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"Intelligence"

Scottish Investment Market

Quarterly Review
December 2021

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WELCOME

“Intelligence”

A bit like the finish to the F1 season, the 2021 investment market has been a little “mad” or, at the very least, a roller-coaster ride...

The year started with the optimism of a vaccine roll-out programme in the offing and finished with our, beleaguered, Prime Minister making a state of the nation “plea” for the public to get their boosters — you couldn’t make it up...

Yet, despite the ups and downs faced during the year, the Scottish investment market has faired surprisingly well with volumes up 24% on 2020, the wall of overseas capital chasing stock continuing and pricing reaching pre-pandemic levels in certain sectors (specifically foodstores, logistics and retail warehousing). However, the picture is not all rosy and challenges remain for significant parts of in-town retail and investors continue to grapple with offices, other than those of the very best quality or which can be adapted to meet more challenging ESG credentials.

One part of the market which was initially hit hard but which rebounded (in part) very strongly during 2021 was operational real estate, namely PBSA, management contract hotels and serviced apartments. Loosely bracketed as alternatives. The best assets, well located, have seen occupancy levels rebound strongly and while net operating income might not quite be back to pre-pandemic levels, investor interest has been pricked by their resilient qualities.

With this backdrop, in addition to our usual market analysis, our focus this review is twofold – (1) looking forward to 2022, how will the market shape-up and (2) looking at the “alternatives” market. To help shape our thinking, we are pleased to share a question and answer piece with James Dunne, Head of UK Transactions at abrdn.

Whether you were a Verstappen or a Hamilton fan — the F1 season was nothing if not exciting. Let’s hope for an equally interesting 2022...

Market overview.

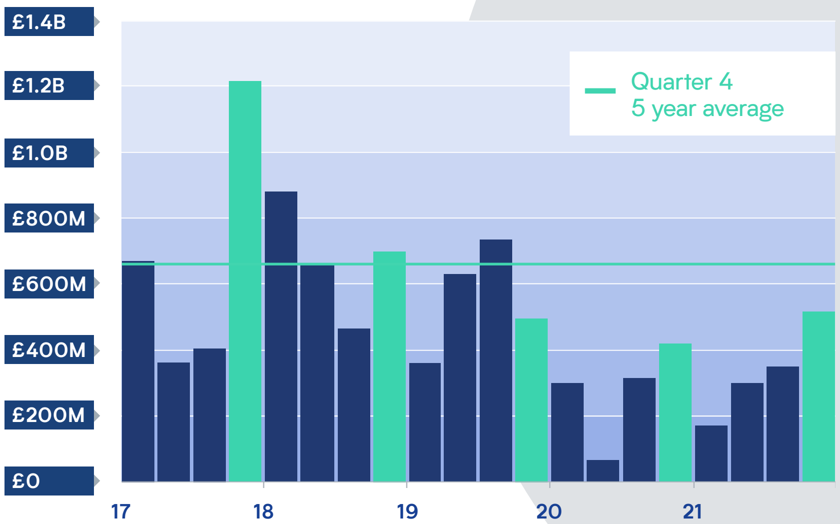
Key themes

- **Operational alternatives bounce back** — The strongest hotels and PBSA schemes have seen a better than expected return of occupancy levels, while the BTR sector continues to prove resilient and attractive to an increasing number of investors.
- **Prime shopping centres finding their pricing level** — The sale of Silverburn in Glasgow is the first sale of a prime centre in Scotland, pricing at c50% discount but highlights that appetite remains for the best re-priced quality assets.
- **A wave of North American investment** — Across various sectors including retail warehousing, offices and industrial, the most active investor pool has come from the US. Scotland continues to see more than its fair share of global capital.
- **Inflationary spike** — In December 2021, inflation rose to 5.1%, its highest level for 10 years. The cost of living is rising significantly but good news for those investors holding assets with inflationary rental indexation.
- **Development stalling** — Q4 has seen the construction sector shrink by 1.8% due to a shortage of raw materials compounded by upward pressure on prices. As a result, developers are having to re-visit rental levels/lease terms to ensure appraisals are viable.

Transaction volumes

- We saw a strong Q4 with c£520m traded, ending up 27% on Q4 2020.
- Q4 volumes were 22% below the 5 year average (£666m), but worth noting this included two stellar years in 2017 and 2018.
- Total volumes for 2021 will end up at close to c£1.345bn, an increase of 24% on the total for 2020.

Sale volumes



Pricing

- Foodstores, convenience stores and distribution have seen the strongest sharpening of yields, anywhere between 50-100bps over the quarter.
- Core-plus opportunities have been relatively limited but we are seeing a softening of pricing around Grade B offices as investors come to terms with increasing levels of CAPEX and ESG challenges.
- The only sector really offering "value-add" pricing is in the shopping centre market where risk remains but the best assets are starting to find their level, between 50-90% discount to purchase levels.

Investor activity

- UK institutional activity remains very focused on longer income defensive stock including retail warehousing and distribution, although we have seen a welcome return by a UK institution to the Edinburgh office market, the first time in a number of years.
- Overseas investors continue to target Scotland (Edinburgh in particular) with buyers from The Middle East and mainland Europe all remaining active but the overwhelming weight of capital has been from North America.
- The level of distressed selling continues to be very limited hence the more opportunistic (private equity backed) buyers are looking further up the risk curve, either direct development, vacant buildings or shopping centres.

Key recent transactions.

Q4 saw some interesting themes and significant transactions which we have highlighted below:

Food Stores:

"Overseas capital, with attractive debt on offer, is chasing prime food stores"

Sainsbury's, Inglis Green Road, Edinburgh

- Vendor — Inglis Property LLP
- Purchaser — Urbium Capital Partners LLP
- Let to Sainsbury's Supermarket Limited
- Price/Yield — £32.2m / 4.60%
- Date — December 2021

Prime Warehousing:

"Best in class ESG industrial attracts premium pricing off market"

Scania, Condor Glen, Eurocentral

- Vendor — West Ranga Property Group
- Purchaser — DVS Property Limited
- Let to Scania (Great Britain Limited)
- Price/Yield — £10.725m / 4.50%
- Date — December 2021

Multi-let Industrial:

"Prime industrial portfolios continue to attract competition from specialist platforms"

The Caesar Portfolio, Edinburgh & Bathgate

- Vendor — J Smart & Co
- Purchaser — Ribston
- Multi-let
- Price/Yield — Confidential
- Date — December 2021

Office:

"A UK fund buys prime Edinburgh office"

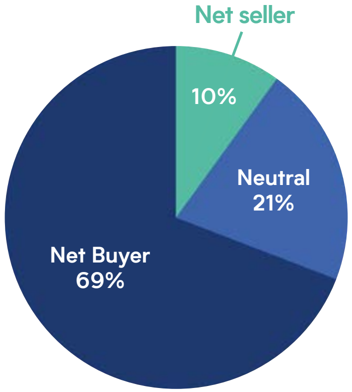
Exchange Place One, 1 Semple Street, Edinburgh

- Vendor — Macquarie Asset Management
- Purchaser — CBRE IM
- Let to Blackrock, Hymans Robertson, Cameron Hume, Cundalls, Evans Cycles
- Price/Yield — £58m / 5.06%
- Date — December 2021

The investor view on likely trends in 2022.

With a seemingly brighter 2022 looming, we are keen to understand if investors will see this as an opportunity, what sectors will see best performance and what factors will drive investment decisions. To assist with this, we have engaged with a wide range of investors (funds, property companies, investment managers UK & overseas and private equity) asking the following questions:

1) In 2022 are you likely to be: a net buyer, neutral or a net seller?

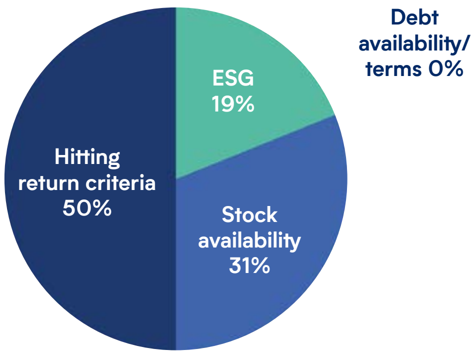


- A significant majority (69%) of respondents expect to be net buyers in 2022, with 21% neutral. A small number of respondents commented that macroeconomic factors would likely play a role in dictating strategy.
- Investment managers and property companies look to be most acquisitive with 83% and 73% respectively anticipating they will be net buyers in 2022. Just over 50% of funds and private equity respondents expect to be net buyers.
- Only 10% of respondents expect to be net sellers, suggesting another year of limited stock and inevitable pricing pressures for the best opportunities.

2) Which will be the top performing sector in 2022: food stores, retail warehousing, distribution, multi-let industrials, alternatives or office?

- Unsurprisingly the top 3 performing sectors are expected to be retail warehousing, distribution and multi-let industrials.
- Of more interest is the extent to which retail warehousing (36%) is supported ahead of distribution (28%) and multi-let industrial (17%). Although prime yields have begun to harden, retail warehousing does still appear to still offer some good value given the rapidly changing retail market and strong occupational demand.
- In comparison to our survey in 2020, support for food stores has fallen slightly, down from 12.5% to 6%. Perhaps an acknowledgment that a lot of the performance in the sector has come during 2021. The office sector received the poorest backing with no respondents expecting the sector to perform strongest in 2022. Concerns over CAPEX requirements and future working habits being mentioned as headwinds for the sector.

3) Which of the following do you see having the greatest impact on your investment decisions over the next 12 months (list 1 to 4): ESG, hitting return criteria, debt availability/terms or stock availability.



- Hitting return criteria (50%) was selected as having the greatest impact on investment decisions in 2022.
- Stock availability was identified as having a significant impact (31%) of respondents which reinforces our view that there will continue to be a significant weight of money chasing limited (quality) stock and for certain sectors, yields will see further sharpening.
- A meaningful number (19%) placed ESG at the top of their criteria, spread fairly evenly across the buyer pool. This has risen significantly since our findings this time last year.

An expert view on operational real estate...

James Dunne
Head of UK Transactions, Real Estate, abrdn

Recent Scottish investment activity:

StayCity, Edinburgh
Fixed lease aparthotel with 108 aparthotel rooms and 20 serviced apartments. 25 year lease to StayCity, £25m/5%.

Maldron Hotel (Dalata), Glasgow
Fixed lease hotel with 300 beds on 35 year lease, £39.7m/4.4%.

Gilmore Place, Edinburgh
Student funding of 230 bed PBSA scheme, £29m/5.5%.

Lochrin Basin, Edinburgh
Direct let BTR with 113 units (191 beds), £27.5m/4.75%.

One of the "mega-trends" we've seen in the real estate market in recent years has been the change in attitude from providing space as a product, to embracing space as a service. In your view, which sectors of the market have been quickest to adapt to this, and which are lagging behind?

I believe we are still in the early stages of this transformation. The way that property investments are owned and valued can make it harder for landlords to adapt their strategies and customer relationships to provide the flexibility and service that a growing number of tenants are demanding. Equally, users of space need to appreciate there is a balance to that landlord and tenant relationship and the property owner needs to be able to generate returns and protect the long term value of their asset.

The most visible area where we have seen an ongoing shift change to a more service real estate environment is the office sector. As with many trends, this is being accelerated by the pandemic and it is an area that could continue to develop rapidly with the long term return to the office. The retail sector is one that will have to continue to adapt if it is to stay relevant. The demands of consumers to have variety, immediacy and evolution of choice means that retailers have to be more flexible and that applies to the real estate they are in. The more experiential retail, most likely digitally enabled, should develop and lead a partial, targeted recovery in the sector.

The alternatives sector (particularly operational real estate) appears to be bouncing back relatively strongly as Covid restrictions have eased. Has this surprised you and is it isolated to certain sectors and locations only?

The catch all categorisation of 'alternative' or 'other' is increasingly less relevant. The breadth of sectors and types of real estate that this covers means that coupled with the increased mainstream investment into a lot of these areas, I don't think we can or should be viewing this as a single sector.

The hotel sector is an example of where we have seen a really interesting pattern in durability. We are all guilty of overestimating the worst and underestimating the speed of bounce back whenever there is a crisis or downturn. It is hard to displace yourself from the current market and mindset when you are in the midst of these events (the same can be said for a rampant bull market). With that said, I think the speed of the hotel recovery has surprised even the most seasoned of investors and hoteliers. What we have seen though is that the recovery has been very narrow and driven by the best assets and the best locations. Whilst we have seen record occupancy and room rates in some hotels and locations, this has not been replicated across the whole sector. As we hopefully continue to emerge from the restrictions of the pandemic then we should see a wider recovery but I think the trend for the best assets to significantly outperform the market will continue.

What are some of the key benefits of owning alternatives and operational real estate to institutional investors? And which have been the favoured sectors?

The breadth of the alternative sectors (I haven't come up with a better name!) means that by not investing in them we are missing out on an increasingly significant part of the real estate investment market. When you consider that a lot of these assets are underpinned by social need (housing, wellbeing, education etc). then it almost seems nonsensical not to invest in these areas. The main hurdles have been the completely correct resistance to buy in areas where we as investors do not have a proper understanding of the sector and also the lack of asset structures that allow us to invest as institutional capital. The pandemic has highlighted the benefits of having a diversity of income and sectors within a portfolio whether that be additional commercial areas or within the social infrastructure space.

One of our preferred target areas has been the extended stay market (aparthotels, serviced apartments). This was a growing market before the pandemic given the obvious attraction of staying in a small apartment with a kitchen and living area if you are away for a few days, weeks or months. They also provide a practical alternative for family's and groups on leisure stays. The lower cost of running the operations means they operator can run efficiently and this counterbalances the larger space requirements. The ability to pivot from more lucrative short term stays to a longer term model which provides certainty of income and was in demand during lockdowns meant that the sector showed very strong resilience throughout the worst of the pandemic disruption and therefore a strong rationale to invest both for the protection in the downside but also the predicted performance in a more normal market.

According to INREV, capital allocations to stand-alone operational real estate currently stand at 11.8%. Do you see this growing over the next 5 years? Which segments of the market will investors be targeting and why?

I think it is inevitable that we will see this allocation increase. The requirement for significant amounts of residential accommodation, the increased understanding of the operational areas and requirement for a large quantum of funding into the social infrastructure areas all provide compelling pull factors for investors. This is also against the backdrop of a shrinking retail market, a low yielding industrial sector and a collective uncertainty on how the office sector will evolve. This disruption in the traditional commercial sectors provides additional push factors into operational sectors.

The growth of the BTR sector particularly in Scotland has been somewhat slower than elsewhere in regional UK and London. Why do you think this is — and do you expect to see it pick up now?

As a house we have BTR exposure in Scotland and it has performed very well for us. The opportunities to invest in strong areas have been limited though as competing land uses and a lack of an established professional and purpose built rental market has potentially deterred some developers from turning out purpose built rental product.

There has potentially been some reticence from other investors around the nuances in the statutory residential framework in Scotland and uncertainty around political situations such as Brexit will have added to this.

I think these are short term issues though and I see no reason why there should not be a flourishing BTR market in the major Scottish cities and towns in line with the maturation of the market across the rest of the UK.

Many investors tend to make investment into operational real estate with a specialist partner. Do you see this trend continuing, or will technology and on-boarding of "in-house" expertise see institutional investors in particular become more hands-on in the management of their operational portfolios?

In order to invest we need to have the confidence that we understand the asset and the market that we are investing in. As investors start to broaden their horizons both into the alternative sectors and more operational real estate it is prudent to have a specialist on board to plug any gaps in knowledge and experience. With the more 'hands on' and direct risk / reward nature of operational real estate, which may well involve wider skill sets than those which a traditional investor may possess this need is even more heightened.

By externalising some of the operational side of the running of an asset it also gives an investor the ability to choose and switch to best in class partners and nimbly take advantage of any evolution of either the market or technology.

'Our view' on what to look out for during 2022...

Off market acquisitions to the fore

As our investor survey illustrates, 2022 will continue to see more buyers than sellers for the best stock. Hence we see "off-market" opportunities as being particularly attractive to investors and believe that buyers will be prepared to pay premium pricing to avoid competition. A number of high-profile transactions have completed off-market (or selective marketing) during 2021 - Exchange Place 1 in Edinburgh and Silverburn in Glasgow as examples. This trend will continue.

Mind the office ESG gap...

We will see the gap between prime (best in class ESG) yields and the rest of the market widen. As occupiers and investors become ever more exacting in their ESG requirements, the few buildings that meet the very best standard will command premium pricing and could be as much as 25-50bps sharper than the next tier.

We have seen the gap already appear in the office market but it is now becoming a feature in other sectors including distribution and retail warehousing. If the relevant sustainability improvements are not made in the short term, the prospect of less liquid assets becomes a real threat in the longer term.

Increasing weight of overseas capital investing in the Scottish market

Despite the threat of further travel restrictions and interest rate rises on the horizon, the Scottish market continues to be seen as an attractive and safe destination for overseas capital. Investors from the US, mainland Europe and Middle East have been particularly active this year and we see this continuing unabated into 2022.

The increasing US investor activity is particularly interesting. A number have deep pockets and we see their market share increasing further during 2022.

Glasgow to overtake Edinburgh in office investment volumes

Edinburgh has had a strong run of transactions during 2021 (£282m traded). We see Glasgow fighting back during 2022 and with a number of high-profile new developments completing and letting up, volumes are likely to rise significantly. The potential sale of 177 Bothwell Street is likely to set a new benchmark for prime office yields, further highlighting our view that best in class (ESG focused) developments will command premium pricing.

Aberdeen to see improved investor activity?

Having had a number of thin years in terms of investment volumes, there are signs that investors are starting to re-visit the Aberdeen market. 2021 has witnessed increasing demand for quality assets in the retail warehousing and industrial sectors, which we anticipate continuing into 2022.

The office market remains more challenging but with the oil price looking stable at c$70-$80 per barrel, the occupational market is showing early signs of improvement and for the right building, with quality tenant(s) and properly priced then we anticipate that the more opportunistic buyers could be tempted by the attractive cash on cash returns available.

The leisure market will be one of the most interesting during 2022

City centre bars and restaurants have been particularly badly hit during the pandemic but the strongest operators had seen a strong bounce-back as restrictions have eased. Stock selection will be even more important but with such uncertainty in the market, there will be value to be had, albeit it may take some time to see the calmer waters ahead.

Out of town, the picture is quite different with roadside and drive-thru markets absolutely thriving. With many new entrants now rolling out their expansion programmes (including Greggs, Subway, Leon, Wendys and Popeye Chicken) in addition to the active existing operators (including Starbucks, Costa and Tim Hortons), there will be very significant rental growth coming through during 2022. On the back of this, long and strong roadside stock will see a renewed level of interest and sharpening of yields.

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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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