Research Report

GVA Grimley

Manchester City Centre Office Market Report

Spring 2008

Introduction

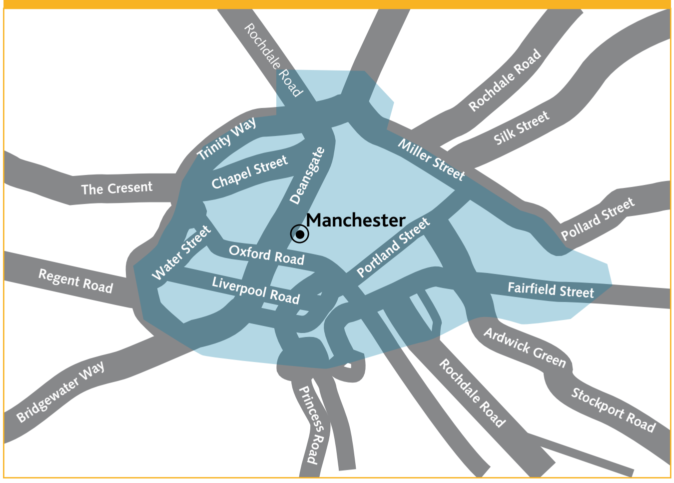
In this report we examine the key drivers of demand, the outlook for the development pipeline over the next few years, and the resulting prospects for rental growth in Manchester's city centre office market. With the UK commercial property investment market very much in the headlines, we also look at the factors driving the current downturn in the UK, and the implications for Manchester.

Greater Manchester is the economic hub of the North West generating an estimated 40% of its GDP, at £52.2 billion in 2007. Finance & Business Services sector (F&BS) now represents more than 21% of the employed workforce in Greater Manchester, and major office occupiers are predominantly from the F&BS sector. These include the Co-operative Society and the Royal Bank of Scotland. Manchester city centre also serves key legal and consultancy firms as well as media groups, all requiring first-rate offices. The importance of the public sector is also reflected with key occupiers including the Department for Constitutional Affairs and the BBC.

Manchester city centre has an office stock of almost 19 million sq ft. The market can be divided into three sectors - the prime core, outer CBD and periphery. Manchester's historic prime core office area is very tightly defined and is bounded by Market Street to the north, Cross Street and Mosley Street to the east and west and Princess Street to the south. The outer CBD has traditionally been defined as being within the boundaries of Market Street, the River Irwell, Peter Street and Portland Street, including Piccadilly.

Land use and the historic nature of much of the prime core has to date prohibited the development of modern high specification buildings with large floorplates and this has led to the majority of the new office development taking place in the outer CBD to satisfy the modern requirements of some of the major corporate occupiers.

Area covered by the Manchester City Centre Market



Occupier Market

- Grade A city centre demand remains high, and a large number of active requirements and the limited past supply has sustained prime rents at £30 psf during 2007.
- Take-up in 2007 totalled 975,000 sq ft, above the 908,000 sq ft achieved in 2006 and above the average of 840,000 sq ft per annum since 1996. Grade A take-up accounted for over 185,000 sq ft of last year's total. Approximately 2.5 million sq ft was available in December 2007, equivalent to three years average take-up. Of this total, over 350,000 sq ft was grade A space.
- In the short term, the slowing UK economy will have an adverse impact on occupier demand, most notably on demand in the Finance & Business Services sector. However, the longer-term fundamentals remain very positive for Manchester, with a rising population and healthy employment growth expected. In addition, a number of major transport improvements are in the pipeline.
- The supply of Grade A stock is set to increase significantly as a number of large schemes complete during 2008 totalling over 1.3 million sq ft (over 1.1 million sq ft of which remains available). This will inevitably create an oversupply of space in the short term.
- With a high level of completions and slowing economic growth, rental growth is likely to be subdued and below inflation this year and next, with this year marking the bottom of the cycle.

Investment Market

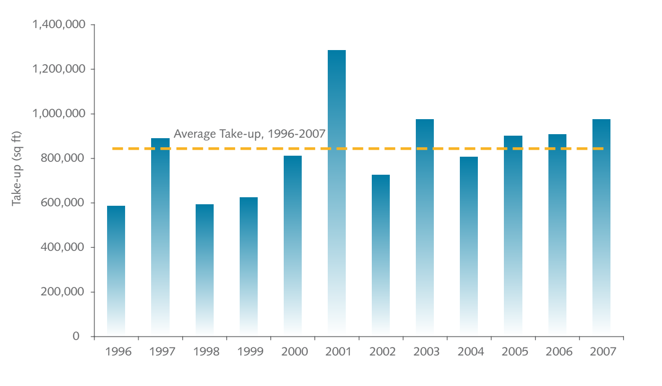
- Manchester is regarded as one of the top tier cities by institutional investors seeking exposure to the regional office sector. The total return for Manchester offices averaged 14.4% pa from 2002 to 2006 (IPD), driven by downward yield movement. However, yields moved sharply upwards in 2007, reflecting overpricing in the UK market as a whole. This resulted in a negative total return of -6.2% (IPD Quarterly Index).
- The outlook for the UK commercial property investment market as a whole remains uncertain. We expect some further upward yield movement during the first half of 2008, and an element of over-correction is likely, but we are hopeful that yields should have stabilised by the second half of the year.
- Gilt yields and Swap rates have been falling since the middle of 2007, whilst office yields have been rising. As a result, the pricing of commercial property is once again looking justifiable.
- The total return for Manchester offices is still likely to be negative for 2008 as a whole, with around -1.5% forecast, but nonetheless a significant improvement on 2007. We are optimistic that from 2009 total returns will begin to revert to more 'normal' levels, as the rate of rental growth begins to accelerate and investor confidence returns.

Occupier market

Take-up

Take-up in central Manchester averaged almost 840,000 sq ft per annum since 1996. The highest level achieved was in 2001, at 1.3 million sq ft, although this was exceptional as the figures were skewed by the 450,000 sq ft RBS pre-let at Spinningfields (35% of the total for that year). Excluding 2001, take-up over the period ranged from 585,000 sq ft in 1996 up to 975,000 sq ft in 2003. Transactions in 2007 totalled 975,000 sq ft, above the 908,000 sq ft achieved in 2006, and marking the third successive year of above-average take-up.

Central Manchester Office Take-Up Source: GVA Grimley



Grade A take-up totalled over 185,000 sq ft in 2007, below the average since 2000 of 270,000 sq ft per annum. The level of grade A take-up has been highly volatile from year to year. Two years since 2000 have seen grade A transactions totalling more than 500,000 sq ft (2001 and 2004), whilst the lowest recorded was under 100,000 sq ft (2002).

The following table shows key occupier transactions over the last year. The rental figures reflect headline rents which do not allow for tenant inducement packages. There is no general norm for incentive levels, as this varies from building to building and this is clouded further by many of the letting transactions being structured by way of profit share on lease regears, together with confidentiality clauses.

Incentive levels on existing stock are generally lower than for pre-let situations but an average of 6 months for every 5 years of term might be appropriate. Longer than 15 years creates a premium level commensurate with the yield shift and can feature as 'profit share' rather than incentive. A rent review summary would argue that such incentives as a result of profit share are not true tenant incentives and therefore should be excluded from rental calculations. It is however generally accepted that a fitting out period for large buildings is 6 months, which also needs to be taken into account as a benefit to the landlord, as this can be disregarded in most rent review clauses.

Key Prime Transactions - 2007 to date Source: GVA Grimley

Property	Date	Tenant	Floorspace (sq ft)	Rent (£ psf)
40 Spring Gardens	April 2007	HBOS	45,000	£28.00
3 Hardman Street	December 2007	Pinsents	34,660	£28.00
4 Hardman Square	February 2007	HSBC	27,750	£28.00
3 Piccadilly Place	January 2008	Weightman's Solicitors	18,900	£23.00
3 Hardman Street	November 2007	Regus	17,330	£28.00
55 King Street	January 2008	Brabners	10,728	£23.50 - £26.00
Chancery Place	October 2007	Jones Lang LaSalle	7,800	£30.00
Zenith	November 2007	Cushman & Wakefield	5,100	£28.50

Demand

We estimate that "Category A" office demand remains healthy, at approximately 1.25 million sq ft, although some requirements are spread across three or more years. The table below shows a summary of the key, publicly known office requirements in Manchester.

Key Requirements (25,000 sq ft and above) Source: GVA Grimley

Occupier	Size (sq ft)
Co-op	200,000
Friends Provident	100,000
PWC	60 – 80,000
Manchester Engineering & Design Consultancy	45 – 50,000
Bank of New York	35 – 50,000
Scott Wilson	35 – 40,000
Beechcrofts	35 – 40,000
Parsons Brinckerhoff	35 – 40,000
c/o WHR	30 – 40,000
Government Office North West	25,000
Davenham Group	25,000
Regus	15-25,00

Supply

At the end of 2007 there was approximately 2.5 million sq ft of immediately available office space in Manchester city centre, equating to a vacancy rate of 13.5% of total stock. This is equivalent to three years of take-up based upon the average take-up rate since 1996 (840,000 sq ft per annum). Grade A availability accounts for over 360,000 sq ft (or around 15%) of the total. The largest quantities of available office floorspace as at March 2008 are:

- 65,012 sq ft at Ship Canal House, King Street
- 46,928 sq ft at 40 Spring Gardens
- 30,143 sq ft at 80 Mosley Street
- 38,978 sq ft at Bauhaus
- 30,430 sq ft at 58 Mosley Street
- 50,274 sq ft at Aurora, Princess Street
- 32,467 sq ft at No 1 Scott Place, Spinningfields
- 44,540 sq ft at Zenith, Spring Gardens

In December 2007, there was almost 1.4 million sq ft of office floorspace under construction in central Manchester, including seven schemes of 100,000 sq ft or more. Almost 75% of total construction activity is new build.

The largest office scheme under way is the 392,000 sq ft 3 Hardman Street, Spinningfields development, due to complete in October 2008. At Spinningfields, Barclaycard has already pre-let 83,000 sq ft of offices but has not taken up an option on a further 80,000 sq ft. Other deals in place include Pinsent Masons (34,000 sq ft), and Regus (17,000 sq ft).

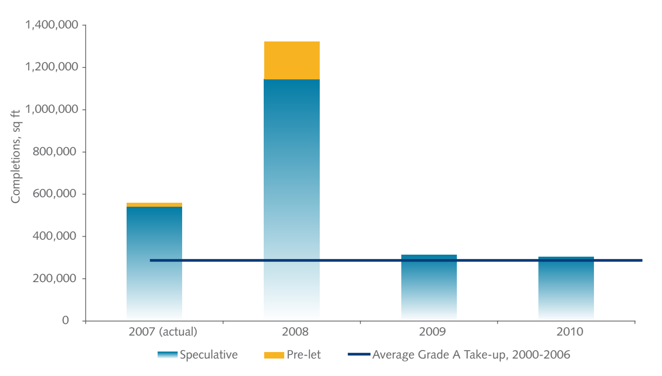
Other significant schemes include Argent's 198,000 sq ft Three Piccadilly Place development where law firm Weightmans has committed to 18,900 sq ft and 165,400 sq ft at City Tower, Piccadilly Exchange (a phased refurbishment by Bruntwood Estates). A summary of the largest schemes under construction as at March 2008 can be found below.

The level of development completions will be very high this year, at over 1.3 million sq ft. Only 178,000 sq ft (13% of the total) has been let prior to completion, leaving 1.15 million sq ft of speculative space completing in 2008. This will add to the 350,000 sq ft of grade A space already completed and still available. This is significant, as annual average grade A take-up has been only 270,000 sq ft per annum since 2000.

Whilst there is a robust demand pipeline, much of it is for 2/3 years hence and is also for bespoke design and built space due to the size of the individual requirement. We therefore believe that there is an oversupply looming in the short term. Indeed, speculative completions in 2008 are the equivalent of four years' average annual grade A take-up.

However, 2009 and 2010 should see a marked reduction in completions, with a little over 300,000 sq ft per annum projected to complete in these years, broadly in line with average grade A take-up since 2000.

Projected Development Completions Source: GVA Grimley



In addition to the space projected to complete by 2010, more than 2 million sq ft of office space has planning permission (summarised in the table below). We have also identified more than 5 million sq ft in schemes awaiting planning permission or sites where an application has yet to be made.

Schemes Under Construction Source: GVA Grimley

Address	Size (sq ft)	Completion date
3 Hardman Street, Spinningfields	392,000	Oct-08
Three Piccadilly Place, London Rd	198,000	Jun-08
City Tower, Piccadilly Exchange, York St	165,400	Dec-08
1 Central Spine (former BT building)	117,000	Dec-08
Belvedere, Booth Street	107,500	Nov-08
Chancery Place, Spring Gardens	102,400	Nov-08
1 New York Street (formerly 45 Mosley Street)	105,000	Autumn-09
Axis, Great Bridgewater St	72,268	Jul-09
9 Portland Street	55,100	Apr-08
Piccadilly Basin, Ducie St	33,400	Apr-08
2 Spinningfields Square	26,500	Apr-09
10 New York St	25,000	Aug-08

Future Pipeline – Key Schemes over 50,000 sq ft Source: GVA Grimley

Address	Size (sq ft)
No 1 Hardman Square, Spinningfields	650,000
Boddingtons Brewery Site, Strangeways	450,000
Victoria Station	400,000
Deansgate Locks South, Whitworth St	300,000
Elizabeth House	250,000
2 and 3 Hardman Boulevard, Spinningfields	154,000
Four Piccadilly Place, London Rd	120,000
30 Grand Island (Phase II), Albion St	117,700
No 1 Hardman Street, Spinningfields	100,000
No 2 Hardman Square, Spinningfields	100,000
Eider House, Piccadilly Basin, Ducie St	86,522
Aytoun St/Bloom St	85,300
Former Peugeot Site, Chester Road	75,000
2 Great Bridgewater St	60,600
18/24 Princess St	50,500

The Outlook for the Occupier Market

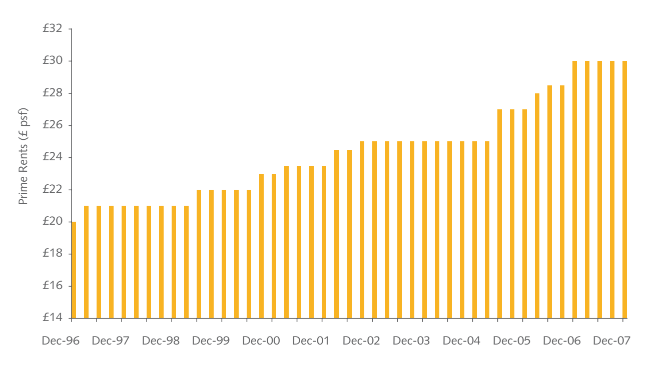
Nationally, economic growth is now slowing, as the 'credit squeeze' and the slowdown in the US and Eurozone begin to have an impact. Much of the slowdown has been in the service sector, and most notably in Business Services & Finance, reflecting the problems in the financial sector.

The latest consensus forecasts expect UK economic growth to weaken noticeably in 2008 to 1.8% compared with 3.1% in 2007. However, growth nearer 1.5% in 2008 is now looking more likely, and we expect a slow recovery to 1.9% in 2009, 2.4% in 2010 and a close to trend 2.6% in 2011.

At the end of 2007, prime headline rents in central Manchester stood at £30 psf, unchanged from December 2006, although significantly higher than the £25 psf level five years ago (the highest recorded rent is £34 psf in mid-2005 achieved at the Pinnacle which can be discounted due to its small (2,000 sq ft) size).

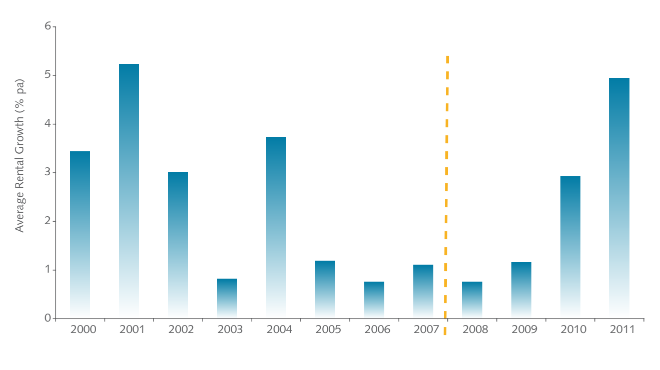
The significant amount of speculative completions during 2008, will limit any room for prime rental growth, although the £30 "barrier" may be exceeded by the better located schemes. Whilst market rumours are of £40 psf rents (Chancery Place), it is our opinion that this level is not consistently achievable for some years to come.

Manchester - Prime Rents Source: GVA Grimley



With a slowing economy combined with the expected high level of development completions this year, average rents are likely to reduce in real terms this year, with growth of under 1% forecast. 2009 will also see subdued rental growth, but as economic recovery gathers pace and the rate of development completions reduces, we expect the rate of average rental growth to increase, with almost 5% pa forecast by 2011.

Average Office Rental Growth Forecasts Source: GVA Grimley



Over the longer term, Manchester's prospects look healthy. The last decade has seen a reversal of the trend of net outward migration from Greater Manchester that occurred during the 1980s and 1990s, due in part to the policy of urban regeneration and better job opportunities being available. From 2000 to 2007, the population is estimated to have risen by around 0.25% pa, and we forecast that growth should remain at around this rate for the next decade.

We expect Greater Manchester to see economic growth of around 2.5% pa over the next 10 years, in line with the growth rate over the last decade, although we expect growth to be somewhat weaker over the next two years, in line with in the overall UK economy. Total employment in Greater Manchester is forecast to grow at a healthy 0.5% per annum over the next 10 years

Transport and sustainability

A £3bn transport plan for Greater Manchester includes expanding the Metrolink tram system and increasing bus and train services. Proposals include improvements to Manchester's Piccadilly station and rail links through the city, creating a northern hub. This will have a far reaching impact, as stronger public transport links between northern centres will improve and extend accessibility, opening up the city region to a larger labour market, providing better public transport and reducing congestion.

Transport improvements would tie in with the proposed introduction of congestion charging (£5 to drive into central Manchester on the busiest roads at the busiest times, and £2 to enter an outer cordon around the M60). The Association of Greater Manchester Authorities estimates that failure to address road congestion could result in Greater Manchester missing out on 30,000 jobs over the next 15 years. The congestion charge plans could be in place by 2012 although a public consultation will be carried out before the proposals are put to the government for approval.

We believe that these proposals would have a direct, positive impact on the attractiveness of Manchester as an office location, resulting in new businesses coming into the city and improving the productivity and performance of existing occupiers, as well as greatly improving the image of Manchester as a sustainable city.

Sustainability is an increasingly important consideration. Our recent report "How Green is my City" highlighted central Manchester as having a large amount (255 hectares) of brownfield land available for regeneration, a larger share of the total area than most other major UK cities.

Investment market

Recent Trends

The UK commercial property investment market as a whole saw significant increases in capital values from 2003 to 2006. Indeed, the IPD Annual Index reports that All Property capital values increased by more than 40% from the end of 2003 to the end of 2006. Significantly, this was due to factors external to the commercial property market, notably falling borrowing costs, equity yields and gilt yields, and volatility in the other key asset classes, rather than the actual or expected performance of the occupier market.

However, as property yields fell, the commercial property sector lost its risk premium over gilts, and also became less attractive to private buyers as borrowing costs rose above property yields. During 2007 it became increasingly evident that the commercial property market was overpriced, with property yields looking difficult to justify. A correction had become almost inevitable, and began slowly in the latter half of 2006, gathered pace in 2007, and has accelerated dramatically in recent months, in part as a result of the credit squeeze and more pessimistic economic outlook.

The Manchester office investment market has reflected these national trends. Prime Manchester office yields fell rapidly from 2002 to 2006, which was particularly steep in 2006, at 100 basis points. This was followed by a sharp upward movement during 2007, which is still under way in early 2008. We assess that prime office yields had risen to 5.5% by the end of 2007, reversing all of the downward movement in yields that had occurred during 2006.

The total return for Manchester offices averaged an impressive 14.4% pa over the five years from 2002 to 2006, according to IPD, and capital values increased at a rate of over 9% pa. This compared to average rental growth of only 1.9% pa, illustrates the disconnect between the investment and occupier markets. Performance in 2007 was very different, and as yields moved sharply upwards the total return fell rapidly, turning negative during Q3, at -2.0% Q-Q, and falling to -8% during Q4, compared with around +2% in both Q1 and Q2. The total return for the year as a whole was -6.2% (IPD Quarterly Index).

Rental and Capital Value Growth — Source: IPD

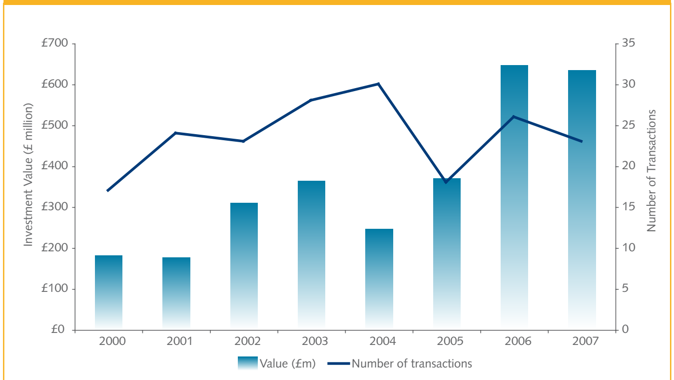
Investor Demand

Demand in the Manchester office investment market was extremely strong in 2006 and 2007, with a total of nearly £1.3 billion transacted over the two year period. This is almost as high as the £1.5 billion transacted over the previous five years. It is noteworthy that there was no change in the average number of transactions in 2006 and 2007, but that the average value of each transaction was more than double that of the previous five years. This reflects both the sharp increase in office capital values, as well as larger lot sizes over the last two years. The value of transactions in Q4 2007 was only £66 million, compared with an average quarterly figure of £160 million over the last two years, suggesting a slowdown (although the figures tend to be volatile from quarter to quarter).

Manchester Office Investment Transactions — Source: Property Data

Year	Total Investment Value (£m)	Number of Deals	Average Value (£m)
2001	£178	24	7.4
2002	£311	23	13.5
2003	£365	28	13.1
2004	£247	30	8.2
2005	£371	18	20.6
2006	£648	26	24.9
2007	£635	23	27.6

Manchester office investment transactions — Source: Property Data



The Outlook for the Investment Market

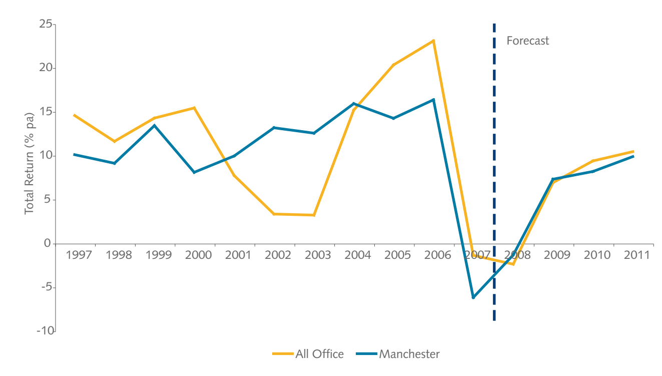
So what are the prospects for recovery in Manchester office investment market performance? The outlook for the UK commercial property investment market as a whole remains uncertain, reflecting general conditions in the global financial and credit markets, the economic outlook in the US and the Eurozone, and the current limited number of property transactions. We expect some further upward yield movement during the first half of 2008, and an element of over-correction is likely, but we are hopeful that yields should have stabilised by the second half of the year.

Once the correction in yields has run its course, rental growth prospects will become a much more important factor in overall investment performance than has been the case over the last few years. Although we expect average Manchester office rents to see little growth this year and next we forecast average rental growth of nearly 2.5% pa from 2008 to 2011 (inclusive), ahead of the UK average (1.6% pa), and ahead of offices outside of London and the South East (2.5% pa).

The total return for Manchester offices is still likely to be negative for 2008 as a whole, with around -1.5% forecast, but nonetheless a significant improvement on 2007. We are optimistic that from 2009 total returns will revert to more 'normal' levels, as the rate of rental growth begins to accelerate and investor confidence returns. Our forecasts suggest that returns should rise to more than 7% pa in 2009 and reach more than 9% pa by 2011, similar to the performance achieved in the period from 1997 to 2001, prior to the investment boom.

As the market recovers, Manchester should be in a strong position to maximise investment demand as the city is regarded as one of the top tier cities by institutional investors seeking exposure to the regional office sector.

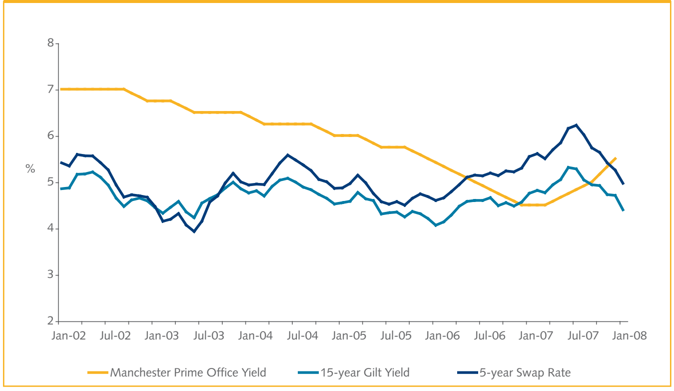
Total Office Returns Source: IPD

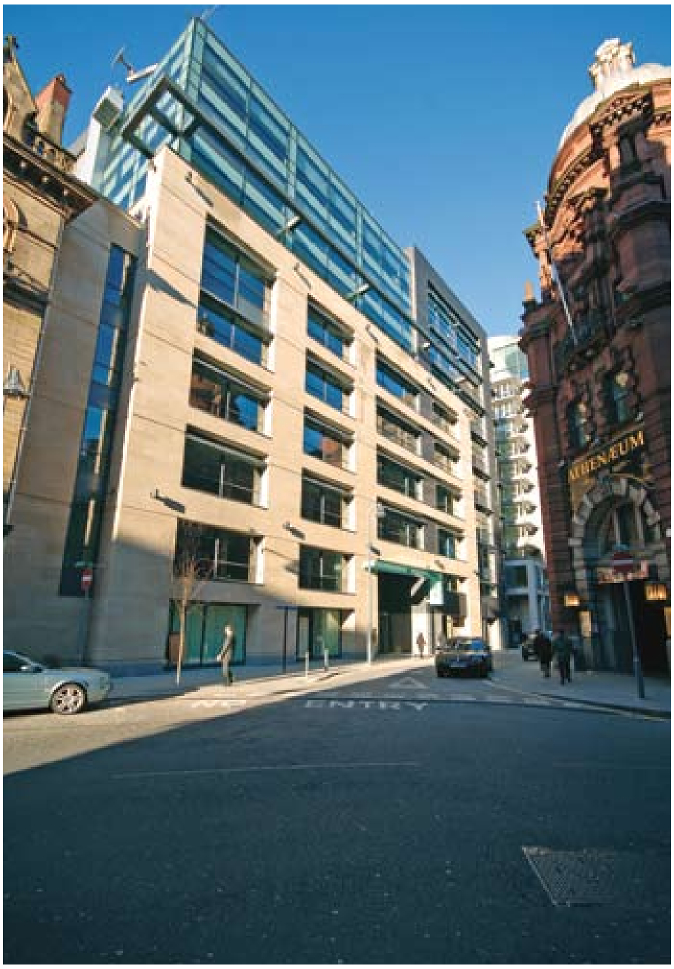


Whilst current investment market performance is very poor, we are optimistic that the sector will turn around later this year, and there is once again a case for investing in commercial property, as demonstrated by the following chart showing property yields, Gilt yields and Swap rates. As property yields fell during 2006 and early 2007, there was a corresponding increase in gilt yields and Swap rates. This eroded the case for property investment for both institutional investors and private buyers.

However, Gilt yields and Swap rates peaked in the middle of 2007 at around 5.3% and have since fallen back noticeably, to around 4.5% in January 2008. Similarly, Swap rates have reduced from around 6.2% to 5% over the same period. With the sharp rise in office yields, the pricing of commercial property is once again beginning to look justifiable. Indeed, a number of private buyers are now back in the market.

Yields and Swap Rates Source: IPD





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