RESEARCH

Knight Frank

EDINBURGH
OFFICE MARKET REPORT
2016

> “Edinburgh’s investment market now has global appeal, with overseas investors increasingly attracted by its strong fundamentals.”

ALASDAIR STEELE
Managing Partner,
Knight Frank Edinburgh

FOREWORD

Steeped in history, the city of Edinburgh has found a new energy coursing through its ancient buildings and lanes in 2016.

The city centre is of course a famous Unesco World Heritage site and is the second most popular tourist destination in the UK after London. Edinburgh is home not only to The Scottish Government, but also to more FTSE 100 companies than any UK city outside London.

Known as a hub for banking and finance, global firms such as Royal Bank of Scotland Group, Standard Life plc and Scottish Widows plc all have their headquarters in Edinburgh. And now, added to its established industries, Edinburgh is growing in importance as a destination of choice for companies from the Technology, Media and Telecoms sector (TMT). Importantly, Edinburgh’s four universities produce in excess of 1,200 graduates with computing related degrees every year. This is supporting both the current and future staffing needs of TMT firms.

The influx of new TMT requirements is helping to drive a strong office market. Occupier demand has remained robust, supported by both rising headcount and new market entrants, whilst the supply pipeline is limited by the marked lack of development sites. The growing imbalance between supply and demand is now fuelling upward pressure on rents.

Not surprisingly, the strength of the occupational market is attracting the attention of investors. Office investment activity in the first half of 2016 is already above that recorded throughout all of 2015. Most notably, overseas buyers are showing greater interest. We anticipate that the lower value of sterling will support further interest over the coming months.

Although there are many positive aspects to highlight, we are mindful of the challenges. At the time of writing, political events provide the greatest concern.

The result of the EU referendum is foremost with a prolonged period of uncertainty now likely. Market confidence will doubtless be undermined although often market turbulence from such events can create new opportunities. The secondary effect of the EU referendum has been to reignite the debate over Scottish independence. Regardless of any political allegiance, adding further doubt to the market could tip the balance in property decision making.

Nonetheless, Edinburgh clearly has the attributes to prosper in a changing market. In the two years since the Scottish independence vote of 2014, both occupier and investor markets have flourished. The established client base has, and will continue to provide strong foundations to the office market. Nurturing the extensive talent pool and embracing new growth sectors will mean that Edinburgh is well placed for years to come.

Atria, Edinburgh. Sold to DEKA Immobilien for £105m

OCCUPATIONAL MARKET

Following the record take-up of 2015, occupier activity has been slower in the first half of 2016, in part hampered by the uncertain political and economic environment.

This has meant that extended negotiation periods have become more common slowing the deal rate. Nonetheless, total take-up at mid-year is 15% above the long term average for the period with occupier sentiment toward the market remaining robust.

Perhaps the most significant trend to emerge in 2016 has been the strength of demand from the Technology, Media and Telecoms sector (TMT). Occupiers from this group account for close to one third of all take-up. Notably, the largest deal of 2016 has been to a TMT occupier.

Take-up and demand

Total take-up at mid-year reached 352,500 sq ft across the city (all grades) slightly behind the same position last year (fig 1). Active demand remains robust with circa 190,000 sq ft of space under offer at the time of writing (September 2016). Two large new requirements circa 30,000/40,000 sq ft were brought to market during August to add to the existing requirements of State Street (60,000 sq ft under offer at Exchange Crescent), Ernst and Young (under offer at Atria), Brodies (60,000 sq ft) and Aberdeen Asset Management (80,000 sq ft).

Key transactions

The largest transaction so far in 2016 was the 80,000 sq ft pre-let to IT firm Cirrus Logic at Quatermile 4. Since this announcement in Q1 2016, Cirrus Logic have committed to a further contiguous floor in the same building providing an additional 15,000 sq ft. Further TMT sector growth is anticipated with incubator site Codebase also expanding in 2016.

Financial services occupiers remain a strong source of demand in Edinburgh although activity has slowed in the first half of 2016. As at Q2 2016, the financial services sector accounted for 9% of office take-up in the city. This compares with a longer term average of 21%.

Availability

As at September 2016, total availability of city centre Grade A space stood at 265,000 sq ft, the lowest level since 2012. Notably, only four buildings were able to accommodate a requirement of over 10,000 sq ft of contiguous space.

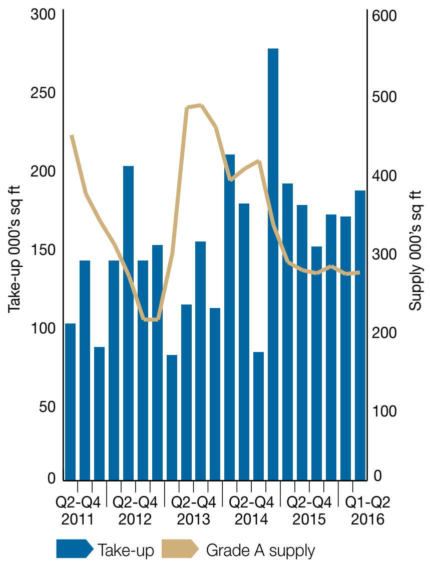
The development pipeline is set to deliver around 520,000 sq ft over the coming 24 months, 76% of which is speculative. At the time of writing however, only 248,000 sq ft of planned space was under construction, 50% of which is pre-let. Of those started, only Quartermile 3 is nearing completion.

Uncertainty around timing now surrounds the Haymarket 5 scheme with site abnormalities being rumoured as the cause of some delay. Elsewhere, work on Chris Stewart Group's "Mint" building in St Andrews Square, is now underway.

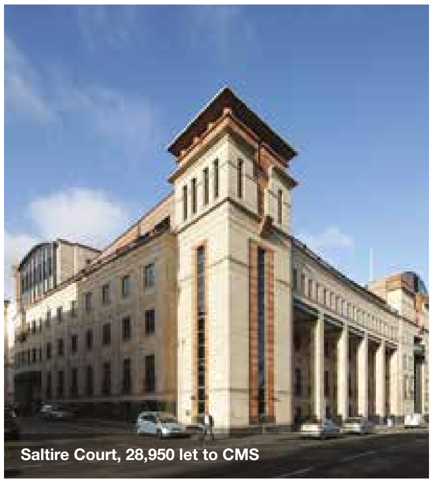
Headline rents

As at September 2016, prime headline rents remained at £33.00 per sq ft, a record for the city. This represents a year-on-year increase of 16%. The record rent for the city was set in Q2 with £33.00 sq ft paid by EDF for a small suite (3,455 sq ft) on level 7 at Atria 1. Current forecasts indicate that prime headline rents will surpass £35.00 within the next 12 months.

FIGURE 1
Edinburgh office take-up



Source: Knight Frank Research


Saltire Court, 28,950 let to CMS

Major leasing transactions 2016

Building	Tenant	Sq ft	Date	Grade
Quartermile 4	Cirrus Logic	80,000	Q1 2016	A
28 Charlotte Square	Peoples Postcode Lottery	33,200	Q2 2016	A
Saltire Court	CMS	28,950	Q2 2016	A
The Walk	Dialog Semiconductor (UK) Ltd	13,650	Q1 2016	A
12&13 Charlotte Square	Baxters	10,950	Q1 2016	A

Source: Knight Frank Research

INVESTMENT MARKET

Unsurprisingly, Edinburgh's office investment market was thrown into a period of uncertainty on the back of the unexpected Brexit vote.

However, a flurry of recent deals suggests that an element of calm has been restored and investors still see the city as a compelling place to invest.

The current imbalance between supply and demand within the office market has put the city firmly on the radar for many UK and overseas investors. The city's historic nature and World Heritage designation mean that development sites within the centre are strictly limited, which prevents developers over building in times of strong tenant demand. Consequently, the 'Achilles Heel' of regional markets – rental growth stifled by too much new development, is less of an issue in Edinburgh.

The current development pipeline is limited, with no buildings expected to complete prior to the end of 2016, and of those buildings due to complete in 2017, all apart from Quartermile 3 are pre-let. At the same time, last year saw record take up, with 1.1 million sq ft of lettings across the city (more than 50% above the ten year average figure).

Add to the mix a new wave of entrants into the Edinburgh market, particularly from TMT, and it's clear the city is well placed for rental growth. We anticipate that Edinburgh Grade A rental growth will be a star performer amongst the UK key regional cities.

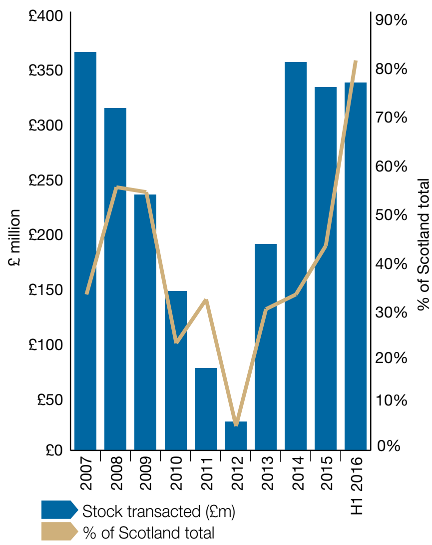
This potential for rental growth has led to strong demand from overseas investors. Whilst a number of the UK institutions have been reluctant to invest in Scotland due to perceived political instability, many overseas buyers seem less concerned by the prospect of Scotland leaving the UK. Overseas investors now make up the majority of buyers with investment originating from such diverse locations as Dubai, Israel, Germany, Denmark and the Far East. In fact, since the start of 2015 only one office building over £20 million has been purchased by UK money.

The Brexit vote appears to have done little to derail this trend, with overseas buyers appearing less concerned by a European exit and attracted by the weaker pound. Since the Brexit vote, the successful sale of Waverley Gate to Triuva for approximately £65 million and the impending sale of Princes Exchange and New Uberior House to Korean investors both suggest that overseas buyers still see value in Edinburgh.

And it's not only at the prime end of the market that there has been strong activity. The compact nature of Edinburgh's city centre, together with the lack of development sites, means that Grade B office buildings with short leases, or indeed vacant buildings, are keenly sought after for refurbishment opportunities. In some cases these are straight forward office refurbishments, such as Knight Real Estate's acquisitions of 2 Castle Terrace and Edinburgh House, whilst other buildings, such as Buchan House, are converted into alternative uses, with developers attracted by the long leases on offer, leading to attractive exit yields. Once again this trend has thinned out the available office stock whilst also providing reassurance to investors that residual values are strong.

Prime Edinburgh yields are now at 5.25%, which still offers a discount compared to other UK regional cities. This yield also looks cheap when compared to other European capital cities and Edinburgh appears set for a period of strong rental growth. Therefore, we believe that Edinburgh remains a sound location for office investment.

FIGURE 2
Edinburgh offices investment volumes



Source: Knight Frank Research/Property Data

Major investment transactions in Edinburgh (Q3 2015-Q2 2016)

Building	Price (£m)	Yield %	Date	Purchaser	Vendor
Atria, Morrison Street	105.25	5.35	Q1 2016	DEKA Immobilien	City of Edinburgh Council
Lothian Road, 30	93.75	5.08	Q4 2015	Overseas client of HSBC	Standard Life
Quartermile, 4	68.50	5.21	Q1 2016	TRIUVA	M&G Real Estate
Gyle Square	48.30	5.76	Q2 2016	Greenridge Regional UK	Superminster
Fountainbridge, 150	44.00	N/A	Q1 2016	Trinova Real Estate Spain	Ardstone UK ROF

Source: Knight Frank Research/Property Data

KNIGHT FRANK VIEW

Embracing a fine balance between historic heritage and a modern day global city, Edinburgh continues to thrive. Education is at its heart, a quality not only keenly sought after in modern business, but one that supports the evolution of the city.

ALASDAIR STEELE
MANAGING PARTNER

"The importance of overseas buyers is increasing, with only one building over £20 million purchased by UK money in the last 12 months. Landlords will need to ensure they take this into account when formulating their development and letting strategy."

JAMIE FERGUSSON
PARTNER

"The current prime yield of 5.25% would suggest limited inward yield movement going forward, with future performance emanating predominantly from rental growth. However, this yield looks cheap in comparison to other major European cities making Edinburgh an attractive proposition."

TOBY WITHALL
PARTNER

"One third of Edinburgh's office take-up is made up of Tech companies. If this sector is to continue to be encouraged to grow in the capital, landlord's need to better align themselves to flexible and collaborative working practices."

KENNETH BREWSTER
SENIOR SURVEYOR

"Edinburgh is losing a significant proportion of its city centre office stock to alternative uses, such as hotels, serviced apartments and residential. This trend will further restrict the choice of traditional office occupiers."

SIMON CAPALDI
ASSOCIATE

"West Edinburgh" will continue to become a focus for occupiers and mixed use development, such is the dearth of suitable brownfield development opportunities in the city centre and the fast improving connectivity offered out of town."

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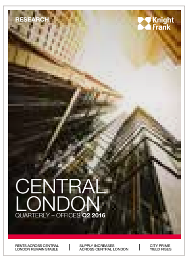

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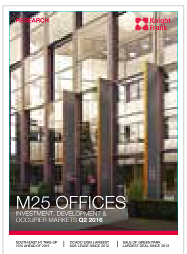

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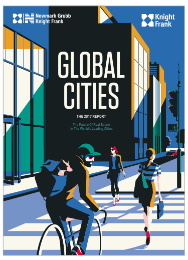

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