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“Intelligence”

Annus horribilis — “2020 is not a year on which we shall look back with undiluted pleasure…”

On the face of it, for the majority of people, 1 January 2021 cannot come quick enough. Whether it is your health, business or home-life — 2020 has been challenging to say the least. However, as this review is being written, the eagerly awaited vaccine is beginning to be rolled out, which will hopefully signal the start of confidence returning and fear subsiding. At least, for our own mental well-being, it is good to be focusing on something positive!

As with any global economic shock, the resultant impact on real estate has produced winners and losers. On the downside, the pace of change within certain sectors (particularly retail) has been truly staggering — one client suggesting that the sector has evolved 10 years in the last 9 months. High streets and shopping centres have been hardest hit but food stores, “local” shopping and retail warehousing have all shown greater resilience. The office evolution has quickened to better accommodate flexible working but without doubt, the biggest winners are in the distribution, industrial and residential sectors. The very significant rise in occupier demand as a result of the structural shift towards on-line retailing, last mile logistics and the robust income collection from all forms of residential has simply fuelled the already insatiable appetite for product in these sectors.

With this backdrop , in addition to our market analysis, our focus in this review is looking forward to 2021 — what will investor appetite be like, what sectors will be in vogue and importantly, how will real estate finance evolve in the year ahead? To help shape our thinking, we are pleased to share short interviews with one of the key high street lenders (RBS) and one of the most active UK institutional investment managers (Aberdeen Standard Investments).

Here’s to a brighter 2021…!

Market overview.

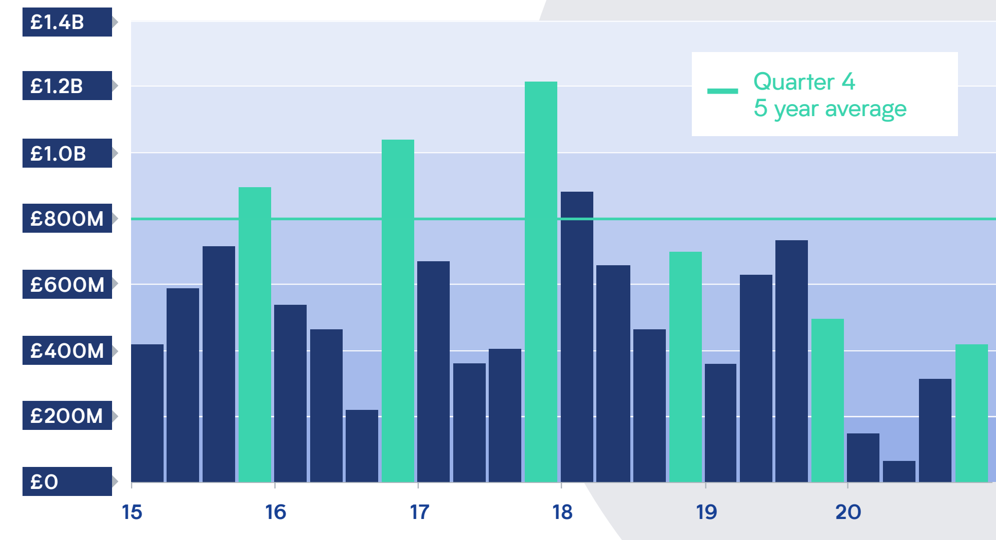
Key themes

- **All hail the vaccine —** those focused on the office sector are desperate for a return of confidence and easing of Government guidance, which will stimulate a return to office working - however flexible that might be.
- **Retail warehousing, appetite growing —** not simply from opportunistic buyers but institutional money is realising that well located (food anchored) parks with ungeared returns, north of 7%, do make sense.
- **Scottish distribution and multi-let industrial —** now attracting a much wider range of global capital — mainland European, GCC, Asian and North American.
- **Residential resilience —** setting aside short-term headwinds - student accommodation, BTR, senior living and care homes are all proving to be very reliable income streams. 2020 will prove to be the highest year on record for BTR volumes.
- **The life sciences sector emerges —** to date relatively under the mainstream radar but all of a sudden thrust into the limelight. In addition to the established specialists, there is a growing weight of money starting to discover the sector.

Transaction volumes

- We are anticipating that Q4 volumes will end up at c£420m, which is some 30% up on Q3 at £320m.
- Against the 5 year average this will be c50% down but in the face of such significant headwinds, it is better than many were predicting during summer 2020.
- After a relatively subdued first half of the year, volumes in the second half of the year have been more encouraging meaning that total volumes for 2020 will end up at close to £1bn.

Sale volumes



Pricing

- Distribution, multi-let industrial, food stores and residential remain the hottest sectors of the market with pricing continuing to harden — in cases anywhere between 25-50bps over the last quarter.
- The core plus sector — despite some concerns last quarter that this market was softening slightly, this has not (yet) happened and the continuing weight of capital circling this sector is helping to maintain pricing.
- Value add, patience is a virtue! The continued support from central Government is meaning that outside of the retail and leisure sectors, the rate of tenant failure and lending default is being curtailed. 2021 is likely to see more opportunity for private equity.

Investor activity

- As the UK open ended funds have re-opened, there has been orderly selling with strong pricing being achieved for sales in the liquid sectors. Other fund activity has been very focused on the safest sectors of distribution, industrial, long income and residential.
- Overseas investors remain prevalent but current travel restrictions have curtailed their activity. Once these ease, we anticipate a strong comeback. The weight of global capital looking for a home has not diminished.
- In the absence of immediate distress, private equity is looking at longer term strategic land acquisitions for mixed use development and re-purposing of shopping centres or urban retail warehousing with strong underlying development potential.

2020 – some of the winners...

It has been a tough year but amongst the COVID gloom there have been some bright spots and we have highlighted below a selection of key deals and active sectors which have defied the odds.

Distribution

Sainsbury's RDC, Langlands, East Kilbride

- Vendor – Orchard Street Investment Management
- Purchaser – Blackbrook Capital
- Let for 14.5 years to Sainsbury's Supermarkets Ltd with 5 yearly RPI rental indexation
- Price/Yield – £31m/4.68%
- Date – November 2020

Food stores

Two Waitrose stores — Glasgow & Milngavie

- Vendor – Town Centre Securities
- Purchaser – client of Avignon Capital
- Let to Waitrose for 9 and 19 years
- Price/Yield – £23.2m/5.5%
- Date – November 2020

Prime offices

Quartermile 3, Edinburgh

- Vendor – M&G Real Estate
- Purchaser — KanAm Grund Group
- Let to State Street/Cirrus Logic for 8.5 years
- Price/Yield – £45m/4.61%
- Date — November 2020

Build to Rent

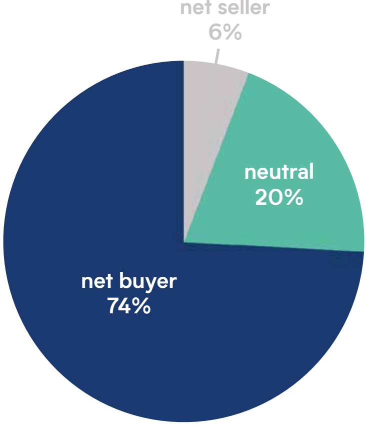
Candleriggs Square, Glasgow

- 346 unit scheme
- Vendor – Drum Property Group/ Stamford Property Group
- Purchaser – LGIM Real Assets
- Development Funding
- Price – £81.5m/4.5%
- Date – September 2020

The investor view — on 2021 and real estate finance.

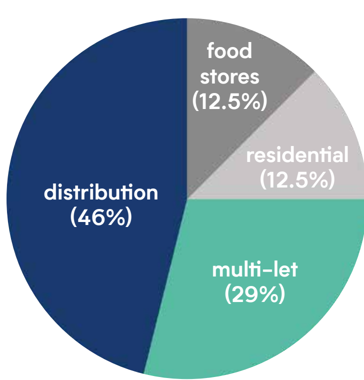
With a seemingly brighter 2021 looming, we are keen to understand if investors will see this as an opportunity to be active, what sectors are likely to perform and how they view the finance market. To assist with this, we have engaged with a wide range of investors (funds, property companies, investment managers and overseas/private equity) asking the following questions:

1) During 2021 are you likely to be a net buyer, neutral or net seller?



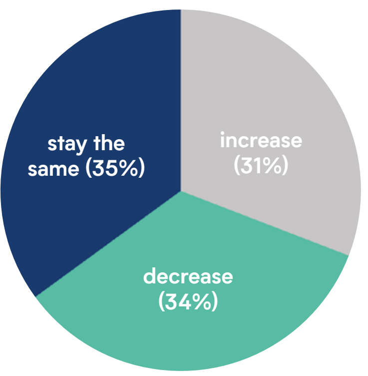
- An overwhelming majority (74%) will be acquisitive, with funds and property companies neck and neck, making up the majority (70%).
- Of those staying neutral the majority were property companies (45%), some stating that they remained focused on income collection ahead of new aquisitions.
- Perhaps the most startling finding was that only 6% said they would be net sellers, reinforcing our view that there will be a very significant weight of capital chasing limited stock in 2021.

2) Which will be the top 3 performing sectors in 2021?



- Not surprisingly the top 3 sectors were (1) distribution (2) multi-let industrial and (3) joint-food stores and residential.
- More interesting is the tier below with both retail warehousing and offices receiving good support. Private equity was the strongest supporter of retail warehousing all highlighted the sector as a target. In the office sector the support came from private equity and investment managers, no funds highlighted offices as a target.
- Hotels and High Street retail were the two lowest ranked sectors.

3) Will Bank appetite for lending to real estate in 2021 – increase, stay the same or decrease?



- This was the question that split opinion mostly evenly with all 3 answers receiving similar support.
- On balance, funds and property companies were more bearish with 25% indicating a decrease against 15% indicating an increase. The overwhelming majority of private equity respondents were supportive of an increase.
- A significant number of respondents commented that the increase in lending was from a fairly conservative base and would be focused on the safer sectors of distribution, industrial, food stores and residential.

To finish, a view on real estate finance...

To help understand how real estate finance is likely to evolve during the year ahead, we have engaged with a leading high street lender (RBS) and one of the most active institutional investment managers (Aberdeen Standard Investments) asking for their views on a range of topics. They very kindly agreed to share their insights which are highlighted below and overleaf:

Stuart Heslop
Managing Director

Recent activity in Scotland:

Cameron Toll Shopping Centre, Edinburgh — Franklin Templeton.

PRS REIT £100m Development Loan

Target Healthcare £70m RCF

Hermiston Gait Retail Park, Edinburgh — Ediston/BauMont Capital.

Real Estate Finance, Scotland & North England and UK Housing Finance

On a general note, do you see more or less appetite for real estate lending in 2021?

That is a very interesting question because in all likelihood we will have arrived in to 2021 on the back of subdued activity in the lending market as we know it. That's not to say that the lending markets have been closed but lenders have been focussing a lot of their time supporting existing clients come through the crisis by providing support via capital repayment holidays and lending through the various Government support schemes. Arguably therefore we should see more activity and subsequently more lending as we move through 2021. That said, lenders will be much more discerning at sub asset class level with certain sectors receiving more lending appetite than others in a more pronounced way than pre Covid-19.

With the main high street lenders remaining fairly cautious, do you see new entrants coming into the UK market?

I would argue that it is not only the high street lenders who are cautious in this current market because most lenders will be dealing with support for existing clients. The issue is that we have seen very little transactional activity since March and as such there is no evidence from either traditional banks or new entrants of new lending. If history repeats itself, we will see new lenders emerge as we move through 2021 who perhaps have no legacy positions in sectors they would rather, in hindsight, not be in and therefore see opportunity in the lending market.

Has COVID changed any process when taking opportunities for credit approval?

At headline level, we have made no changes to what was already a very measured process on appetite for lending. We have always looked at the sponsor and their track record, the asset class and location of the particular building or portfolio and then the quality of the income. One thing that I could point towards, which is not a change per se but more of a deeper dive would be a much more rigorous approach to appetite at sub asset class level. We all know that retail is not as simple as a headline statement with shopping centres operating and trading very differently from supermarkets and convenience lead retail parks. I would expect that you would begin to see a differing lending appetite across these sub asset classess.

To date, forbearance has been shown by the majority of mainstream lenders when dealing with clients under pressure, do you see this continuing into 2021?

Throughout the crisis we have been extremely supportive of our clients as they navigate what have been some extremely difficult times. In Q2 this year we received requests from and granted support to c25% of our real estate clients across the UK. That support varied from capital repayment holidays, to interest roll up in some cases and covenant waivers for others. We also assisted via the provision of loans via the various Government back Bounce Back Loans, CBILS and CLBILS. We are seeing these requests recede as we approach the year end with rental collection levels being ahead of where many commentators had predicted. So, whilst we shall remain supportive of our clients as we move in to 2021 my expectations are that we will not see as many requests coming our way.

Are there sectors which the Bank is favouring/avoiding and why?

As mentioned above, the one change to our risk assessment since the crisis, has been a much deeper dive in to sub asset classes. To be fair, that had already been the case in retail prior to Covid-19 with a recognition that there are many aspects to the retail market and they have been diverging over the last number of years. We are currently focussed on the more resilient sectors in industrial/logistics and residential markets but we also retain appetite for office markets as they have performed better than we had expected through the crisis with much better rental collection than had been anticipated, even whilst tenants were not actually in occupation. With more positive news on the vaccination programme and some light at the end of the tunnel, I would expect that we will see all asset classes find their equilibrium in the market and our appetite will be based on that. Lenders like stability and certainty and that has been in short supply recently so we all hope to see a return to a form of normality as we move through 2021.

How does the lending market during COVID compare with the challenges of the GFC?

I've had the experience of working through both crises in the sector and they have been very different. If I reflect back to the GFC, we had a set of circumstances that collided to create the problems that we encountered. Asset values had peaked, leverage in the market had gone beyond where it had been before and of course the Banks also found themselves at the centre of the downturn. So, not only did we see borrowers in distress, we also had the lenders in a similar situation. How do you square that circle? Not easily and not quickly so it took a long time for the challenges to be worked through. This time around feels different. Attitudes towards debt from borrowers has changed significantly with the danger of high leverage understood and of course lenders have also tempered their lending appetite. The result is that we entered this crisis with much lower leverage. That makes it much easier to deal with for many clients. Coupled with near zero interest rates when compared to 2008 interest rate markets and the fact that the lenders are in much stronger financial and capital adequacy positions results in a much more benign backdrop. It feels like we will bounce back from this crisis much more quickly than 10 years ago.

Is development funding on the Bank's radar?

Development funding has always been an area where we have tried to stand apart from the market. We have always retained an appetite to support our development clients and I would estimate that 30-40% of deals that we write in any year will be development led. Clearly a pre let development scheme is much easier for us to assess and deliver leverage to support but we have consistently executed speculative development funding over the last few years across the country. We think it is important to be able to support clients to execute their plans. Recent examples would be Chris Stewart Group's Mint Building development in St Andrew Square, Edinburgh. It would be fair to say that we are cautious at the moment with occupational markets difficult to predict in the midst of a crisis but we will be back on the front foot as soon as the market conditions allow.

Tom Elviss
Deputy Fund Manager

Recent development funding activity:

Maldron Hotel, Glasgow —
300 bed 4 star hotel.

Clyde Gateway, Cambuslang —
mid box warehouse development.

Glenthorne Road, Exeter –
227 bed PBSA scheme.

RE Investment Management
Aberdeen Standard Investments

Traditional bank debt has continues to be challenging, particularly for development projects. Do you view this as an opportunity for institutional investors such as ASI?

Yes, there has definitely been a tightening of credit conditions and an increase in margins from the traditional lenders. This will in time lead to issues with investors refinancing and for value add work which requires debt backing. This will lead to opportunities for institutions to fill the gap in the market, providing equity in place of bank lending or indeed acquiring distressed assets.

Although short term the traditional UK lenders have taken a very pragmatic approach to existing borrowers there will undoubtedly be an ongoing economic impact of the Covid19 pandemic. It was clear in the Chancellors Statement that, although the health issues may be coming to an end, the economic issues are only starting. However, in a highly polarised market the greater distress is still likely to become prevalent in the less favoured sectors of retail and leisure.

What sectors do you view as most attractive when considering new opportunities and why?

We continue to remain focussed on the industrial and residential markets, where we have greater confidence in the underlying market dynamics and resilience to respond to the disruption caused by the Covid19 pandemic and ongoing economic issues. The investment market for these asset classes is incredibly competitive and we continue to see yields hardening. This is particularly evident in urban logistics where the growth story is strongest and we see huge demand growth and limited supply given the shortage of sites in these last mile locations.

Retail remains very challenging and the high street and shopping centres continue to bear the brunt of falling customer demand and spend. Supermarkets are the obvious exception to this sector wide view and have continued to increase sales and still offer long secure income streams to investors. Retail warehousing also can show more resilient fundamentals where we see strong line ups at rebased rents and the yield margin over the market is starting to look compelling. As always understanding the underlying trade from these assets is key to appraising risk.

The office sector is challenging short term as we are yet to establish when and how businesses will reoccupy their space. There have undoubtedly been structural changes to how office workers will fulfil their role in the future with greater working from home, but with a vaccine on the horizon and many contemporaries finding working from home more challenging through the depths of winter it will be fascinating to see the return to the office as and when that is allowed.

Has Covid-19 changed the way you view the risks in funding transactions and do you see these as short or long term?

As a house we are taking a low risk approach to managing our portfolios. However, in select sectors, we are still willing to take development risk. Ironically we have been active in the student residential development market and the delayed delivery of these assets a year or two in the future is actually seen as advantageous as we hope to be delivering a product in a more normalised environment. This does however need to be offset with the risk of delays to the construction program caused by sites being closed and raw material supply pipeline delays.

Although we have seen a Covid19 impact on all markets we believe that sectors such as PBSA are likely to revert back to their previous condition once a vaccine allows life to become more normalised. This is in contrast to the retail and office markets which we believe have seen a longer term and permanent structural change to demand and operations.

Longer term with lower returns forecast and competition to acquire standing investments, development will continue to be an attractive route to secure stock.

How important are ESG credentials of a development when taking new opportunities to Investment Committee?

ESG is at the core of the investment process at ASI. Dan Grandage who is the Head of the Private Markets ESG team sits on the main decision making committees including the investment committee. At an asset level we have also developed a bespoke model the Impact Dial which will enable us to measure 20 ESG criteria and set asset level targets.

There is a clear direction of travel with regard to environmental legislation and if we do not incorporate and improve the ESG rating of our assets there is a greater risk of obsolescence.

I agreed a funding of a PBSA scheme in the South West in Q1 and the asset was targeting an Excellent BREEAM rating and a carbon neutral construction. This was a major benefit for us as regards the accreditation of the scheme and also will be an important factor when we market the asset to an increasingly environmentally aware generation of 19-22 year old occupants.

The "Living" sector has proven particularly resilient. Do you see this sector continuing to grow as a target for your capital, particularly in relation to operational assets?

ASI are one of the largest residential landlords across Europe with c €7bn of assets under management. The sector will continue to be a target for Capital and we are seeing renewed interest from some of our traditional commercial funds looking to diversify income streams.

Although not immune to the impact of the last years disruption, the durable and diversified income stream offered by the sector offers a compelling investment case in a low risk investment environment. One of the major challenges remains the efficiency of running these assets and our vast experience across Europe helps us to control operational costs and drive the operating income from our assets.

Outside of this sector, do you see appetite for speculative development returning for any of your funds?

As a house we would look at speculative development within the industrial sector. Given the current depth and breadth of bidding for vanilla standing investments, there is an appetite to take on the development and lease up risk. This is a strategy we have been following as a house over a number of years and have had successful projects delivered and let at Enfield Distribution Park and Birch Coppice.

“Intelligence”

Scottish Investment Market Quarterly Review – December 2020

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