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"Intelligence"

Scottish Investment Market

Quarterly Review
March 2022

“Intelligence”

An old Scottish joke says “Edinburgh boys come to Glasgow for a laugh and go home in stitches...”

Edinburgh v Glasgow may not have quite the same ring as New York v Boston, Sydney v Melbourne, or Toronto v Vancouver but the (friendly) rivalry is just as fierce and in property terms, both cities offer investors something very different.

Glasgow is the strongest retailing centre outside of London (Glaswegians like to spend), while Edinburgh is the UK’s largest regional financial centre with c£500bn of assets under management (Edinburgh folk are more canny with their money). Glasgow has an enviable track record of attracting major inward investment — most recently with Barclays opening its 470,000ft Glasgow Campus on Drum Property’s Buchanan Wharf development fronting The Clyde. While Edinburgh saw one of the largest pre-lettings ever seen in Scotland in 2020, with Baillie Gifford committing to 290,000ft at M&G Real Estate and Qmile’s Haymarket Square development, due to open later this year. Both cities have their good news stories as well as challenges.

With this backdrop, in addition to our usual market analysis, our focus this review is on comparing Glasgow and Edinburgh — what attracts investors/developers, what sectors are most resilient in each city, and how both are recovering after the pandemic. To help shape our thinking, we are pleased to share views from two leading developer/investors. Graeme Bone, MD of Drum Property Group gives his thoughts on Glasgow, while Chris Stewart, Chief Executive of Chris Stewart Group, covers Edinburgh.

Investors may have a preference between this pair of vibrant cities but no-one can understand Scotland without paying attention to both. Property aside, it would be a terrible shame if the rivalry were ever settled...!

Market overview.

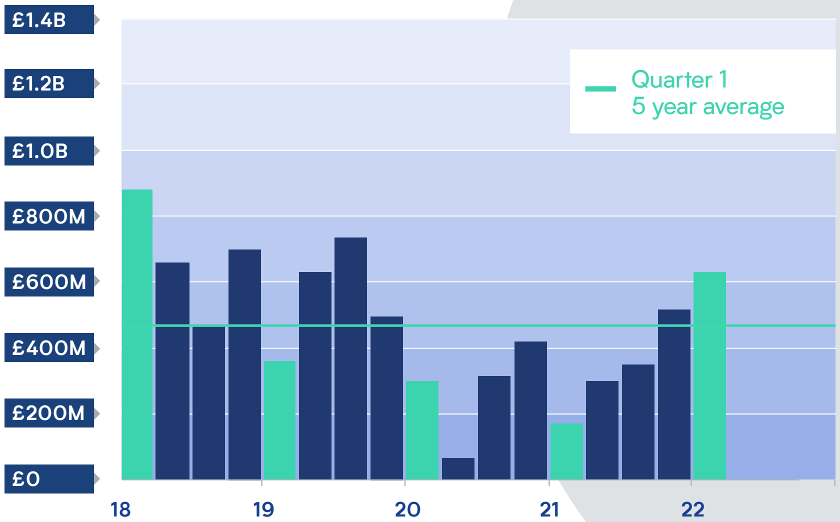
Key themes

- **Prime distribution pricing hardens** — The sale of Pinnacle, Eurocentral at 3.41% reflects a 100bp yield shift for prime long income distribution assets (with indexation) in the best locations. Investors will continue to chase these opportunities, sustaining pricing during 2022.
- **Opportunistic buyers seeing value in prime shopping centres** — The sale of Silverburn in Glasgow is the first sale of a prime centre in Scotland, pricing at c50% discount (to peak) but highlights that appetite remains for the best re-priced quality assets.
- **Retail warehousing in demand but limited stock** — Investors targeting retail warehousing on the back of strong occupational demand are finding assets hard to come by, with a pool of market specialists on a spending spree and fierce competition for the best assets.
- **High Street retail shows signs of recovery** — Interest in prime high street retail, particularly assets with quality upper floor offices, is generating an increasing depth of investor demand and with pricing offering a discount, those willing to dip their toes in the water will find significant value.
- **Cost of living pressures** — CPI rose by 6.2% in the 12 months to February 2022, with the monthly rise in February of 0.8% representing the largest since 2009. With rising energy prices expected to push inflation to a 40 year high of 8.7% by Q4 2022, there is the potential for a knock on effect filtering through to retail spend.

Transaction volumes

- Q1 has seen a strong start to the year with c£630m traded, up 260% on Q1 2021, which was significantly affected by the pandemic.
- Q1 volumes were 35% over the 5 year average, the first time this has happened in 3 years.
- While there remains limited stock being openly marketed, we are aware of a number of larger assets (c£50m+) either under offer or quietly being prepared for sale which should ensure the positive start to the year continues.

Sale volumes



Pricing

- The distribution sector saw the strongest yield compression of 75-100bps over the quarter, for long income with indexation to strong covenants.
- Other sectors also seeing a sharpening of yields are retail warehousing and PBSA. For direct-let PBSA, yields have hardened c25-50 bps over the quarter and for long leased PBSA (to Russell Group Universities) we are anticipating this will harden to a new record level during Q2.
- Prime high street retail is starting to provide some opportunities which are hard to ignore, with prime assets in Glasgow trading at a discount of c300 bps to pre-pandemic levels with the backdrop of an improving occupational market.

Investor activity

- There continues to be strong investor interest in the Living sector (PBSA and BTR), particularly from UK funds and the sector specialists, targeting strong locations many of which remain severely under supplied.
- Despite pricing hardening further, the distribution/logistics sector continues to attract a significant weight of capital with prime Scottish assets still looking like reasonable value compared to south of the border.
- The US remains the most active source of overseas capital particularly targeting retail warehousing and core plus offices.
- South Korean investors remain the most active vendors for larger assets, primarily on the back of some institutions unable to secure sufficient syndication in their domestic markets.

Key recent transactions.

Following a positive start to the year, we have highlighted some significant transactions from Q1:

Offices:

"US capital acquires Edinburgh core plus office"

Waverleygate, Edinburgh

- Vendor — Patrizia
- Purchaser — Kennedy Wilson
- Let to H&M, Amazon, Handlesbanken, Microsoft, NHS and others
- Price/Yield — £78.05m / 5.50%
- Date — January 2022

Retail Parks:

"Competitive bidding for dominant Aberdeen retail park"

Beach Boulevard Retail Park, Aberdeen

- Vendor — abrdn
- Purchaser — US investor
- Let to Aldi, Asda, Pets at Home, Home Bargains, Dunelm and others
- Price/Yield — c£60m / c6.25%
- Date — February 2022

Shopping Centres:

"Prime shopping centres becoming liquid"

Silverburn, Glasgow

- Vendor — Hammerson and Canadian Pension Plan Investment Board
- Purchaser — Eurofund Group and Henderson Park Capital Partners
- Let to multiple tenants anchored by Tesco, M&S and Next
- Price/Yield — £140m / 9.3%
- Date — March 2022

Distribution:

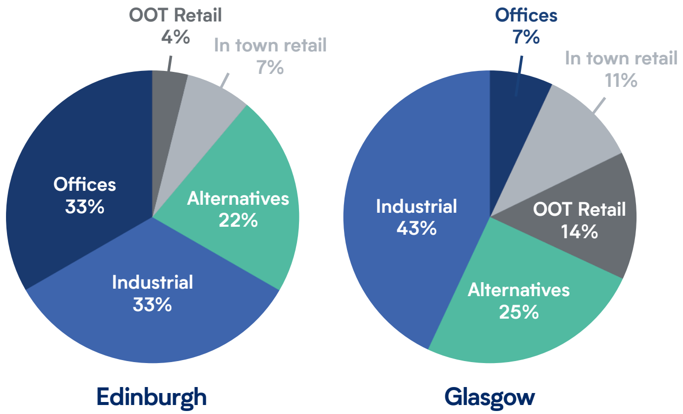
"Record yield for prime logistics asset"

Pinnacle, 6 Brittain Way, Eurocentral

- Vendor — Pie & Mouse
- Purchaser — Fiera Real Estate
- Let to Brewdog plc — 20 years with RPI indexation
- Price/Yield — £12.37m / 3.41%
- Date — March 2022

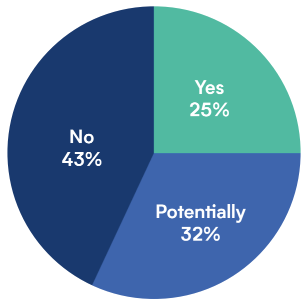
The investor view on the Edinburgh and Glasgow markets.

1) When considering opportunities in Glasgow and Edinburgh, which is your favoured sector?



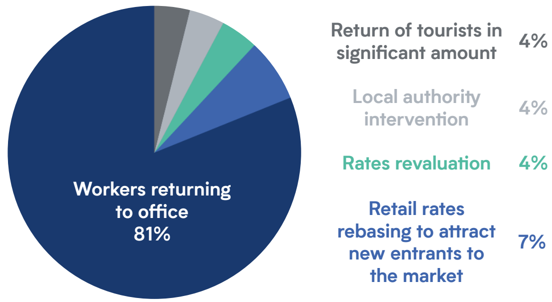
- The traditional view that Edinburgh is strong in the office sector and industrial is king in Glasgow are reflected in the responses received. 43% of respondents listed industrial as their top sector in Glasgow compared to 33% in Edinburgh although this is perhaps closer than expected.
- The Edinburgh office market is the sector of choice for 33% of respondents (on a par with industrial!) with only 7% selecting offices as their first choice in Glasgow.
- The alternatives sector is very similar in both cities accounting for 22% of respondents in Edinburgh and 25% in Glasgow. The availability of sites in Edinburgh was highlighted as a limiting factor in comparison to Glasgow.
- Glasgow remains the dominant retail centre with out of town retail accounting for 14% of responses in the top category compared with 4% in Edinburgh. In town retail accounted for 11% in Glasgow and 7% in Edinburgh.

2) Buchanan Street in Glasgow and Princes Street in Edinburgh are quality retailing pitches. Have rents and yields stabilised sufficiently for you to seriously consider them as an investment option?



- Whilst the majority of respondents are cautious about investing in Buchanan Street and Princes Street presently, a quarter of respondents do see the opportunity and a further 32% are willing to consider opportunities in these locations.
- Prop co's are the most bullish with 83% willing to consider investments in these locations.
- Encouragingly, some 50% of funds, investment managers and private equity would consider an investment on Princes Street or Buchanan Street. With a number of high profile lettings currently under offer or recently concluded, it certainly feels like these locations are turning the corner.

3) Both city centres are recovering from the effects of the pandemic. What is most important to ensure both recover their vitality and appeal to investors?



- 81% of respondents identify workers returning to the office as the key factor in vitality returning to the city centre. Among the many factors highlighted by respondents, the return of trade to city centre restaurants, bars and coffee shops are highlighted as significant contributors to a healthy city centre.
- Both prop co's (62.5%) and investment managers (33%) chose the return of tourists in significant numbers as the second most important factor. It remains to be seen what form and scale the Edinburgh Festival season will take this year. Will we see the return of the largest annually ticketed event globally or pared back event and visitor numbers affected by the cost of living squeeze?
- With 74% of respondents identifying local authority intervention as the least important factor for a return of vitality to the high street, it is clear that it will be the private rather than public sector which drive the evolution of the high street in the immediate future.

An expert view on the Glasgow market...

To help understand the market dynamics in Glasgow and Edinburgh, we have sought the views from Drum Property Group, one of the leading developers of mixed use space in Glasgow and Chris Stewart Group, a major developer of mixed use schemes particularly active in the operational development market. We are very grateful for their insight below and overleaf.

Graeme Bone
Group Managing Director at Drum Property Group

Recent Glasgow development activity includes:

Candleriggs Square
£300m mixed use scheme comprising residential, hotel and commercial. First phase (BTR) funded with LGIM.

Buchanan Wharf
1.25 million sq ft mixed use scheme — offices (Barclays and Student Loans) , BTR and commercial. Student Loans and BTR funded with LGIM.

G3 Square
250 bed residential development (residential/serviced apartments and BTR). BTR funded with Rothschilds.

You have been a leading developer in Glasgow for some time — what are the key fundamentals of the market that gave you confidence to invest so significantly?

Glasgow has a significant skilled labour force, is an established centre of educational excellence and has a very diverse local economy. It's a really attractive place to live and work with great public transport infrastructure. We like Glasgow and think it is undervalued in a UK context, so we decided to give the city some attention. Compared to other major cities in the UK, there is a relatively good supply of development opportunities where there is potential for place making at scale. The theory seems to have some foundation — we have pre-let and pre-sold over 2m sq. ft. of mixed use space in the city since in the last 5 years.

You have been very successful in identifying sources of capital (both UK and overseas based) when delivering and exiting your development projects. Do you see that stream of equity continuing?

For good projects built to an appropriate specification, undoubtedly yes. Real estate fundamentals will always drive the inward flow of equity. Build the right thing in the right place and the money will find you.

When considering new development projects, what sectors do you see as being most attractive — both in terms of potential returns but also when considering exit options?

BTR has a long, long way to go in Glasgow assuming the administration post-election wants to embrace that. Recent messaging from the elected members has been mixed, and that's really dangerous for the city. In a construction market facing inflationary headwinds which threatens viability, the addition of political risk in the planning process into the mix may well mean that Glasgow loses out, and falls into the 'let's not bother' bucket. That would be unfortunate, and a huge opportunity missed.

We are also really positive about offices. Arguably everyone in the country is in the wrong size of office right now and in addition many will be in facilities that don't fit emerging corporate ESG aspirations. If managed properly, we should see significant activity in the medium term. There will be winners and losers, but there should be a lot of movement. Never has the function of the office and its relevance to organisations been higher up the corporate agenda. Markets go down, markets go up, but we all need churn and there should be a lot of that.

The pandemic has obviously had a significant impact on the vitality of the city centre — do you see a swift return to "normality" and what opportunities might arise as restrictions ease?

It's early in the recovery, so in my view too soon to determine exactly what the new normal will look like. That said, town centres have been at the heart of human interaction for hundreds of years. I don't see that changing. It will be exciting to see the next manifestation of a post pandemic / post technological revolution city centre. It will be different, there will be disruption, and disruption creates opportunity. Human beings are basically sociable creatures and my gut feel is after the enforced hiatus, city centres will recover strongly — but perhaps not in their current form. Intensification of development in city centres will create a new vibrancy with a more affluent, mobile, resident population than in previous cycles.

Looking at Manchester as an example where the public sector have been proactively engaging with developers to facilitate regeneration in the city centre, how does Glasgow compare? What aspects can we learn from?

We've enjoyed an excellent relationship with the public sector in Glasgow. 'Team Glasgow' is really slick when it it's working well and perfectly capable of competing on a level playing field with the likes of Manchester and others. In the challenging times we find ourselves in, resource is an issue however. Justifying spend to encourage inward investment in, and regeneration of, the city centre when there so many other worthy service lines competing for budget must be very difficult. That said, improvement of the built environment is vital for a whole host of reasons. The private sector should all be doing more to help Councils with this key function where we can.

An expert view on the Edinburgh market...

Chris Stewart
CEO of Chris Stewart Group

Recent Edinburgh development activity includes:

The Edinburgh Grand, Edinburgh
Redevelopment of historic banking hall with 50 luxury apartments operated by the Cheval Collection, Hawksmoor restaurant and Lady Libertine bar.

The Mint Building, Edinburgh
60,000 sq ft Grade A office development, 100% pre-let to Baillie Gifford and sold to Hines Pan European Core Fund.

Advocates Close
£45m award winning mixed use development including offices, Old Town Chambers comprising 50 serviced apartments, and Devil's Advocate bar.

You have been a leading developer in Edinburgh for some time — what are the key fundamentals of the market that gave you confidence to invest so significantly?

Edinburgh is a city that people want to visit, want to live in, and want to do business in. Outside of London, it is the most prosperous and economically successful city in the UK. It is a centre of excellence for education and has a well-educated resident population. It has an incredibly buoyant level of employment with the legal, financial, and professional services sectors, as well as tourism, hospitality, and public sectors well-represented in the city. As a location for investment — local, national, and international — Edinburgh has and will continue to inspire confidence and interest.

Aside the obvious economic strength of the city and its abundance of heritage assets it is also a city where people have always lived and worked within the core. That extra layer of demand means that many sites and buildings have potential multiple uses making it easier to reposition assets as demand changes over time.

The ability to be able to be neutral on sector when identifying the right opportunities in the right locations has allowed us to unlock some complex and challenging sites in the city.

You have been very successful in identifying sources of capital (both UK and overseas based) when delivering and exiting your development projects. Do you see that stream of equity continuing?

The fundamentals of the market and your track record as a partner are critical to securing capital. Financial alignment and performance with those partners will build confidence to reinvest. This comes into sharper focus when delivering a complex piece of city centre development where your track record and capabilities trump the market dynamics. This is important because without good local real estate partners, cities cannot optimise their opportunity to secure investment.

There is a significant amount of money seeking a home in good real estate deals and Edinburgh is high on the list for those looking to deploy capital. That weight of money alongside a lack of product continues to support the market, buoyed by the prospect of COVID-19 and its restrictions fading, and with sectors and economies reopening. However, the headwinds of rising inflation, interest rates, changes in planning legislation, and recent events in Ukraine all mean that we should be on our toes and ready for whatever comes next.

The challenge for us is to adapt and keep pace with a rapidly changing marketplace, whether that's embedding ESG strategies across our assets and businesses or creating the type of operational income streams that have proven to be more resilient and dependable than many leased assets.

When considering new development projects, what sectors do you see as being most attractive — both in terms of potential returns but also when considering exit options?

Our focus will be on repeating the city centre approach that we have always had. Mixed use developments in strong locations provide opportunity to create a blend of leased and operational income streams. Quality and strong design are important to us, and we can apply that to residential, hospitality and commercial assets.

Many established asset classes are being disrupted at the moment with big unanswered questions over how we will live, work, play. How sustainable are our buildings and the companies that occupy them? What does that mean for their immediate and future value?

I think many asset classes will bifurcate, with well located, innovative, high quality, sustainable buildings attracting more than their fair share of the market, whilst secondary buildings that fail to satisfy changing occupier demands or deliver the necessary credentials will need to find ways to be repositioned.

Our focus will be on creating buildings and income streams that are innovative, relevant, and desirable.

The pandemic has obviously had a significant impact on the vitality of the city centre — do you see a swift return to "normality" and what opportunities might arise as restrictions ease?

The market seems to be split into three; those who want to get back into work and into cities, those who are clinging on to the hope that they keep their new virtual lives and those fortunate enough that they are in charge of that decision.

There is already huge evidence that many, especially younger, people want to be and are heading back to the office. You just need to have been on Threadneedle Street or St Peter's Square during restrictions and see them now to see the change. We also see that many businesses are now tightening the flexibility offered and being clearer about how much time people must spend in the office. There is certainly a reckoning coming for many businesses and their staff who don't see eye-to-eye on the matter and decisions will need to be made, but there are strong signs that the private sector is on its way back to the office in a meaningful way.

We are seeing a strong return to cities from tourists, whilst predominantly domestic, international travellers are returning as restrictions are being lifted. It's encouraging to see the appetite to travel.

A clear opportunity exists for cities to reset their vision and accelerate out the pandemic with clear reasons why people should come back. Some cities appear to be grasping the opportunity more than others resulting in a visible difference in how busy those cities are now.

Looking at Manchester as an example where the public sector has been proactively engaging with developers to facilitate regeneration in the city centre, how does Edinburgh compare? What aspects can we learn from?

I think the answer is in the question. Manchester has for some time had a clear vision for the city and importantly a real ability to engage with the private sector. There is real pace and energy in the city, a clarity of purpose and there is always a sense of urgency about getting things done. That overlayed with a strong leadership pressing the Manchester agenda means they clearly have a winning formula.

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