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REAL ESTATE ADVISORS

"Intelligence"

Scottish Investment Market

Quarterly Review
June 2022

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WELCOME

“Intelligence”

Elon Musk’s recent tweet to a follower who asked him for additional comment on people who think coming into work is an antiquated concept was “they should pretend to work somewhere else…”

Whether he did send a memo to Tesla executives entitled “Remote work is no longer acceptable” is still up for debate, but what is not in doubt is the fact that many senior management teams (particularly in larger organisations) are still grappling with the future of their offices and how they would like their staff to use them.

There are huge variances in what businesses need from their offices and as real estate advisors, clearly we have a vested interest in seeing a strong return to the office. The challenge remains for employers to create spaces and environments that people want to return to and accentuate the positives of learning, collaboration, career progression and enjoyment (remember some of the best office parties??), while still offering some sort of flexibility. However, it runs deeper than this and to maintain exciting, attractive and economically vibrant cities, they need people! Office staff form an important part of their future success.

With this backdrop, in addition to our regular market analysis, our focus this review is on the office market in Scotland, what are the key drivers for occupational demand, where is pricing likely to end up during the rest of the year and, post-pandemic, how important or otherwise has the office become. To help shape our thinking we are delighted to share views from Stephen Lewis, Managing Director of HFD Property, one of the most active and successful office developer/investors in Scotland.

With a cooler economic air having arrived, it will be interesting to see if this speeds up a stronger return to the office and it re-emerges as the focus for thriving businesses who see their “space” as an asset and reflects what they stand for — modern, collaborative, inclusive, welcoming and good fun…

Market overview.

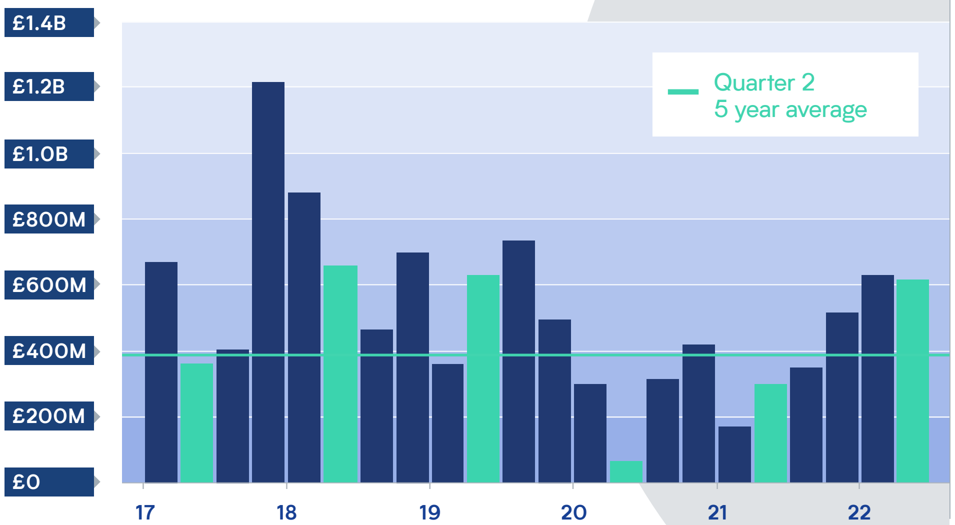
Key themes

- **Caution in the air** — after a strong Q1, a combination of the war in Ukraine, rising inflation and more challenging debt conditions has caused many investors to pause for breath.
- **Cash is king** — the increasing cost of capital for debt backed investors is creating an advantage for cash buyers. If they can move quickly then opportunities will arise in the second half of the year.
- **Occupational real estate thriving** — Persistent strong demand for PBSA from sector specialists and funds is driving pricing and with the key Scottish university cities significantly undersupplied this will continue in the medium term. In addition, the Scottish BTR market continues apace in Glasgow and Edinburgh although build cost inflation is keeping the supply pipeline in check.
- **Pre summer flurry** — a number of significant transactions are expected to complete in early Q3 before what could be a more subdued period as investors take stock of the macroeconomic environment.
- **The re-emergence of Aberdeen?** — Aberdeen could be one of the winners over the next 6 months, with investors seeking out higher yielding stock to balance their portfolios. The granite city may well begin turning heads, with a yield discount to prime central belt assets of c400-500bps.

Transaction volumes

- Following a strong start to the year, Q2 has seen momentum continue with c£612m traded, up 104% on Q2 2021.
- Activity for the quarter was some 56% above the 5 year average. It should be noted that the average is skewed by a Covid hit Q2 2020 and, excluding 2020, the Q2 2022 figure is 27% above the average.
- A number of significant deals, particularly in the PBSA and office markets, are due to complete early in Q3 which should provide a positive start to the quarter.

Sale volumes



Pricing

- The “beds” sector including student, BTR and hotels continues to see pricing holding firm with UK funds, overseas investors and specialist platform builders all seeing the sector as a safe haven in choppy waters.
- In the core plus sector, demand for well located office assets remains (particularly from overseas investors) with Edinburgh’s occupational dynamics proving particularly attractive.
- We anticipate pricing will come under pressure cross sector on assets which are not absolutely prime, especially if not meeting ESG credentials. This is further driven by increased cost of capital and more cautious decision making.

Investor activity

- UK pension funds and investment managers continue to seek secure long income defensive stock, particularly in the logistics and PBSA/alternative sectors.
- There remains a significant weight of capital from overseas investors, particularly from North America, the Middle East and Europe, illustrated by Pontegadea acquiring 177 Bothwell Street, Glasgow representing Scotland’s largest single asset office sale.
- UK based property companies continue to be acquisitive in the retail warehousing and industrial sectors, targeting the best locations with strong occupational dynamics where they can achieve optimum pricing/value.

Key recent transactions.

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

Offices:

"Strong ESG credentials drive premium pricing."

177 Bothwell Street, Glasgow

- Vendor — HFD Property Group
- Purchaser — Pontegadea
- Let to Virgin Money, BNP Paribas, CBRE, AECOM, Transport Scotland, HFD Group
- Price/Yield — £215m / 4.50%
- Date — April 2022

Retail:

"Prime high street retail begins to trade."

123-129 Buchanan Street, Glasgow

- Vendor — SW Pooled Property ACS fund c/o Abrdn
- Purchaser — Clydebuilt Fund c/o Ediston
- Let to White Company, Hobbs, Tiso, Fleeson & Robb
- Price/Yield — £16m / 7.93%
- Date — April 2022

Mixed use:

"Princes Street targeted by overseas investor."

124-125 Princes Street, Edinburgh

- Vendor — HECF Edinburgh S.a.r.l c/o Hines UK
- Purchaser — Overseas private investor
- Let to Urban Outfitters, Harley Haddow, RICS, Ofcom, Recast and Cenkos Securities
- Price/Yield — £15.8m / 6.33%
- Date — June 2022

Hotels:

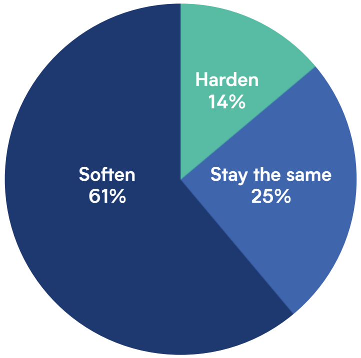
"Long income hotels with indexation continue to attract strong institutional investor interest."

Premier Inn, Sauchiehall Street

- Vendor — Regent Capital
- Purchaser — BP Pension Fund
- Let to Premier Inn
- Price/Yield — £30.2m / 4.35%
- Date — June 2022

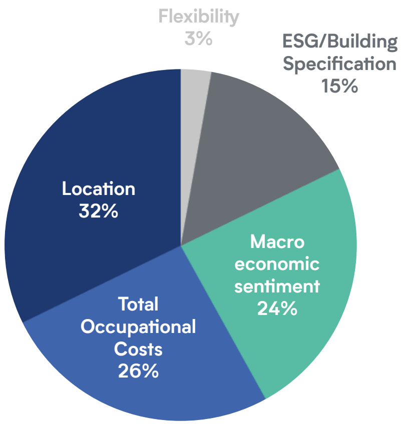
The investor view on the office market.

1) Do you expect prime office yields to harden, stay the same, or soften over H2 2022?



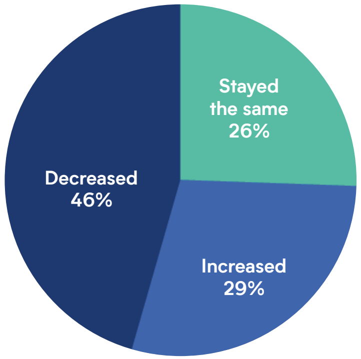
- 61% of respondents expect prime office yields to soften over the next 6 months. It was noted that prime London yields have already begun to soften as a consequence of the wider economy, resulting in a change in sentiment, with the regions traditionally lagging behind the capital.
- Funds and investment managers were the most pessimistic with 100% of funds and 63% of investment managers anticipating yields cooling in the remainder of 2022. However, a quarter of investment managers expected yields to harden in H2 2022.
- Property companies are more bullish with 64% expecting yields to stay the same.

2) Rank the key drivers for occupational demand (1-5):



- The key driver for occupational demand was identified as location (location location!). Accounting for 32% of responses, this confirms our view that well located buildings, offering excellent staff amenity are becoming even more attractive.
- Total occupational costs are identified as a key driver by 26% of respondents and macroeconomic sentiment was chosen by 24% of respondents, with persistently high inflation and rising interest rates identified as key issues over the next six months.
- ESG continues to be a growing consideration and, despite the economic challenges, occupiers are perpared to accept higher rents for the best ‘sustainable’ buildings.

3) Post pandemic, has the importance of the office increased, stayed the same or decreased?



- Just over half (54%) believe that the importance of the office will stay the same or increase. However, some 46% believe it will decrease, which highlights the diversity of views and fuels the ‘debate’ (and challenges) which investors are facing when considering new opportunities.
- We had a significant number of comments confirming that to attract staff back to the office, it was anticipated that many businesses have and would be investing in their work spaces both in terms of physical improvements but also highlighting stronger ESG credentials.
- It was highlighted that there has been a permanent shift in working patterns with hybrid working here to stay. However, the proportion of those working predominantly from the office will continue to increase over the coming months, as more emphasis is placed on the benefits of a shared office space.

An expert view on the office market...

Stephen Lewis
Managing Director,
HFD Property Group

How can Glasgow differentiate itself from the rest of the UK's "Big-6" office markets?

In occupational terms, it's really about what attracts a business to establish roots in a particular location. Scotland performs well in terms of inward investment with recent research from EY highlighting four years of continued growth in terms of foreign direct investment (FDI), including a 14% rise in 2021. Outside of London, Scotland continues to be the favoured destination for FDI and over the last year, Glasgow alone saw 23 different projects covering digital, utilities, manufacturing and other sectors.

We also have a strong talent pool and globally recognised universities that boost Scotland's attractiveness. Glasgow, in particular, has established a reputation for financial services with large-scale lettings to companies like Virgin Money and Morgan Stanley (both HFD) and other notable investments by Barclays and JP Morgan underlining the city's position. The latter have both also demonstrated their commitment to the city by adopting an owner occupier model to accommodate thousands of staff.

Most recently, Glasgow has been firmly focused on the climate emergency with COP26 last November putting an international spotlight on the city's sustainability. Believed to be the first in the UK, Glasgow City Council has also made a formal commitment to achieving net zero by 2035. With environmental, social, and governance (ESG) standards becoming increasingly important for investors at an asset level, it seems only natural that a more holistic approach to property decisions will be adopted in the future, with a city's overall environmental performance undoubtedly an important consideration.

The sale of 177 Bothwell Street is one of the biggest regional deals ever seen, what do you think were the key considerations for the purchaser?

Generally, it's not unusual for investors' considerations to mirror those of occupiers across all sectors and at the moment, the key factors influencing property decisions are the flight to quality and ESG.

Especially for offices, ESG is a core concern and 177 Bothwell Street is market leading in that respect, however, wellbeing, connectivity and other attributes will also contribute to the selection of one building over another. Of course, we can't forget that having a diverse range of occupiers on weighted average unexpired lease terms (WAULT) of around 20 years will also support any investment decision.

"Throughout the project at 177 Bothwell Street, we have continued HFD's delivery of market 'firsts', including the incorporation of Scotland's first metro data centre, rooftop running track and drone landing pad. It's about future-proofing and providing resilience, looking at trends that will likely become more mainstream in the years ahead, which, in our view will include commercial drone deliveries to offices and other properties.

Do you think it is only major corporates who are prepared to pay for their buildings (through higher rents) to meet the highest possible sustainability credentials?

Not at all. Through our business park portfolio — which includes both large corporates and SMEs — we know that sustainability is fast becoming a priority for all. We are seeing all types of occupiers embarking on their own ESG journeys and commitments.

Across our Business Park portfolio we are undertaking a significant decarbonisation project to improve energy efficiency, increasing the use of renewable energy and installing infrastructure to support electric vehicles. It's important for us as a business, but more importantly, it's something our occupiers are looking for.

While rents are higher at 177, reflecting the overall quality of the development and the higher environmental performance, it is more than ameliorated by the reduced service charge and operating costs. It might seem a counter-intuitive position but ensures that occupiers really do get the best of both worlds ie the best specification and performance, without a 'green premium'.

What is the best test of a truly sustainable building — BREAAM, EPC, whole-building life cycle assessment and which do you favour?

There is no one-size-fits-all approach to sustainability and each of the different accreditation schemes addresses a different aspect of a building's impact and performance. Over the past 15 years or so HFD has leaned more towards EPC than BREEAM, as we could see that energy efficiency was perhaps a higher priority for occupiers. It was our view that BREEAM didn't go as far in demonstrating energy performance and perhaps most importantly, didn't include any kind of action plan for continued improvements. BREEAM is still relevant, of course, and we've been delivering Excellent ratings as a minimum standard.

EPCs provide a useful benchmark for energy efficiency but when you consider the fact that every new build should readily deliver an 'A' rating, there is a need to delve a little bit deeper. These days it is the number, not the letter than is most important. An 'A' rating is a score of 15 or less, and some developments will just meet the grade, while others will perform significantly better. 177 Bothwell Street is targeting a score less than 9, for instance. This would make it more than 40% better performing that a standard 'A' rating scoring 15.

How do you feel construction of modern workplaces will evolve over the next 10-15 years in terms of materials, technology adopted and use of the space created?

In terms of the materials we use, this will largely be driven by decarbonisation, both from an operational and embodied perspective. So much of a building's carbon performance is associated with the fabric and structure so it certainly needs to be a 'fabric first' approach.

There are some myths to dispel around the choice of materials. For example, it is possible to build a fully glazed building and still meet energy performance targets, however, it undoubtedly takes a lot of work. There's also a need to balance both sides of the equation between operational and embodied carbon — improvements to one side can lead to increased carbon on the other. We reviewed research to determine whether a third layer of glazing would go far enough in terms of energy savings to offset the embodied carbon associated with the manufacture of the extra layer of glass and it concluded that it would not.

It is difficult to predict how the fast-paced world of technology might change in the next decade but what we can foresee is that there will an even greater focus on data and 'smart tech' in its broadest sense, including sensor networks to gather real-time information about how occupiers use buildings. We've incorporated that at 177 Bothwell Street and have seen first-hand that occupiers understand and appreciate the benefits in terms of space utilisation, health and safety and most importantly, energy efficiency. With the right tech, buildings can automatically react to how they are used to maximise efficiency and minimise energy use, without human intervention.

Is hybrid working here to stay or a moment in time that will change in the event that we start to meet the challenges of a recession?

Hybrid working is here to stay but we will see more changes as macro factors influence the way we work. I often stress that hybrid working isn't new, it was here before Covid but was super-accelerated by the pandemic in a short space of time.

What we haven't been able to fully determine yet is the impact on the demand for office space. While overall occupational demand for space has reduced, it isn't necessarily aligned to working from home with more space also being converted to alternative work environments.

Something that remains to be seen is how policies on remote working might change when the recession bites. During economic downturn, the need to maximise productivity, innovation and collaboration is never higher, and I suspect that will translate into a desire to get people back together more in the same shared workspace.

"Our view" on investor sentiment in the office sector.

Colin Finlayson
Director
Lismore Real Estate Advisors

Overview

Much has been written on what the future of the office may, and may not, look like. The pandemic accelerated trends which were already evident — technology-enabled flexible working, focus on sustainability and wellness, evolving occupier fit-outs encouraging interaction, lower desk/employee ratios and, of course, many organisations analysing how much space they actually need, and where, to attract staff and best meet the needs of their respective functions. Now the pandemic is behind us, and weekly occupancy rates are steadily increasing, investors are focused on what are short-term trends and what look to be long-term. These will influence their market-focus and stock selection in the sector. Investors are driven primarily by relative value and potential for future performance. Does the office sector offer this? We believe so, but not everywhere.

Where is the growth?

In the two main Scottish cities of Edinburgh and Glasgow, we've seen resilient demand over the last two years, and some significant increases in prime headline rents. This is predominantly in the city centre and newly developed/refurbished buildings. However, the development pipeline in both cities is extremely limited — partly down to a lack of quality sites, but also down to the significant rise and ongoing uncertainty around construction costs. Almost no developer can agree a fixed price contract, meaning significant risk around project viability, making funding new development extremely challenging. This is against a backdrop of historically low levels of supply of vacant city centre accommodation (Grade A in Glasgow, and all grades in Edinburgh). This is unlikely to be resolved quickly. Even when it is, the consented pipeline is very low in comparison to annual take-up. In our view, this creates favourable conditions for rental growth on existing assets in city centres, provided they are well-located and capable of meeting (or already meeting) more exacting sustainability and wellness requirements of businesses. New prime rents at £40.00/sq.ft+, compared to many existing rents at £20.00 - £30.00/sq.ft provides plenty headroom for growth. Not all offices are created equal though, so stock selection and intelligent application of capex are key to capturing potential performance. Out-of-town, the picture is less positive, with higher existing vacancy rates, less amenity, and lower return-to-office rates from staff. The exception to the rule may be the best-in-class business parks which have invested in amenity and benefit from multi-modal transport infrastructure.

What next for yields?

Prime yields remained stable during the pandemic, with secondary yields increasing as buyers focused on core locations and buildings. Many buyers in the market across all grades have used debt however, and with the recent sharp rise in both swap rates and gilt yields, the cost of debt has increased. This, in turn, is likely to lead to yields rising, unless the weight of capital forces levered investors to lower their target returns to remain competitive. We expect to see core yields remain relatively stable, supported by the rental growth prospects discussed above, with yields for secondary and peripheral assets moving out further. It's also important to remember that many buyers invest pure equity, so are unaffected by the debt markets. The prime yield spread above both comparative European cities and 10-year gilts remains positive to the tune of 200bps and 160bps respectively, which is compelling.

Where will the capital come from?

We have seen investor interest in the office sector from a very wide geographical range in the last 12 months — UK and European institutions, Israel, GCC and North America. We expect this range to remain diverse and international capital to continue to dominate the market. One region that has seen a big increase in liquidity because of oil price revenues (and consequently interest in assets marketed) is the GCC.

What are the prospects for the remainder of the year?

With the summer (and school holidays) now upon us in Scotland, coupled with a less certain sentiment in the market, we don't expect to see many sales campaigns launched until late-August. The current uncertainty stems from concern over what the MPC's next move is on base rates. There have been five rate rises now since December 2021 and investors are anxious to know whether these will continue. Much of this will depend on inflation but it seems unlikely that the central bank will want to cause a recession and will likely prefer inflation over job losses. One way or another, we must pay at some point for the debt raised to deal with the GFC and COVID — inflation may be chosen as the least painful way to do so. The rise in swap rates appears to have settled and, in fact, the rates over all time horizons have reduced recently suggesting some stabilisation. If this remains the case, then we expect this will give investors confidence to return in September looking to deploy the significant dry powder that has been raised.

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