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"Intelligence"

Scottish Investment Market

Quarterly Review
July 2021

WELCOME

“Intelligence”

The investment market in Scotland is currently a bit like watching the national football team in the Euros — something of a rollercoaster!

The highs include the wall of overseas equity continuing to target our best long income assets (American REITs being the latest to join the party), increased activity in the food store and retail warehousing sectors and growing appetite for anything close to the life sciences sector. Against this, on the downside, city centres are taking time to regain momentum, with footfall remaining fickle and retailers/restaurateurs having to work very hard to attract customers back through the doors. Retail re-purposing has started in some of the strongest streets but there remain significant challenges for those city centre locations unable to attract alternative use investment.

The new kid on the block (the Billy Gilmour) is the Scottish logistics market which has burst onto the scene and is, at last, seeing some real impetus. Occupational demand has increased dramatically with something like c1.5m sq ft of unsatisfied requirements in the central belt, against a real dearth of new development. Rents are rising (fast) and yields are hardening but still lag those being achieved in the key locations south of the border. Speculative development is becoming more feasible and with the demand/supply imbalance, those developers brave enough to get in early will be well placed to achieve letting and investment sale success.

With this backdrop, in addition to our regular market analysis, our spotlight this quarter is on the logistics sector — what sort of rental growth can be expected, how low can yields go and will there be sufficient new development to meet the spike in demand. To provide insight and specialist knowledge, we have a short interview with Knight Property Group, currently active in the logistics development market. In addition, this review we have a new section entitled ‘Our View’, with Simon Cusiter contributing his thoughts on the wider logistics market.

Scotland may be out of the Euros but, a bit like the market, there are still plenty of reasons to be cheerful....

Market overview.

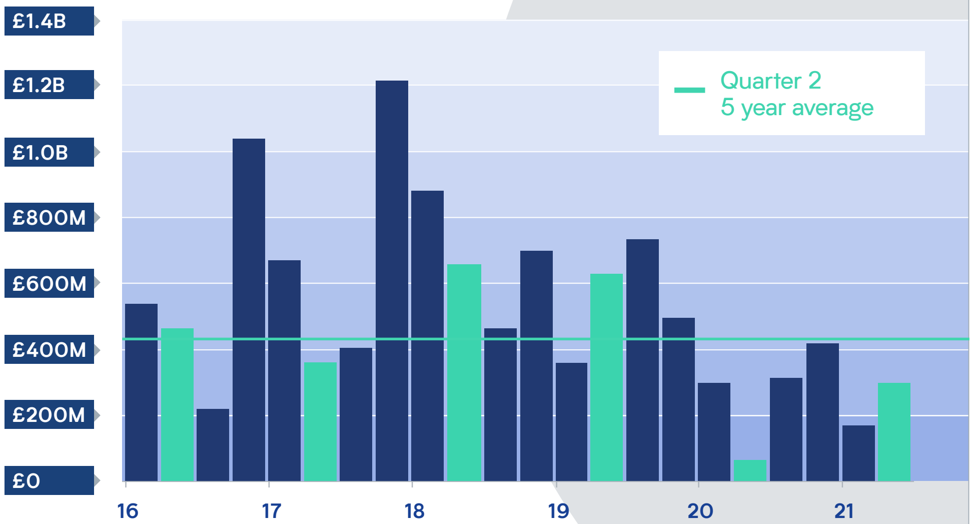
Key themes

- **Economic recovery —** UK GDP contracted by 8.7% in Q1 2021 vs Q4 2019, however the UK economy grew 2.3% in April, the fastest monthly growth since July last year and the Bank of England has forecast growth of 4.25% in Q2 2021.
- **Employee is king —** with larger corporates remaining cautious about encouraging staff to return in numbers. While this may remain during 2021, those employers requiring collaboration, staff development and a team ethic are likely to start expecting their staff to return to their offices (flexibly) in the not too distant future.
- **Here come the Americans —** 2021 has seen several US based REITs enter the Scottish market — focussed on longer income retail warehousing where in Q2, they have dominated the sector. We anticipate more to follow.
- **Tenant specification is key —** developers and occupiers are increasingly working hand in hand to create bespoke units (particularly in the logistics sector) which clearly meet tenant specifications, providing occupational certainty for both parties. Tenants will pay for an exacting specification.
- **Build cost inflation —** beginning to have a significant impact on proposed new developments. Appraisals are under pressure with rents having to be pushed — particularly in sectors where yields remain static.

Transaction volumes

- Activity remains relatively subdued, albeit volumes have increased by 71% compared with Q1 2021 with c£300m traded in Q2 2021.
- Activity for the quarter was some 30% below the 5 year average but we are aware of at least 3 transactions of £50m+ which are currently under offer.
- There remains restricted stock availability but a good number of significant assets are being prepared for sale which will ensure a stronger second half of the year.

Sale volumes



Pricing

- Retail warehousing is continuing to attract a significant weight of capital, with schemes anchored by food stores and value retailers (B&M, Home Bargains, The Range etc) particularly liquid. Pricing in this sector has sharpened anywhere between 100-200bps during the course of this year.
- Logistics yields are continuing to harden with prime yields at 4.50% trending keener, still offering a significant yield discount to prime logistics south of the border.
- We anticipate prime Edinburgh office yields to sharpen before the year end, with limited stock and strong occupational demand the key driver.
- In the value add sector, offices capable of re-positioning, first generation retail warehousing with underlying industrial or residential potential, are in demand albeit the market remains relatively tight for these kind of deals.

Investor activity

- Open ended UK Funds have continued to sell, increasing their cash levels to meet redemptions through a steady disposal of liquid assets.
- Overseas investors with a UK presence (and capable of travel) remain active, US and Middle Eastern being the two most active sources of equity.
- The weight of capital waiting to be deployed is considerable, suggesting it should be a busy end to 2021 with more stock to come to the market.

Key recent transactions.

Q2 saw some interesting themes and significant transactions which we have highlighted below:

Retail Warehousing:

"The emergence of American REITs – focussed on retail warehousing"

Renfrew Retail Park, Paisley and Almondvale Retail Park, Livingston

- Vendor – London and Scottish Developments Limited/Magell Limited
- Purchaser – US REIT
- Let to M&S, The Range/Dunelm, B&M
- Price/Yield – £21m/c6.15%
- Date – May/June 2021

Office:

"Corporate tenant acquires mission critical offices"

Holyrood Park House and Barclay House, Edinburgh

- Vendor – St James Place Property Unit Trust/Lochlann Quinn
- Purchaser – Rockstar North
- Let to Rockstar North, Citibank, InterSystems, ESRI and Universities Scotland / Rockstar North
- Price/Yield – £18.25m/5.52% & c£30m/5.25%
- Date – June 2021

Mixed-use site assembly:

"Appetite remains for core city centre mixed use developments"

200 Renfield Street, Glasgow

- Vendor – Aegon Asset Management
- Purchaser — McAleer & Rushe
- Let to DWP (in part)
- Price/Cap Value – £10.1m/£190 psf
- Date – May 2021

Industrial:

"Industrial platform building continues"

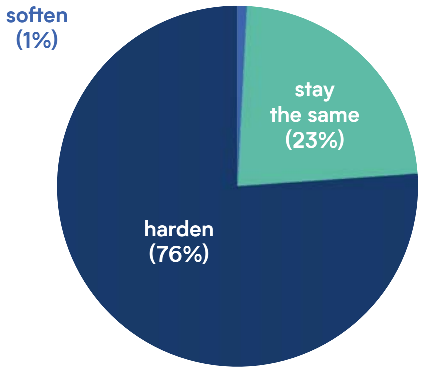
BP, Dyce, Aberdeen

- Vendor – Nuveen Real Estate
- Purchaser – Kennedy Wilson
- Price/Yield – £17.95m/7.8%
- Date – May 2021

The investor view on the logistics sector.

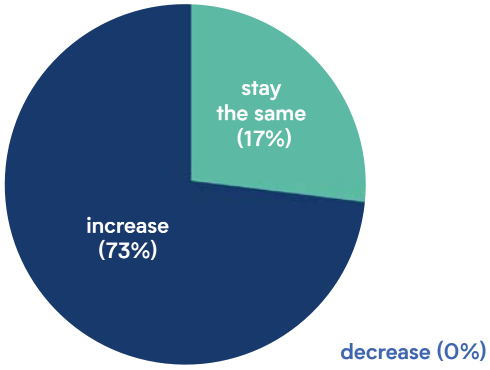
The Scottish logistics sector has grown from strength to strength over the last 18 months, driven by changing consumer habits resulting in increased need for warehousing and logistics space. To help understand this rapidly evolving market, we have sought the views of a wide breadth of investors, asking the following questions:

1) Do you expect the prime logistics yield to: harden, stay the same or soften?



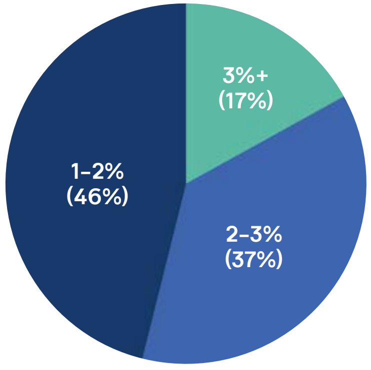
- The overwhelming majority (76%) of respondents anticipate yields hardening, which is perhaps unsurprising given Scotland's continued yield discount compared to key markets in England, as well as potential rental growth and strong occupier demand. Only one respondent was of the opinion that yields would soften!
- Funds are the most bullish with 95% forecasting that yields will sharpen in the coming months. Private equity (71%), Prop Co's (70%) and Investment Managers (65%) are also firmly of the opinion that logistics yields will compress further.
- Of the 23% indicating yields would remain the same, it was relatively evenly split between Prop Co's, Funds and Investment Managers.

2) Do you think speculative logistics development will: increase, stay the same or decrease?



- 73% of respondents expect an increase in speculative development however, this is unlikely to be sufficient to meet both existing and future occupational demand.
- Of those expecting speculative development to increase, the majority are investment managers (33%).
- Just over a quarter (27%) believe spec development will not increase, which was fairly evenly split between the range of respondents. Specific comments highlighted this as due to the lack of prime development sites available.

3) Over the next 6 months do you expect rental growth to increase by: 1-2%, 2-3% or 3%+?



- Over half of respondents (54%) expect rental growth of over 2%, with 42% of fund respondents expecting rental growth of 2%-3% and 25% expecting rental growth of 3%+.
- Just under half of respondents expect modest rental growth of 1%-2%. Interestingly 45% of investment managers are forecasting a growth of less than 2%, despite an overwhelming proportion (74%) anticipating an increase in speculative development. This could be explained by the lag in speculative developments coming online and resulting lettings.
- With a relatively low proportion overall (17%) expecting rental growth of 3%+ and 76% expecting yields to harden, it appears many expect yields to compress principally due to the sheer weight of capital chasing the logistics sector.

An expert view on the logistics sector...

To provide their expert on the ground knowledge, we have sought the views of a leading Scottish based developer Knight Property Group. They have very kindly agreed to share their insights:

Knight Property Group

James Barrack
Founder and Chairman

Howard Crawshaw
Managing Director

Current logistics activity:

Langlands Commercial Park, East Kilbride
Speculative development of a 10 acre site for multi-let and stand alone industrial.

Belgrave Logistics Park, Bellshill
Speculative development of 5 logistics/industrial units totalling 255,430 sq ft.

Belgrave Logistics Park, Bellshill

Is this the strongest occupational market you have seen during your 25 years as a developer?

Most definitely! Over the last 25 years we have witnessed some exceptionally strong occupational markets, especially in the Aberdeen area however demand for the industrial and logistics sector feels structural. Office rents in Aberdeen rose quite dramatically between 2011 — 2014 and it was a race to build good quality product in order to satisfy demand. In reality, the main difference between that period of time and where we are now in terms of logistics is the fact that, when the Aberdeen oil and gas occupiers satisfied their spatial requirements, they were largely done. The structural shift in online shopping and associated demand feels as if it has a longer legs which should lead to longer term, sustainable demand.

The recent rental growth that we have seen in Scotland — how much of this is down to rising build costs and how much is through the imbalance between demand and supply?

To date, we think much of this has been down to the dynamics of supply and demand however new build rents will have to increase further to offset increasing construction costs. If this fails to materialise we could see delays in product delivery until construction costs stabilise. The short term winners could be average quality second hand stock which could witness rental improvement if new build pipeline slows. If you add in occupiers increasing appetite for greener stock there is a strong case for more rental growth to come.

How do you see the current pressure on build costs affecting speculative development and is it a short term issue?

This is becoming a real issue in the market at the present time. Both pricing pressure and lead in times for materials. Potential tenants need space quickly and, as a developer, we need to be able to deliver quality product for them on time. We hope that this is a short term problem but it is difficult to see this dynamic changing dramatically within the next 12-18 months. There is a real prospect of some developers pausing for breath for a period of time in order to allow this to settle. We have witnessed strong rental growth in the market over the last 24 months, partly down to rising construction costs. Even with higher rents, yield levels will require to remain strong in order to facilitate ongoing development.

Within Scotland, where do you see the future "hot spots" for speculative development?

Location, location, location! The main road networks will continue to play a big part in ascertaining the quality and suitability of logistics sites. This was the primary reason for buying 14 acres at Belgrave, Bellshill. This said, demand is such that, availability of oven ready land which ticks most of the occupier boxes may force tenants to take a view on some compromises. Pre let demand is as high as we have ever seen in this sector but not all tenants can wait for new stock to be built!

What appetite are you seeing for speculative development from the UK high street banks?

Overall, we can't really comment on this in any great detail but feels generally that the high street banks would still be reluctant to engage depending on the nature of the proposed scheme however we are aware of lending appetite from at least one high street bank. This is something that we may see a little more of going forward but the most likely avenue for funding speculative logistics development in Scotland is the UK institutional market or via sector specialists. With pricing being so stiff and demand so strong for up and built or pre let product, investors are having to be more creative in terms of trying to access the sector so we do think that we could see more speculative schemes being traded going forward. From a developers perspective, the balance will always be how much yield would have to be conceded as part of a speculative agreement. If the strong occupational market continues, we envisage the yield gap between pre let and speculative development narrowing.

The ESG agenda is moving to the top of most occupiers requirement criteria, how is this affecting building design?

Building standards are also leading this but there are additional optional measures to make buildings greener. This is something we have fully considered when designing our site at Belgrave Logistics Park in Bellshill and will be incorporating specification items such as 100% renewable electricity to power the buildings, EPC 'A' ratings, electric car charging points, water management flow restrictions and photocells for electric lighting etc. Suppliers and manufacturers are now really buying into the green agenda and this is set to continue. The institutional market is demanding this as much as tenants so, undoubtedly, it is coming to the fore. The supply/demand dynamics that current exist are such that, if tenants are in a hurry to secure space quickly, they are having to compromise. If pre let space is sought the ESG piece is becoming more and more important. This said, we are still of the view that location remains the main driver for tenant demand in the industrial and logistics sector at present.

'Our View' – on the logistics market.

Simon Cusiter
Director
Lismore Real Estate Advisors

General

There are many themes emerging in the industrial/logistics sector. Appetite is undoubted across the board, but we are certainly witnessing a "tiering effect" when it comes to sub sectors and rents. In Scotland, the traditional multi let market continues to be heavily dominated by sector specialists with the mainstream UK institutional investors struggling to find appropriate scale in individual lot sizes. Rental growth will continue and will be more pronounced in urban schemes but not at the levels of stand alone, logistics product.

Lidl Distribution Centre, Eurocentral

Rental growth

In terms of logistics, new build or modern, high quality buildings are witnessing strong growth with rents ranging from £7.00-10.00 per sq.ft. More recently we have seen a sharp rise in rents for bespoke facilities with rents ranging from £10.00-15.00 per sq.ft, these tending to be let on long leases, with some form of indexation. These tend to be larger in size and have competitive appeal, leading to strongest yield compression.

Construction costs

With construction cost inflation in focus it is clear that rental growth is set to continue, perhaps in tandem with letting indexation in order to support capital values on exit. We are of the firm view that speculative development will increase over the next 12 months which will lead to a narrowing yield gap against up and built/pre let stock. With construction costs being a constant, less core locations may begin to see more indexation appearing in leases in order to support pricing. This may also lead to accelerated rental growth in prime locations.

Yield compression

We don't anticipate a flood of new development happening. In the short term we anticipate the focus being on the golden triangle of the M8/A725 and M74 but the demand/supply dynamics and lack of oven ready land will certainly open up alternative locations going forward. Prime Scottish yields remain discounted to comparable key southern markets — this gap may continue but we certainly see scope for a further hardening, particularly as some of the significant occupier requirements are fulfilled, creating market friendly, long lease, indexed linked product.

For the future

How far can rents rise? Tricky one to pinpoint accurately, but, with continued demand, pressure on land and low availability of fit for purpose stock it does not take much to assume 2-5% pa over the next 3 years. Some commentators are suggesting that Europe needs an additional 300m sq.ft of industrial stock by 2025, with the UK's share of this being in the region of 60m sq.ft. If these numbers prove to be roughly accurate it is good news for developers and landlords!

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