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“Intelligence”

Scottish Investment Market

Quarterly Review
March 2021

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“Intelligence”

“A more positive outlook, the return to some sort of normality is within reach — hopefully!”

The new year certainly didn’t bring the news we had hoped for with a return to a countrywide lockdown. The Government’s timetable for restrictions to be eased has been welcomed, however by the time the most significant restrictions are eased, it will have been 5 months since the much needed Christmas break. The roll out of vaccinations has (so far) progressed quickly and efficiently, providing light at the end of what has been a very long tunnel!

The true impact of the economic shutdown over the last 12 months has yet to be fully realised, however the impact on the various property sub-sectors has been pronounced. The logistics /industrial juggernaut moves apace but we believe any talk of the demise of offices is hugely over-stated, with the majority of workers keen to reconnect with colleagues in an attractive, healthy and flexible environment. The Living sector continues to be top of many investors buying lists but it is the retail sector which has seen the most severe reaction — both negative and positive. From “value destruction” and “re-purposing” in the shopping centre and high street sectors through to “resilience” and “opportunity” the buzz words in the foodstore/convenience and best located retail warehousing sectors. Structural change for sure but not total decimation.

With this backdrop, in addition to our regular market analysis, our focus this quarter is on the retail sector and the significant impact of the last year which has fundamentally changed the retail landscape. To help give some perspective and to provide insight and expertise, we have sought short interviews with Ediston Real Estate (one of the leading Scottish based Investment Management businesses with a particular expertise in retail warehousing) and Nuveen Real Estate who, together with APG, are investing over £1 billion into the St James Quarter in Edinburgh, due to open June 2021.

Market overview.

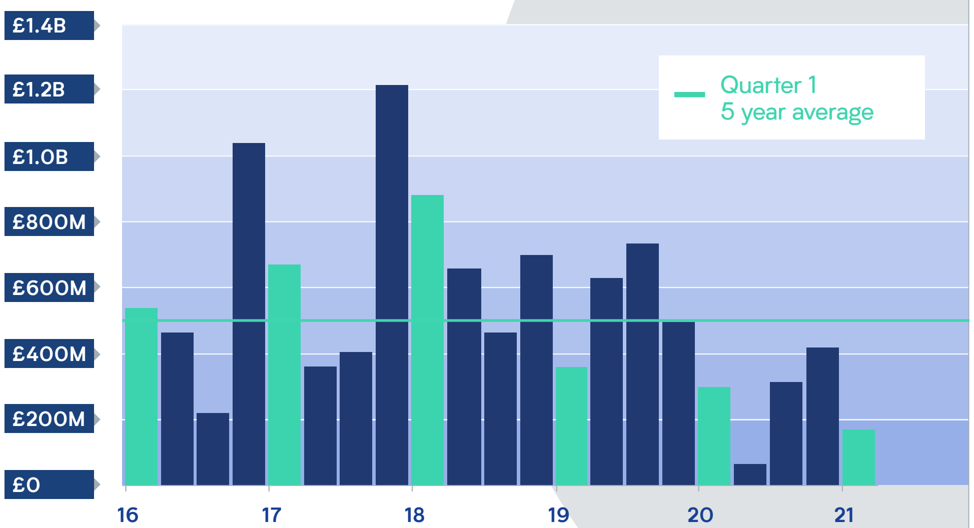
Key themes

- **Office polarisation —** with ESG and staff well-being now firmly at the top of the agenda for offices, those buildings that offer (or can be adapted to offer) features to meet occupier demands will succeed and thrive. Those that can't will come under serious pressure from occupiers and see a softening in values.
- **Spec logistics development increases —** no great surprise that with such strong market dynamics, the pipeline for new space located in the central belt is, at last, gaining momentum. Demand continues to outstrip supply, so those currently on-site are likely to be the early winners.
- **Post COVID leisure bounce —** as the vaccine rollout continues and with the easing of restrictions, those operators that have survived should see a strong return of business. Returning to significant profit levels is likely to take longer.
- **New lending into retail warehousing —** we are seeing some new entrants into the market who do not have legacy issues, primarily focused on urban parks and food led schemes. Terms remain conservative but an acknowledgment that certain physical retail still has a future.
- **Shopping centre value destruction —** those owners who are keen to sell schemes with limited alternative use options are having to accept huge value reductions with recent examples in Scotland showing anywhere between 50-75%.

Transaction volumes

- After a comparatively strong Q4 2020, Q1 2021 has been a more subdued quarter with c£175m traded.
- Perhaps not entirely surprising considering the lockdown headwinds and puts it c.70% lower than the 5 year average.
- With more product being either prepped for sale or being quietly marketed, we are anticipating a stronger Q2 but still likely to be significantly lower than the 5 year average.

Sale volumes



Pricing

- Logistics and foodstore yields continue to harden (even for shorter leases) and we are aware of an Edinburgh BTR transaction which will see prime yields in the sector sharpen by c25 bps.
- In the core plus sector — offices and retail warehousing are in focus with pricing remaining firm for quality offices without significant capex requirements and value/DIY retail warehousing off affordable rents. Outwith these sub-sectors, pricing is under pressure.
- Value add — we are starting to see some examples of encouraged selling in the shopping centre sector with very significant value reductions but with limited "forced selling" in other sectors, values have yet to significantly readjust. Our feeling is that with the continued weight of capital waiting to be deployed, real "value" will remain hard to come by.

Investor activity

- Open ended UK Funds are generally continuing their steady selling strategies, while other Funds concentrate on liability matching product or the strongest sectors of logistics, living and life sciences.
- Overseas investor activity has been temporarily subdued as travel restrictions have stagnated this buyer pool. The weight of capital remains and we fully anticipate that this will return by the half year.
- Private equity is getting frustrated as the volume of forced selling remains limited. The speculative funding of logistics in Scotland, backed by PE funding, cannot be far away.

Key recent transactions.

Despite a relatively quiet start to the year, we have highlighted below some of the key transactions which have kicked off the year...

Office:

"core plus pricing remains firm for quality product"

Cuprum, Glasgow

- Vendor – Credit Suisse
- Purchaser – Trinova
- Let to Teleperformance Ltd, AXA Insurance UK PLC, SAS Software Ltd
- Price/Yield – £28.25m / 7.10% (SPV)
- Date – March 2021

Life sciences:

"starting to attract ever more investor interest from overseas and the UK"

Q2 Solutions Ltd (formerly Quintiles), Kirkton Campus, Livingston

- Vendor – ICG Longbow/ Ambassador Group
- Purchaser – LCN Capital Partners
- Let to Q2 Solutions Ltd for 15 years with RPI indexation
- Price – £47.5m / 5.75%
- Date – December 2020

Logistics:

"shorter leases with scope for rental growth proving attractive to Funds"

Titan, Eurocentral

- Vendor – Winward Titan Limited
- Purchaser — Lothian Pension Fund
- Let to The Scottish Ministers for 10 years, TBO at year 5
- Price/yield – £14.326m / 5.01%
- Date: February 2021

Shopping Centres:

"new cash buyers only being attracted by distressed pricing"

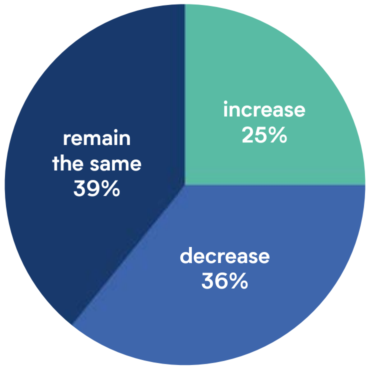
Oak Mall Shopping Centre, Greenock & Ayr Central, Ayr

- Vendor – Apollo Global / M&G Real Estate
- Purchaser – Comer Group
- Price – £4.5m c.20% & £10m / 15%
- Date – February 2021

The investor view on the retail sector.

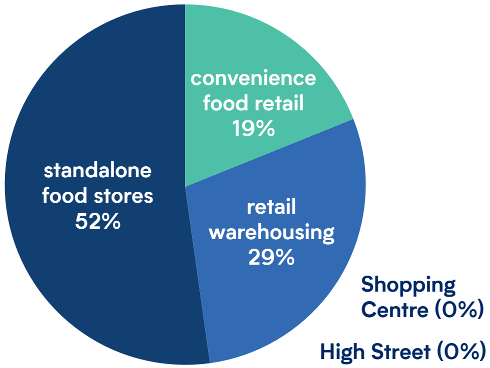
The pandemic has accelerated many of the structural changes in the retail sector that had commenced over the last 5 years. However, the impact of the sub-sectors has varied and to assist in understanding this further, we have engaged with a wide range of investors (funds, property companies, investment managers and overseas/private equity investors) asking the following questions:

1) During 2021, will your exposure to the retail sector increase, remain the same or decrease?



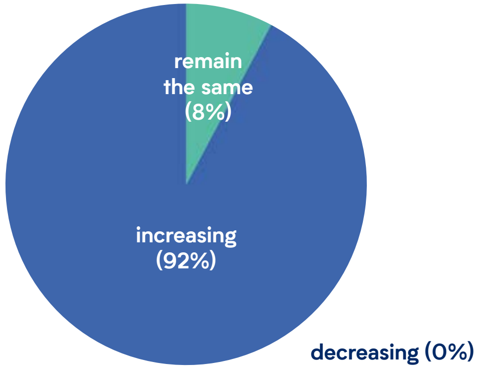
- The majority of respondents will either decrease or maintain their retail holdings (75%), interestingly a significant number will increase their exposure (25%) albeit this is predominantly through an increase in exposure to retail warehousing and food stores.
- Of those increasing their retail exposure, the majority are investment managers (15%).
- Most likely to decrease retail holdings are funds (22%) with only 1% of property companies contemplating a reduction in retail.

2) Rank in order the best performing retail sub-sectors during 2021: high street, shopping centre, retail warehousing, convenience food retail and standalone food stores. The chart below illustrates the results for the best performing retail sub-sector.



- Unsurprisingly, High Street and Shopping Centres are viewed as the weakest sub-sectors, accounting for over 95% of responses in the weakest two categories.
- Standalone food stores contributed to 52% responses within the strongest retail sub-sector, with convenience food stores accounting for the majority in category 2 (51%), followed by retail warehousing in category 3 (54%).
- As expected, essential retail impacted least by the effect of COVID-19 and in many cases over trading during the last 12 months, are viewed as the strongest performers over the next 12 months.

3) As the market settles, do you see the frequency of turnover rents increasing, remaining the same or decreasing?



- The strong sentiment is that turnover rents are here to stay, with no respondents expecting turnover rents to decrease in the short to medium term.
- 92% of respondents expect the prevalence of turnover rents in the retail sector to increase, which will have significant implications for both rental levels and the relevance of retail zoning in the future.
- There was a clear view that turnover rents would be focused on shopping centres and high streets rather than retail warehousing, where landlords are in a stronger negotiating position.

To finish, expert views on the retail sector...

To help understand the ongoing changes in the retail sector, we have sought views from Ediston Real Estate (one of the leading Scottish based investment management businesses who asset manage over £400m of UK retail warehousing) and Nuveen Real Estate, who together with APG, are investing over £1bn into the St James Quarter in Edinburgh due to open in June 2021. They very kindly agreed to share their insights which we have highlighted below and overleaf:

Graham Lind

Director of Retail Warehousing at Ediston Real Estate

Recent activity in Scotland:

Hermiston Gait Retail Park, Edinburgh — JV acquisition Ediston/BauMont Capital

New Town Quarter, Edinburgh — 117 homes, 144 BTR units, 80 affordable homes, 83,000 sq ft office and a hotel

Why is retail warehousing proving one of the more resilient retailing sub-sectors?

I think with the much discussed and debated advancements of online retailing, retail warehousing was proving a resilient sub sector even prior to the dawn of the pandemic. The omnichannel experience that shoppers now demand is very aligned to the out of town retail model with retail parks catering perfectly for click and collect, which often results in additional spend on the Park. The recent progress Retail Parks have made with the variety of offer such as fast food / drive thru provision, coffee houses and leisure operators have lent itself much more towards the modern shopping habits, which demand convenience, accessibility and variety. In a post pandemic world, all of these attributes remain relevant but the physical qualities of Retail Parks, such as open-air public walkways and large units providing suitable social distancing and plentiful free car parking allowing for safe travel to and from retail locations mean the sub sector has not suffered in line with in-town retail provision. All of this is combined with an increase in demand for home purchases; be that DIY, sofas / beds or simple homewares, where Retail Parks have been the traditional home for such items providing a further level of resilience. One should also not forget that on the supply side that, despite the difficulties of the last two years, void rates across the sector remain relatively low at around 5%.

Are your equity partners seeing the current market challenges as an opportunity?

Yes, but the difficult question is; Will it get worse before it gets better? Tenant failure will continue to be a concern after the pandemic recedes and rental values across the sector will be under pressure for some time to come. Artificially high Net Initial yields look attractive but can mask real prospects of significant cuts at lease expiry or upon a corporate event. So value is in the detail of income flows, as it should be, and understanding not only what ERV's may be but what occupiers are prepared to pay. In saying this we do hope to deploy capital into the sector and add to the 18 parks we own and manage for clients.

Debt finance for retail remains challenging, do you see this easing in the short to medium term?

While institutions and banks are reducing exposure to the sector debt finance will be scarce and where it does exist it will be at lower leverage levels and higher margins. The quality of the equity participant and the Investment Manager will also be important. As capital value reductions bottom out, the resilience of rent collection and low vacancy rates will attract lenders back but I don't think it will be until 2022. While new debt is scarce, we are seeing existing facilities being extended quite readily where asset income stream is secure and the bank has confidence in management and equity.

When dealing with tenants who are not paying rent, have you found most taking a sensible approach to working with you?

In the main we have found tenants to have been pragmatic in their approach to rent payment and we have reciprocated. Some as usual have been a pleasure to deal with and talk to. There has been a handful of tenants who have not engaged and have acted unprofessionally and improperly but thankfully that has been in the minority. Good relationships are key to business success and we want to have good relationships with all our tenants. It has helped that the vast majority of the sector was able to trade through the lockdowns with around 75/80% of units in our portfolio trading through the various lockdowns.

Do you envisage a situation where retail parks will become hybrids for physical retailing and distribution hubs for on-line retailing?

It will be interesting to see if retail units evolve into serving this dual purpose, and in some locations servicing local deliveries could prove cheaper than using 3rd party logistic companies. I see the bigger opportunity in the growth of click and collect which is predicted to grow by 50% over the next 3 years and Retail Warehousing is a medium suited perfectly to this where plenty of storage exists and the customer has ease of access to free parking near to units to collect goods quickly.

How will the ESG agenda affect retail warehousing?

Like all property businesses ESG will be at the heart of our investment policies and management of assets. There is a lot that can be done with Retail Warehousing. We are implementing electric vehicle charging points throughout our Retail Park portfolio as well as ensuring that all common electricity is derived from renewable sources. We have existing recycling units on Parks and are working on more formal agreements with a selection of retailers to put permanent recycling units in place. Socially, and when social distancing allows us to, we will be back holding community events in the large common space available at Retail Parks. Working with our tenants Is obviously key to all of this and on top of the Park activities mentioned, we have teams working hand in hand with retailers to encourage the actioning of EPC recommendations and sourcing renewable power for their own use. Finally, and always trying to think outside the box, such ideas as solar roof panels, solar panelled covered walkways and even small wind turbines on site are being investigated. It's such an important part of our business than we have to look at every possible opportunity to make sure we are leading the way in this field.

Martin Perry

Director of Development, Real Estate, Europe at Nuveen

Leading the redevelopment at the St James Quarter, jointly owned by Nuveen and APG.

With the retail and leisure element of the St James Quarter due to open in June, what impact will it have on the Edinburgh/Scottish retail offering?

St James Quarter was designed to complement the City's existing retail offer by completing an anticipated primary shopping circuit, which uses the eastern half of Princes Street and George Street, Frederick Street and Hanover Street, St Andrew Square and Multrees Walk. Whilst Covid has accelerated this consolidation of the primary retail offer in the City, it is still expected to broadly settle as the master plan envisaged. The key impact to Edinburgh and Scotland as a whole are the new brand additions that are coming within the development, which include a number of key fashion, high street and F&B brands new to the city and some new to Scotland. Together with some existing city retailers opening flagship stores within St James Quarter and the significant event-led support for retailing proposed within the scheme, it is expected that the Scottish Capital City can once again have the retail strength it deserves.

Given the rapidly evolving retail environment and (various) economic shocks over the last few years, how has the make up of St James Quarter differed from what was envisaged?

The development master plan envisaged a number of consumer behavioural changes and sought to respond to these with the mix of uses. The original plans have not been significantly altered and the collection of world class brands have been carefully assembled to meet 2021 local and international consumer's needs. However, shifts in retailers trading models have brought a physical change during the development, where the established desire for mezzanine trading within retail units fell away entirely. This has allowed us to utilise this space for more emerging leisure concepts or "competitive socialising", as it is largely referred to now. The degree of flexibility needed within retail has also changed more quickly than we originally envisaged, requiring greater landlord investment in the retailer success, with a larger turnover proportion and some direct involvement in the retailer businesses. Additionally, the development of an all-encompassing, unique omnichannel leasing strategy with brands across the development has ensured alignment of all interests and future proofs St James Quarter for consumer behavioural shifts.

How do you see the future of shopping centres across the UK, is St James a blueprint for mixed used developments?

St James Quarter is not a shopping centre but a blueprint for mixed use development. Shopping Centres have an extremely uncertain future and wholesale redevelopment in many instances is needed but largely unaffordable. As we look to the future of retail, it needs to focus on the consumer and their desires. Bringing a mix of uses and brands together that can not only complement each other, but enhance performance for each brand beyond what could be achieved in isolation within a traditional shopping centre environment. The partnership programme within St James Quarter targets this outperformance that can be achieved by engaging brands to work together offering more consumer choice and excitement, which ultimately is the key to attraction, loyalty and spend.

Considering the wider retail market, what do you see as the biggest challenge for the sector in the next 5 years?

The challenge to the retail market is that the cost/value relationship has been substantially altered by digital progress and the property industry needs to respond faster to this and modernise practices in all areas including governance, investment, leasing and operation. The pace of digital technology does not wait for industries to catch up and you either embrace it and invest, or fail as we have seen during these last few years. There are significant challenges ahead but with the right changes, approach and investment, good returns for all participants can still be achieved.

The use of turnover rents has increased significantly over the last 12 months, do you see this as a long term structural shift and if so how do you see this impacting on retail values?

There is clearly a growing trend towards turnover rents, accelerated by the pandemic because of the current strain on retailer capital sources, creating limited appetite for risk from lenders to retailers. Previously turnover provisions were largely included for outperformance purposes, but it is clear that there is a trend requiring greater proportions of Landlord risk with higher turnover rent proportions replacing base rent. Whilst this will be reflected in valuations, if on the other hand retailers are able to trade at good levels (if the environment is right), Landlords stand to receive a greater share of the dividends, allowing turnover rents to be evidenced with perhaps even greater landlord income in some instances, so it should have limited valuation effect in the long term.

Are there any specific measures which you would like to see the UK or Scottish Government implement to positively impact the retail market's recovery from COVID-19?

There are two key measures that I believe the Government should be urgently enacting. The first is recognising that the retail world has changed substantially as a result of Covid-19 and business rates should be suspended for the entire period to allow for full recovery of physical retail, and going forward they should be set at sustainable levels that would allow physical retail trading to meet the challenges of technology influenced trading on a more even footing. Secondly, and tied to the earlier point, the Government needs to level the playing field between physical retailers and on line retailers by introducing online sales taxes and allowing the revenue generated to be put back into the upgrading of physical retail environments, such as town centres, before these options cease to become viable.

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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

Chris Thornton
T 0131 202 4565
M 07843 975345
chris.thornton@lismore-re.com

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