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REAL ESTATE ADVISORS

"Intelligence"

Scottish Investment Market

Quarterly Review
September 2021

WELCOME

“Intelligence”

“We are the first generation to feel the effect of climate change and the last generation who can do something about it”

As we approach the final quarter of 2021 the market has been on something of a roller coaster. Sluggish start, easing of lockdown, improving confidence, growing weight of money, volumes picking up but one of the over-riding themes characterising this topsy turvey year has been the rise of ESG to the forefront of many investors agendas.

The effect of the pandemic has simply accelerated some of the themes that were already emerging in the ESG space — including staff wellness, sustainable development and impact investing.

The spotlight is on the environment and climate change like never before, with a global consensus being sought aiming to reduce harmful emissions at the upcoming COP26 being held in Glasgow next month. The pressure on the built environment to promote sustainability is growing, particularly from corporate occupiers keen to demonstrate their ESG commitment by locating in best in class sustainable buildings.

With this backdrop, our focus this quarter is on real estate sustainability — which sectors will be impacted most, where does sustainability sit in investors purchase considerations, and is there a pricing premium for a best in class sustainable investment? To provide insight and specialist knowledge, we have a short interview with Qmile Group who are one of Scotland’s leading developers currently undertaking a number of large city centre projects, including partnering M&G Real Estate on their landmark mixed use development at Haymarket, Edinburgh — aiming to be one of the most sustainable new developments in the city. In addition, Chris Macfarlane shares his thoughts on sustainability in ‘Our View’.

Market overview.

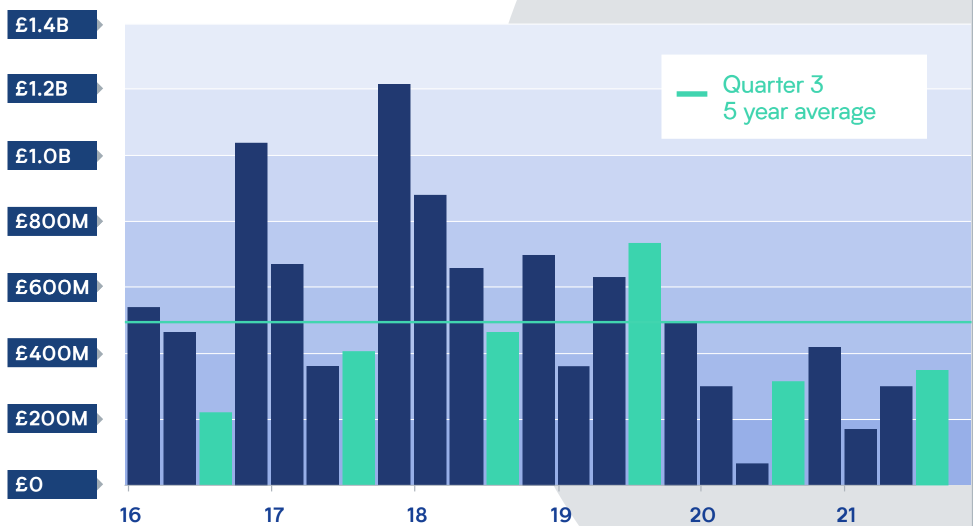
Key themes

- **ESG credentials in focus** — Sustainability is top of the agenda with the UK hosting COP26 in Glasgow. Whether consensus can be reached remains to be seen, however with the UK built environment contributing approximately 40% of the UK's carbon emissions, the importance of ESG credentials continues to grow.
- **On market vs off market** — Investors continue to seek off market deals, preferring to secure assets prior to open marketing campaigns. Many are prepared to pay a premium to avoid competition.
- **Prime office accommodation squeeze** — Edinburgh & Glasgow continue to experience very low levels of Grade A office availability, evidenced by both M&G's Haymarket in Edinburgh and HFD's 177 Bothwell Street in Glasgow being fully pre-let. This lack of availability continues to drive prime rents to new record levels.
- **International travel restrictions loosen** — The loosening of international travel restrictions has enabled foreign investors to inspect assets, notably leading to the completion of the purchase of Princes Exchange and New Uberior House by Union Investment. With market activity beginning to pick up, the ability to travel freely is crucial to transactions.
- **Logistics yields harden further** — The weight of money chasing logistics and distribution continues to grow, with yields hardening for prime stock. Despite this, Scottish yields continue to appear attractive when compared against prime yields south of the border.

Transaction volumes

- After a significant increase in Q2 2021, volumes have marginally increased again with c£350m traded in Q3 2021.
- This figure is 30% below the 5 year average but c15% up on Q3 2020.
- The quantity of stock coming to the market remains restricted, however, with a number of significant deals under offer, we expect the volume traded in Q4 to be significantly higher than 2020 and closer to the longer term average.

Sale volumes



Pricing

- Logistics yields are continuing to harden with prime yields under 4.50%, even for sub 5 year income.
- Prime Edinburgh office yields are unchanged at 4.50%, however we expect this to sharpen in Q4 with an increase in foreign investment and a number of transactions currently under offer.
- Retail warehousing, particularly anchored by foodstores, remains in high demand with prime yields at 6.00% and trending keener. Supply concerns in the run up to the festive period are unlikely to dent confidence in the sector.

Investor activity

- US investors have continued to be acquisitive in the retail warehouse and logistics sectors, targeting strong locations with foodstore anchors.
- Overseas equity is targeting value add offices, with Glasgow particularly attractive due to the stock available and restrictive Grade A supply.
- Core European investors continue to be active in the Edinburgh office market, with prime assets trading at a discount to other European cities.

Key recent transactions.

Q3 saw some interesting themes and significant transactions which we have highlighted below:

Retail Parks:

"Profit realisation for parks that were acquired well"

Hermiston Gait, Edinburgh

- Vendor — Baumont/Ediston
- Purchaser — Realty Income
- Let to B&Q, Tesco, Decathlon, Halfords and others
- Price/Yield — £86.5m / 6.50%
- Date — July 2021

Distribution:

"Prime logistics yields with short income harden"

Atlas, Dovecote Road, Eurocentral

- Vendor — Broomford Holdings
- Purchaser — ARA Dunedin
- Let to Hermes Parcelnet Limited for 7 years
- Price/Yield — £7.54m / 4.50%
- Date — August 2021

Multi-let Industrial:

"Well located multi-let estates continue to trade well"

G3, Arrol Road, Dundee

- Vendor — West Ranga
- Purchaser — JV between Chancerygate and JR Capital
- Let to Scania, Ford and Grimme UK
- Price/Yield — £6.47m / 6.50%
- Date — August 2021

Office:

"International travel opening up"

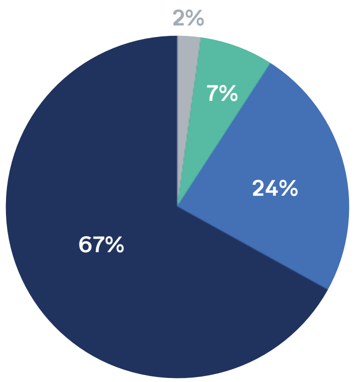
Princes Exchange & New Uberior House, Edinburgh

- Vendor — MAS Real Estate
- Purchaser — Union Investment
- Let to Bank of Scotland Plc
- Price/Yield — £78.6m / 5.25%
- Date — August 2021

The investor view on sustainability.

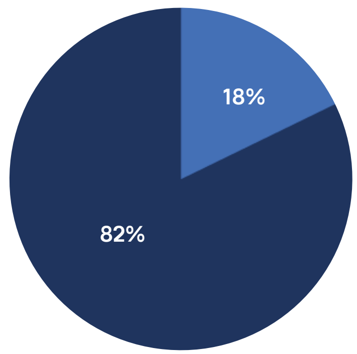
As ESG rises up the investment agenda, we are keen to understand how sustainability is affecting decision making. To assist with this, we have engaged with a wide range of investors (funds, property companies, investment managers and overseas/private equity) asking the following questions:

1) Which sector is likely to experience the greatest sustainability impact in the next 5 years: office, industrial, retail or residential?



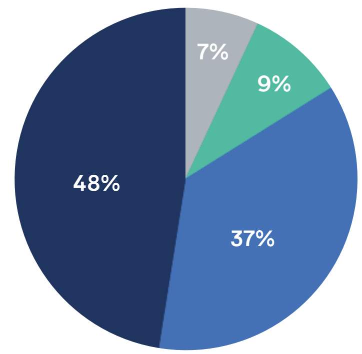
- Almost ¾ respondents (67%) anticipate the office sector will experience the greatest impact from sustainability, with a small number of respondents attributing this to tenant pressure. Retail is expected to be impacted least, followed by industrial with 47% and 37% of respondents respectively selecting these sectors in the lowest two categories.
- The results are reflected in the breakdown of investors responses, to varying degrees. Overwhelmingly, funds predict the office sector will feel the greatest impact (88%), whilst over 50% of investment manager, prop co's and private equity respondents agree.
- The results are equally conclusive regarding the sectors expected to be affected least by sustainability, with 91% of respondents selecting either retail or industrial in categories 3 & 4. 100% of fund responses and 92% of investment managers reflected this finding.

2) Which of the following purchase considerations is the highest priority: sustainability, property fundamentals, or 5 year IRR performance?



- Unsurprisingly property fundamentals remains the key metric to the majority of investors' purchase considerations, accounting for 82% of responses.
- 57% view 5 year IRR performance as the second most important purchase consideration. Perhaps expectedly private equity were the only investor group where a majority selected IRR performance as most important (60%).
- Sustainability was selected as the lowest priority by 74% of respondents, with over 80% of prop co's, investment managers and private equity ranking sustainability behind property fundamentals and 5 year IRR performance. A significant number of respondents noted that increasingly sustainability is being viewed within the framework of property fundamentals and is now a key consideration for Investment Committees.

3) In your view what pricing premium does a best in class sustainable investment carry: 0 bps, 25 bps, 50 bps or 75 bps and greater?



- The majority of respondents believe sustainability carries a pricing premium of between 25 bps (48%) and 50 bps (37%).
- There is a widespread acknowledgement that sustainability has an impact on yield, with 91% of respondents indicating a yield premium of 25 bps or greater. With the relentless advancement of sustainability criteria, the yield premium for best in class is likely to widen further.
- The impact of sustainability on yield wasn't unanimous, with 15% of prop co's attributing no pricing premium to a best in class sustainable investment.

An expert view on the sustainability...

Paul Curran
Chief Executive, Qmile Group

Recent projects in Scotland:

Quartermile, Edinburgh
Forward funding of Quartermile 3 & 4 with M&G.

Haymarket, Edinburgh
JV with M&G developing Haymarket, a landmark mixed use development with 350,000 sq.ft of office space, 190 room hotel, 172 room aparthotel and 40,000 sq.ft of retail & leisure.

Craighouse, Edinburgh
A 52 acre, £100m development comprising 145 residential units on a historic Category A listed site.

How has the leasing campaign at Haymarket progressed and what are the key factors tenants have cited for choosing to locate at Haymarket?

The letting campaign at Haymarket has progressed extremely well over the past 18 months, despite the official launch event on 5 March 2020 being one of the last events prior to the national lock down. With key lettings to the likes of Baillie Gifford and significant interest in all the remaining space it really has reaffirmed that the office is part of corporate fabric that is here to stay, although maybe being used in a different manner by occupiers. As with all aspects of business the general campaign has been adapted to operate through the usual Teams and Zoom platforms which has resulted in us being able to react quickly to occupier demand and interest in the development. The benefit being that potential occupiers are significantly more informed and interested once they were able to visit the site. The message from occupiers has been consistent in that they want the best office space to attract and retain talent to their business. The ESG demands of organisations is no longer a nice to have, but something that is required of them by investors, clients and staff. The buildings at Haymarket have been designed with sustainability and wellness at the core of what we want to achieve, including sustainable commutes using public transport with the adjacent railway station, tram stop, bus routes and cycle network all next to the development. The buildings have been designed with class leading cycle, wellness and shared facilities such as roof terraces which allow all building users to benefit equally from the views and the fresh air.

How important has sustainability been to tenants in choosing to locate at Haymarket?

The buildings have been designed to achieve the highest standards with EPC 'A' and BREEAM "Excellent" being the minimum of what we have been looking to achieve. There are also no fossil fuels used for the offices. Discussions with occupiers have gone beyond the benefits these achieve in terms of running cost, and a number of discussions have considered the benefits of a wellness agenda for the occupiers, this not only includes the facilities within the building such as showers, drying rooms and lockers but also aspects of air quality and providing 100% fresh air provision on the office floor plates. Tenants now understand the benefits to their organisation of having a sustainable building and are willing to pay a rent premium to secure the best buildings in the best locations.

Have you noticed sustainability expectations evolve between the development of Quartermile and Haymarket?

There has been a dramatic change in the expectations of occupiers and funders/landlords over the last ten or so years. In reality, historically, very little attention was given by potential occupiers to the benefits of a sustainable building over others on the market, as this was often presented as a financial benefit to running costs rather than environmental and climatic benefits moving forward. This has changed completely where some buildings will not be considered by a tenant or funder if key environmental criteria are not being achieved. Even across the various office buildings at Quartermile the last office block produced over 70% less carbon than the earlier buildings, despite being a significantly larger building. Technologies have changed and evolved to become more efficient i.e. no gas in buildings, and utlising air sourced heat pumps as standard. There has also been some impact on the net/gross ratio of buildings as riser sizes have increased to accommodate larger ducts to enhance the volume of fresh air within the buildings.

How has the focus on sustainability and impact from Covid changed how Haymarket has been designed and let?

The drive on sustainability has been at the heart of the development brief since day 1. The masterplan set out to create a place that was inclusive, not only for occupiers and commuters, but for the local community to spend time and feel comfortable in. This was supported by our decision to minimise the provision of car parking and maximise the benefits of the site's location for public transport, cycling and walking, which consequently creates a place for people rather than cars in the heart of the city. With approximately 66% of the carbon produced by a building over its lifetime being generated during the construction process, we have analysed the specification of materials i.e. concrete mix, recycled steel etc. to significantly reduce the carbon generated through the construction period, and this is monitored and recorded on a regular basis. This is absolutely key moving forward and we, as developers, have a responsibility in all our developments to embrace the benefits of a sustainable development.

In terms of the impact of Covid on the building design we undertook a full review of design and user experience to ensure that what could be realistically incorporated was if it were beneficial to the user experience. This included undertaking a review of the consequences on building design, and controls post the SARS outbreak in Hong Kong and other locations around the world. The outcome of this was for a more measured consideration of providing a healthy building and working environment so we have made some enhancements including touch free entry and lift controls. However the quality of the base design (i.e. 100% fresh air, filters etc) was such that the M&E systems required no modification. In reality the bigger changes are likely to come from tenants and how they use their space, so office floor plates are likely to be less densely populated which more collaboration spaces.

On a more general note — do you envisage a divergence in liquidity and exit pricing between prime assets and prime assets offering best in class sustainability credentials?

Prime assets with best in class credentials will attract a premium as institutional funds compete to replace ageing assets and meet their ESG targets.

Is the sustainability agenda having a meaningful effect on build costs?

There is an impact on build cost, whether it be less efficiency through larger risers/more common space or introduction of new/additional technologies, so a premium of in the region of 10%. In reality though these additional costs will become the base cost as tenants demand higher standards and building regulations move on further. But, without these enhancements, buildings in the future will be very difficult to let and tenants are willing to pay a premium for the best buildings.

'Our view' on sustainability and its effect on the investment market...

Chris Macfarlane
Director
Lismore Real Estate Advisors

Background

For most investment agents, it continues to be a steep learning curve, trying to understand the sustainability agenda and, more importantly, what effect it will have on assets and ultimately their pricing/liquidity. Green energy, net zero carbon, EPC's and building "wellness" are among some of the buzz topics and, while not all agents are au fait with the finer detail, the bottom line is sustainability is here to stay and its influence on assets from an investment perspective is becoming ever more pronounced.

Who is driving the agenda?

Not surprisingly the more sophisticated investor pool (UK and overseas funds, REITS, listed property companies and established investment managers) are all totally in tune with the sustainability agenda and aiming to play their part in driving it. Ambitious net zero carbon pledges have been made by most and within investment committees a senior ESG presence is becoming more influential in stock selection. Away from these investors, the knowledge/influence is more mixed with a significant proportion of overseas, and private investors being less concerned and their focus being much more on traditional considerations of quality of location/asset and strength of income.

Variance in sector influence

The office sector, in particular the prime end, is most in focus — driven principally by corporate occupier requirements for staff well-being but also to meet their net zero carbon pledges. This is not the whole picture however, and there remain many office occupiers and building owners of older properties who have different priorities — specifically keeping occupational costs to a minimum. Having said this, older offices with opening windows are back in vogue with some occupiers — so it is not straightforward! Across other sectors — by their very physical nature, existing industrial and retail parks are proving easier (cheaper) to meet improved sustainability standards, but more complex structures such as shopping centres will be facing similar challenges to offices with very significant capex requirements in the medium term. Underwriting business plans for this kind of asset is becoming more challenging and investors are having to make significant provision in cashflow/appraisals for sustainability improvements. In sectors such as secondary offices and shopping centres (where values are already under pressure) the effect is exacerbating the existing challenges.

The effect on pricing and liquidity

Again, we are seeing a range of influences across different sectors. The prime office sector is certainly seeing an emergence of a tiered market, with the very best (greenest) buildings able to attract strongest interest from European and UK Funds, who are usually most competitive on price. Placing a pricing differential on this sector against other less green buildings is difficult but what is definitely occurring is that unless the building is ticking all of the sustainability boxes, your target market is thinner and the chances of achieving a premium price are reduced. In other sectors, including industrial and retail warehousing, the effect seems less pronounced with sustainability further down the agenda, perhaps partly driven by occupiers having less demanding "wellness" credentials for staff.

The opportunity

As with any challenge, there comes opportunity. Already we are seeing funds and investment managers understanding the desire for ethical investment and the subsequent emergence of a range of "Green" funds. Some that will only invest in the very best buildings with the strongest sustainability credentials, others set up to target buildings that require re-positioning and capital expenditure to meet longer-term sustainability goals. In practice, how the sustainability credentials are measured remains something of a dark art, but what is clear is that there remains a serious appetite from sophisticated investors to fulfil their ESG credentials, so the opportunity for Green Funds can only continue to grow. Elsewhere, developers who acknowledge the sustainability agenda and build it into design will benefit, not only from improved tenant demand perspective, but also from wider investor appeal on exit and ultimately the strongest possible pricing.

For the future — 5 things to look out for:

Ethical investing is here to stay. Whether it be dedicated Green Funds or simply meeting corporate ESG credentials — existing property owners who bury their heads in the sand and are not thinking about the sustainability agenda do so at their own peril.

Two-tier market — starting to appear in the prime office market. At the super-prime end of the market there will be a premium paid for the greenest buildings.

Increased legislation — the built environment creates c40% of carbon emissions globally. Our industry continues to be in the Government's sights and as Net Zero Carbon commitments become more challenging, further prescriptive legislation is inevitable. Those investors who understand this and adapt quickly will benefit.

Cost inflation — future-proofing buildings to meet sustainability criteria is an additional development/holding cost which is likely to rise. However, the longer-term return will come through improved exit pricing and sale liquidity.

COP 26 — will put Glasgow on the global stage. It is a fantastic opportunity for the City to be associated with addressing climate change but also for visiting delegates to sample it's famous warm welcome...!

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