Review 2018

The London Report 2018



Aberdeen Office Market Report - 2018

Knight Frank Research Reports are available at **KnightFrank.com/Research**

Newmark Knight Frank