lismore

REAL ESTATE ADVISORS

"Intelligence"

Scottish Investment Market

Quarterly Review
September 2020

lismore-re.com

“Intelligence”

WELCOME

“This time is different” — always a dangerous thing to say?!

Over the last decade the Scottish investment market has faced more than its fair share of uncertainty from The Independence Referendum and build up (2012-14), The EU Referendum (2015-16),Brexit negotiations (2018-19) and now COVID (2020). Despite this disruption, investment volumes have remained remarkably robust and what has changed over the period and is now genuinely “different” is the profile of buyers who are active in Scotland.

Ten years ago the market was dominated by UK buyers with a sprinkling of overseas capital. Today Scotland continues to attract UK buyers but it is also attracting investors from a much broader and more exotic range of countries — mainland Europe (including Germany / France / Austria), all of the GCC states, Asia and North / South America. In short, our market has globalised.

With this backdrop, in addition to our market analysis, our focus in this review is on the range of overseas buyers. Identifying who will be most active in Q4 and sharing short interviews with two of the most active overseas investors (German and South Korean) to understand why Scotland is proving a resilient and an attractive place to invest.

Market overview.

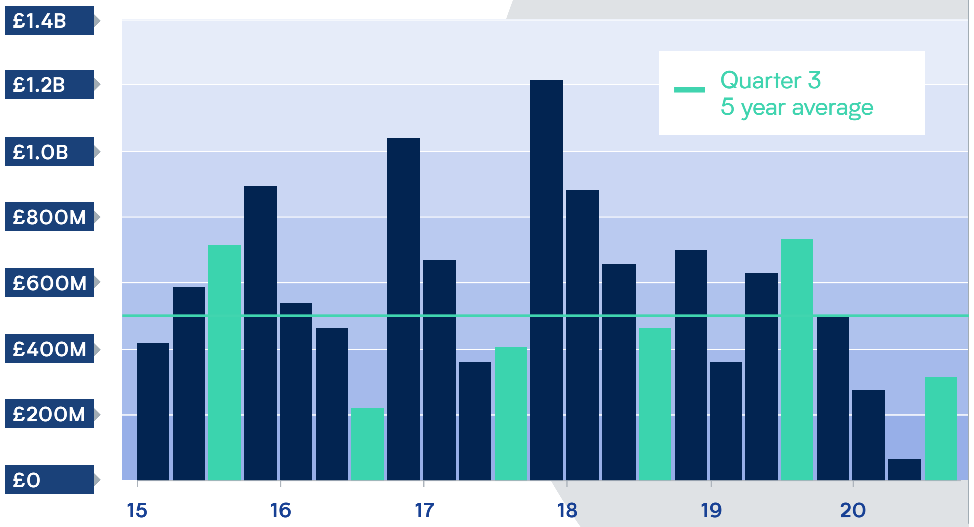
Key themes

- **Sheds, sheds, sheds** — multi-let estates and well let distribution warehousing remains top of many investors requirements lists.
- **The regions strengthening** — "working local" is proving popular and the UK regional cities may well benefit from being less reliant on densely populated public transport systems and find it easier to offer a more flexible work/life balance.
- **Out of town retail finding its level** — quicker than the high street and shopping centres. Well let urban parks, particularly if they are anchored by food stores are proving liquid.
- **Growing weight of private capital** — as interest rates look set to remain at record low levels for the foreseeable future, there is a burgeoning weight of private equity chasing well let assets — particularly urban logistics.
- **Material uncertainty clauses lifted** — has helped to free up some stock and should also help to bring a little more liquidity to the debt markets.

Transaction volumes

- After a subdued Q2, Q3 has been much more encouraging with c£320m traded.
- This was some four times greater than Q2 2020 (£80m) but 37% less than the 5 year Q3 average of c£500m.
- In addition, we are aware of a further c£100m across central Scotland currently under offer to equity based in the US and Germany.

Sale volumes



Pricing

- Multi-let industrials, logistics and food store yields are hardening, while annuity and prime offices are holding firm.
- After a period of limited activity in the core plus sector, there is now more stock on the market and early signs are that pricing may come off slightly.
- Value add — the weight of capital chasing this stock is growing but as yet, little has been traded. We anticipate a softening in certain sectors as inputs during underwriting will be scrutinised forensically.

Investor activity

- A combination of the lifting of the material uncertainty clauses and the phased unlocking of the open ended UK Funds is likely to see a stronger flow of stock either quietly or openly on the market.
- For prime larger opportunities overseas capital is dominant — Asian and German investors continuing to be particularly active.
- The Private Equity wall of cash continues to build with a weather eye on 2021 when less bank forbearance and corporate distress is anticipated.

Buyer Spotlight: Overseas Capital.

This quarter we are shining our spotlight on the growing trend of overseas capital targeting opportunities in Scotland. Key deals, who is active and why they are choosing to invest in Scotland.

Key office transaction

Aegon HQ, Edinburgh Park

- Vendor – M&G Real Estate
- Purchaser – Roebuck Asset Management on behalf of Hyundai Asset Management (South Korean)
- Let for 16 years to Scottish Equitable plc, with annual RPI rental indexation
- Price/Yield – £133m/4.85%
- Date – July 2020

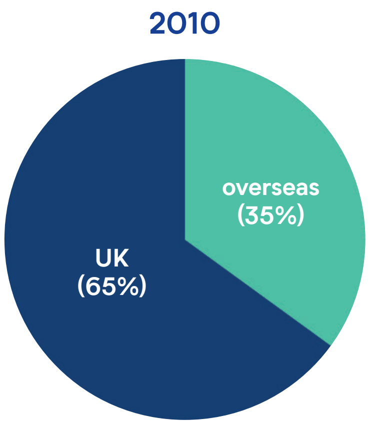
Key logistics transaction

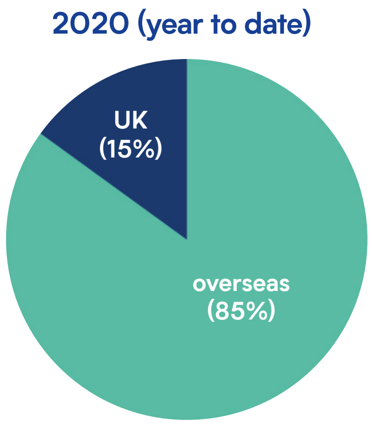
Amazon fufilment centre, Dunfermline

- Vendor – Rasmala Real Estate
- Purchser — Knight Frank Investment Management on behalf of KB Securites (South Korean)
- Let for 11.5 years to Amazon with 5 yearly CPI rental indexation
- Price/yield – £65m/4.8%
- Date — September 2020

Buyer profile analysis

The graphics below give a snapshot of how the buyer profile (equity origin) has evolved over the last decade comparing 2010 v 2020 (year to date). As is evident, the key markets in Scotland have been globalised with the buyer profile almost completely unrecognisable from 10years ago.





- The top 3 buyers (by volume) in 2010 were Land Securities, Standard Life Investments (now ASI) and Aviva.
- Of the overseas buyers prevalent at the time, the majority were German (KanAm, SEB and Patrizia) with US Private Equity (Moorfield) also active.

- The top 3 buyers (by volume) in 2020 have been Hyundai Asset Management (South Korea), KB Securities (South Korea) and BauMont Real Estate Capital (France).
- Other significant activity has come from Elite Capital Partners (Singapore) and Maya Capital (Russia).

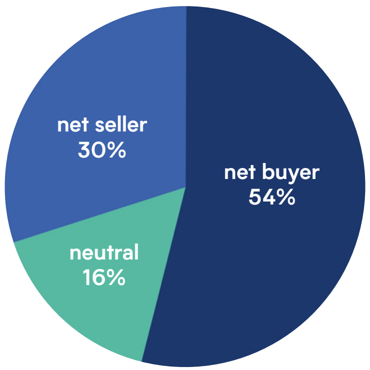
Why Scotland?

- Excellent quality of life enabling employers to attract and retain the best staff.
- World class Universities, attracting students from across the globe.
- Robust Legal system enhanced by no ’54 Act, offering investors a strong negotiating position at lease expiry.
- Good market dynamics of healthy demand and limited supply in the key centres, in particular Glasgow and Edinburgh.
- Relatively good value (slightly more yield) when analysed against London and other comparable mainland European cities.

The investor view — on Q4 2020.

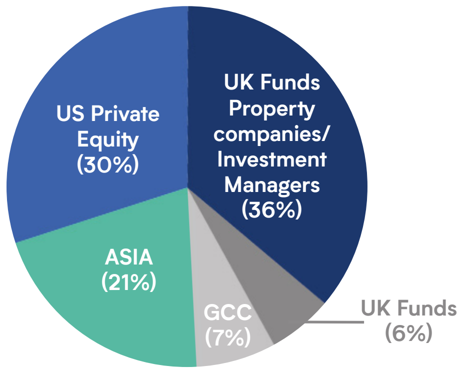
As we begin to see some momentum slowly returning to the market, we are keen to understand how Q4 2020 might shape up. To assist with this, we have engaged with a broad range of investors (Funds, property companies, investment managers and overseas/private equity) asking the following questions:

1) For the remainder of 2020 are you likely to be a net seller, net buyer or neutral?



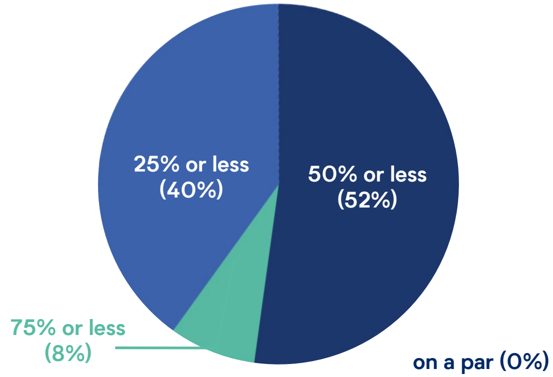
- Of the 54% saying that they would be net buyers, almost half (48%) were either US private equity, overseas capital or UK managers fronting for overseas capital. Funds and property companies were evenly split at 26% each.
- It was clear that of the active Funds, the majority were segregated mandates, with the open-ended Funds being acquisitive only on a very selective basis.
- Perhaps unsurprisingly, of the 16% saying that they would be sellers, 75% were Funds. Of those adopting a neutral position, the largest group (45%) was property companies, with Funds, investment managers / overseas capital fairly evenly split at 25% and 30% respectively.

2) Who do you think will be the most active buyer group — UK Funds, Property companies/ Investment Managers, investors from the GCC, investors from Asia or US Private Equity?



- There was a clear majority (58%) saying that they felt the most active buyer group would be overseas capital. Of this, the split was 48% US private equity, 40% Asia and 12% GCC.
- Despite the current wave of overseas buyers, there was still significant support for property companies and UK investment managers (36%) with most saying that they anticipated some "opportunity" over the next 12 months.
- Only 6% felt that UK Funds would be acquisitive but it was clear that a small number of Funds would be active once there was more clarity in the market.

3) Do you think investment volumes in Q4 2020 will be on a par with the 5 year average, c25% less, 50% less or c75% less?



- There are lies , damned lies and statistics but there was a very clear message (0%) that Q4 volumes would be on a par with the 5 year average!
- Interestingly only 8% felt that volumes would be 75% less than the 5 year average, equally split between property companies and investment managers.
- The overwhelming majority (92%) indicated that volumes would be either 25% or 50% less. Of this figure, (41%) were 25% less and (59%) were 50% less. Importantly, a significant number highlighted a reluctance to travel as one of the key drags to stronger transactional activity. As and when the current restrictions ease (particularly from overseas) this should help to improve liquidity.

To finish, a view from the dealmakers...

To help understand what overseas capital is most active in Scotland and their investment rationale, we have engaged with two of the most high profile players fronting capital from Germany (KanAm Grund) and South Korea (Knight Frank Investment Management), asking them a range of questions about their market activity. They very kindly agreed to give us their insights which are highlighted below and overleaf:

Anthony Bull-Diamond

Head of Investment Management Europe,
KanAm Grund Group

Recent acquisitions in Scotland:

4North, Edinburgh - 41,000ft prime office let to Computershare. c£31million.

4-8 St Andrew Square, Edinburgh - 165,000ft prime office, leisure and retail block let to ASI and a range of restaurants and retailers. c£120million.

Greenside Building, Edinburgh - 38,000ft multi-let prime office. c£18million.

Broadway 1 , Glasgow - 125,000ft prime office let to Tesco Bank. c£55million.

German institutional investors have been active in the UK for decades now and have been particularly active recently. What is it that drives this continued outbound investment?

Most German Institutional core/core+ investors are long term holders. Of course the impact of Covid-19 and the ramifications of Brexit on the wider UK economy are major concerns, however, provided the underlying sub-market (supply demand dynamics) and real estate (quality of asset, location, reversionary potential, quality of tenant, WAULT, relatability etc.) tick the boxes in combination with an attractive risk return profile, we are willing to selectively invest into “best in class”.

The majority of activity has been in the office sector. Why is this and do you see any value or opportunity in other sectors?

Now more than ever, other alternative sectors are coming to the forefront of discussions, however, the KanAm Grund Group does what it has been doing best over the last 20 years which is investing predominantly into offices. Having said that we have also been diversifying our asset base over the years into logistics, hotel and selective high street retail and remain core/core+ opportunistic buyers for these sectors.

The UK regional market still offers a substantial headline yield arbitrage compared to similar European cities. With hedging and slightly more expensive debt costs, is the UK regional market still comparatively attractive?

This usually represents the biggest challenge for us and our investors. With current hedging costs close to 100bps on equity invested p.a. with all-in senior debt lending rates substantially higher than on the continent of Europe, a UK regional core/core+ office investment typically calculates comparatively worse than a similar investment in core markets on the continent. However if the investment rational is sound and the underlying real estate is convincing, investors are keen to diversify and compliment their existing holdings with UK regional investments on a very selective basis.

KanAm and other German investors have been very active in Scotland, especially so in Edinburgh. What is it about the Scottish market which appeals?

I think most people admire Edinburgh as a City. The city ranks highly in terms of quality of life, has a sound employment base, a great university and generally has much to offer as a destination.

From a commercial real estate perspective, we like the fact that the supply of new Grade A office schemes is severely constrained which in light of healthy take-up over this cycle has reflected in healthy rental growth. This in combination with an international and moreover liquid investment market, ranks it highly as a top UK regional investment destination.

COVID-19 has taken the spotlight off Brexit, but it’s clearly still an additional layer of uncertainty? As a European investor active in the UK, how does Brexit feature in your thinking?

The combination of Covid-19 and Brexit is a key challenge in justifying a UK investment at this moment. For this reason, our strategy is more risk averse at this point of time in the UK and we are extremely selective in what we pursue. We do however have appetite to go up the risk curve where we identify value but generally speaking we see a disconnect on pricing expectations between vendors and buyers in the UK at the moment.

KanAm has grown substantially as a business in recent years, with a number of new mandates. Where do you see the growth opportunities coming from in the current market?

I think we will always create growth opportunities when we focus on what we are best at and stay true to what we believe constitutes a good investment.

David Johnson

Partner

Knight Frank Investment Management

Recent acquisitions in Scotland:

Amazon Fulfilment Centre, Dunfermline – 1million ft Amazon distribution depot. £65million.

Leonardo Innovation Centre, Edinburgh – 430,000ft office and technology centre let to Leonardo. £100million.

Bothwell Exchange, Glasgow, 155,000ft prime office let to Morgan Stanley. £55million.

110 St Vincent Street, Glasgow. 95,000ft prime office let to Bank of Scotland. £48 million.

South Korean institutional investors have been very active globally over the last 5 years. What is it that has driven this wave of outbound investment?

South Korea is a fascinating economic success story recording significant economic growth over the last few decades, the rate of which is actually quite unusual for developing countries. As the domestic wealth has grown so has the need for investment diversification to other key global markets, the next logical step, and KFIM were quick to identify this and start developing relationships with some of the largest Korean investor groups. The population of South Korea is ageing and in the current low interest rate environment, real estate provides an attractive investment option, being less volatile than the stock and bond market. In addition, relative to demand, South Korea simply does not have enough real estate to satisfy the weight of capital or indeed provide the same level of return that investors can secure in other countries.

The focus has very much been on office and logistics investments. What is it about those sectors that is attractive, relative to other sectors?

These sectors are typically very easy to understand and sectors that KFIM have advised our Korean clients to focus on. Our strategy is to target well located long income assets, generally let to globally recognisable covenants.

KFIM's primary objective is to minimise our clients risk whilst generating investment performance, our Korean clients often have a very specific target return and hold period to work within. The logistics and office sector are where we have identified a higher number of well-located assets that provide an attractive blend of covenant, lease term and yield. By targeting this profile asset KFIM are able to utilise existing lender relationships to secure attractive lending terms allowing the client to benefit from the enhanced leveraged returns.

With the ongoing turmoil in the retail markets, as the traditional retail operators struggle to compete with online offer, retail pricing, in our opinion, still needs to undergo greater adjustment, not least with many assets still being significantly over-rented.

South Korean investors have been active throughout lockdown, in challenging market conditions. Are you sensing that the investors are becoming more discerning with their requirements?

There is no doubt that the investors we have worked with in recent years are incredibly bright and have absorbed a huge amount of information about property across Europe. Korean Investors are becoming far more discerning but do still require a local asset managers to accurately present and appraise a deal. KFIM provide the balanced advice that is often needed, giving an investor the complete picture, good and bad. Overtime we expect a greater knowledge of some local European markets to result in some investors moving slightly further up the risk curve, potentially towards assets that provide a greater opportunity to add value through asset management.

Two features which are common to all deals are senior debt financing and, ultimately, partial sell-down of the equity. How are you finding the conditions currently in those areas?

Importantly the first point I would make is that, contrary to popular perception, not all Korean investors sell down post acquisition. Yes, this often applies to the Securities Companies (albeit even some of those companies will hold on their own balance sheet), but it does not usually apply to the pension funds (many of whom will enter into a club arrangement at day one and will not subsequently sell down). For those investors that do sell down, there is no doubt that Covid-19 affected the process, not least due to issues with travel and inspection. However, based on the conversations we continue to have with our Korean clients (which are quite varied in type), there is still significant appetite for European real estate from the whole spectrum of investors.

The debt market has been challenging there was a complete lack of liquidity mid pandemic, and when it did start to return it was at lower LTV's. Based on our own relationships with lenders, it is clear that there is starting to be a higher degree of liquidity albeit lenders remain very selective in terms of what assets they are prepared to lend against, margins are higher and LTV's remain challenging. A number of the deals that were under review pre-Covid have been affected by the current debt terms and will no longer provide the Korean capital with its desired level of return.

We have been fortunate to be able to attract substantial amounts of South Korean capital to invest in Scotland. What is it about the Scottish market that attracts them?

I think Scotland has some really good quality office stock, both Glasgow and Edinburgh particularly are vibrant cities with great universities, a young tech savvy population with an attractive office market that makes a compelling business case to invest. There are genuine prospects for rental growth, a tight supply of offices and a large number of financial institution and investment grade companies that have a significant base or HQ in the cities. These positives aspects have been complimented by good lending terms and at an entry yield that has been able to meet the Korean investors target returns.

KFIM has grown substantially as a business in recent years, with both UK and overseas mandates. Where do you see the growth opportunities coming from in the current market?

With 15 assets being acquired across Europe on behalf of Korean capital over the last three years we have made a lot of friends in Seoul and hope that we can continue to develop these relationships and grow this part of the business.

Since the KFIM business was re-launched back in 2012 we have taken an entrepreneurial approach to everything we do, including the management of our portfolios and client relationships — the growth of the business during this period, combined with the out-performance (independently measured) of our portfolios, is testament to the success of our approach. Looking to the future, we want to target other international markets where we believe that we can genuinely add value to the decision-making and investment aspirations of the investors — countries such as Japan immediately come to mind. Critical to achieving this is understanding what is important to individual investors, their culture and their long-term aspirations, all of which understandably take time and commitment to achieve.

Domestically we are very focussed on the ESG agenda, both in terms of how we run the KFIM business, and how we can help to meet our Clients own ESG aspirations. Quite rightly, this is a theme which is not going to go away and which we expect to grow a significant head of steam over the next few years.

“*Intelligence*”

Scottish Investment Market
Quarterly Review – September 2020

For more “***Intelligence***” contact:

Simon Cusiter
T 0131 202 4561
M 07815 135222
simon.cusiter@lismore-re.com

Colin Finlayson
T 0131 202 4562
M 07739 299530
colin.finlayson@lismore-re.com

Chris Macfarlane
T 0131 202 4563
M 07711 851700
chris.macfarlane@lismore-re.com

Richard Mackie
T 0131 202 4564
M 07966 396480
richard.mackie@lismore-re.com

lismore
REAL ESTATE ADVISORS

Visit **lismore-re.com**