lismore

REAL ESTATE ADVISORS

"Intelligence"

Scottish Investment Market

Quarterly Review
September 2022

lismore-re.com

WELCOME

“Intelligence”

“I cannot lead you into battle. I do not give you laws or administer justice but I can do something else — I can give you my heart and devotion to all the people of our brotherhood of nations...”

– Queen Elizabeth II

Unlike our recently deceased Monarch, who did exactly what she said she would do, for a remarkable 70 years (thank-you Ma'am), the property investment market is showing less stability, with “volatility” very much order of the day.

Coming on the back of a strong post-Covid bounce, the effect of double-digit inflation, rising cost of debt, war in Ukraine and the financial markets turbulence has produced an equally sharp pause for breath, and in some cases a swift adjustment in pricing. Not all sectors are seeing the same movement — prime logistics has been the first to soften and significantly so, with offices also seeing sentiment move, albeit with few prime deals to benchmark the shift. Retail warehousing and the residential sectors have remained somewhat more robust, but most investors are currently erring on the side of caution and needing to see real value to tempt them “off the fence”, hence values are likely to ease across the board.

With this backdrop, in addition to our regular market analysis, our focus in this review will be on trying to make sense of the current market volatility, which sectors will fare best, how might pricing change and is there a real opportunity looming for those well capitalised/canny investors. To help shape our thinking, we are pleased to share views from David Shaw, of Peritus Corporate Finance, who will give us a real insight into what is happening in the debt markets and how this may play out in the short to medium term.

It feels like a time to adopt the Queen's legendary calm and reassuring nature for the months ahead...

Market overview.

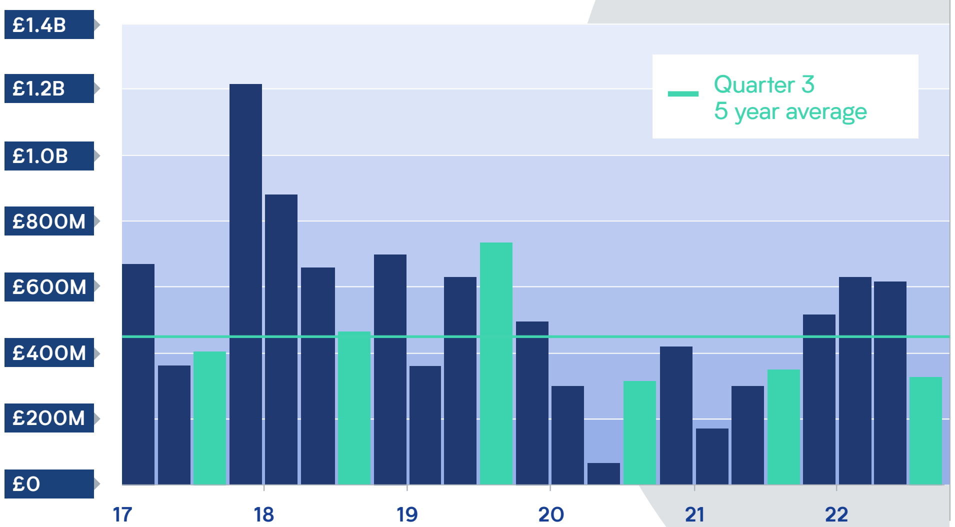
Key themes

- **A long summer** — the increasing economic headwinds and easing of confidence in the market has ensured a significant slow-down in deal volumes during an elongated summer period, as we began to see a stand-off between buyers and sellers.
- **Market volatility** — with prime logistics yields already shifting by c150 bps in the Scottish market, and price adjustments of between 10-20% on deals under offer, we are anticipating that Q4 is likely to see continued pricing volatility.
- **Cash is king (again)** — equity backed investors will be best positioned to take advantage of opportunities in Q4, with those able to act fast in pole position.
- **Development pipeline remains slow** — developers are continuing to face a challenging period as build costs remain stubbornly high and development finance gets tougher. The only silver-lining being that with many schemes across sectors stalling, the prospect of tight supply in key sectors remains.
- **Changing buyer profile** — as Sterling has fallen against most of the major currencies (the US Dollar in particular), different (overseas) buyers are emerging who can benefit from the currency play and see better comparative returns against other markets.

Transaction volumes

- The momentum from Q2 has stalled somewhat, with Q3 seeing c£339m traded, down 45% on Q2 2022.
- Activity for the quarter was some 26% below the 5 year average, however the YTD position of c£1.45bn is still significantly ahead of the same period in 2021 (£1.1bn).
- After a quiet end to the summer we are aware of a number of significant deals being prepped for sale but we anticipate targeted campaigns being preferred to a high and wide approach.

Sale volumes



Pricing

- Pricing is under pressure cross sector, with the logistics sector seeing an outward shift of c150bps to the top of the market. Demand for PBSA and BTR remains, however it is unlikely to be immune from the wider market slow-down.
- Prime high street retail has found its level at c6.5%, but with total occupational costs rising substantially, those retailers on less sure financial footing face significant headwinds in the short term and yields are likely to come under pressure again.
- Retail warehousing and food stores retain investor demand given the strong fundamentals compared to other sectors with a more mixed occupational story.

Investor activity

- We expect to see the re-emergence of North American private equity who sense there is opportunity to come. Those with deepest pockets will be first to move.
- Far Eastern and Middle Eastern investors are still in the market but refocused on more defensive stock. Long income, PBSA, BTR and food stores preferably with indexation is the order of the day.
- On balance UK funds are expected to be net sellers although for the right deals selective opportunistic buying is still possible.

Key recent transactions.

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

5 Brittain Way, Eurocentral:

"Prime logistics pricing softens."

- Vendor — Threadneedle Pensions Limited
- Purchaser — Custodian REIT
- Let to Gist Limited, 3 years to the break
- Price/Yield — £11.114m / 5.25%
- Date — August 2022

Equinor House, Prime Four, Aberdeen:

"Investor buys into improved Aberdeen sentiment."

- Vendor — Golden Globe Merchants
- Purchaser — GG Capital
- Let to Equinor for 9.5 years
- Price/Yield — £20.00m / 7.70%
- Date — September 2022

86, 88 & 90-92 George Street, Edinburgh:

"Prime city centre mixed-use blocks remain in demand."

- Vendor — BBC Pension Trust c/o CBREIM
- Purchaser — Broadland Properties
- Multi-let retail with offices above
- Price/Yield — £15.35m / 6.5%
- Date — August 2022

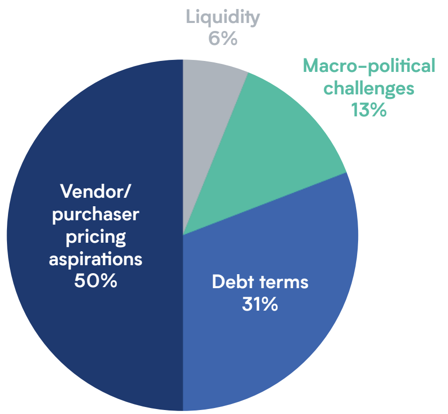
11 Minerva Way, Glasgow:

"Attractive income with potential for redevelopment."

- Vendor — Hampshire County Council c/o CBRE IM
- Purchaser — Redevco
- Let to Nuffield Health for 2.5 years
- Price/Yield — £9.25m / 8.72%
- Date — August 2022

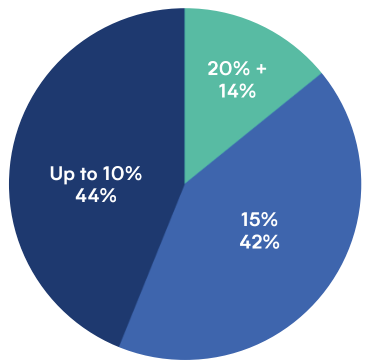
The investor view on the market...

1) **What do you view as the key market challenge over the remainder of the year:**
1. Debt terms, 2. Liquidity, 3. Vendor/purchaser pricing aspirations, 4. Macro-political challenges



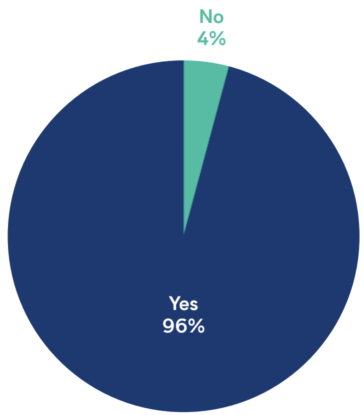
- 50% of respondents view vendor/purchaser pricing aspirations as the key challenge over Q4 and with market volatility likely to continue into the new year we anticipate the pricing differential to persist. Prop co's (71%) and investment managers (60%) overwhelmingly supported this view.
- Debt terms accounted for 31% of responses, perhaps surprisingly low when considered against the Peritus forecast detailed overleaf. Over 50% of funds selected debt as the key challenge.
- A number of respondents highlighted the key macro challenges of inflation, interest rates and energy prices as significant hurdles over the next 12 months. On the construction side, the viability of projects will be brought into focus, with the timing of projects key.

2) **What average cross sector reduction in values are you anticipating:**
1. Up to 10%, 2. 15%, 3. 20% +



- 42% of respondents believe values will reduce by up to 10% with 44% anticipating a reduction of up to 15%.
- Only 15% expect values to reduce by 20%+. It was noted that certain sectors, in particular BTR, life sciences and PBSA, may be protected to an extent from the wider market turmoil due to robust fundamentals.
- Prop co's are the most bullish with 63% expecting values to reduce by up to 10%, whilst 89% of fund respondents expect a reduction of 15%, perhaps indicative of more significant reductions seen in the larger lot sizes.

3) **Do you see the next 12 months as a buying opportunity?**
1. Yes, 2. No



- Positively, 96% of respondents expect to be on the acquisition trail over the next 12 months albeit with vendor and purchaser pricing aspirations expected to be out of sync, many expect the market to remain sluggish for some time.
- 100% of prop co's and funds view the next 12 months as a buying opportunity.
- It is worth noting that our survey results came back in early September. On the back of the recent fiscal uncertainty, we would suspect that while the next 12 months will bring opportunity, there is likely to be a period of inertia while investors seek a little more certainty in the markets.

An expert view on the debt market...

David Shaw
Consultant Real Estate Finance
Peritus Corporate Finance

The Peritus Corporate Finance Team brings together decades of experience across all asset classes with a team who have seen and understand complex property markets and investment cycles be it expansion or recession.

How have you seen the debt market evolve during 2022?

It's fair to say that the UK Economy is being buffeted by a wide range of headwinds. The UK has benefitted from a long period of record low interest rates and more recently substantial financial support for individuals and businesses during the COVID pandemic, however we are now seeing rapidly rising inflation driven by (amongst other things) supply shortages post COVID and the ongoing war in Ukraine, which is pushing energy prices ever higher and also feeding in to rising food costs and many other aspects of people lives. The Bank of England has responded with increases in the Base rate which are well publicised, however what is perhaps less "newsworthy" but important for commercial real estate borrowers is the increase in SONIA and SONIA swap rates. Sonia is the rate banks borrow from one another at and which is the lender reference rate for many commercial and development loans. As we'll discuss later this is going to have a material effect on leverage and asset pricing going forward.

2022 has also been the year that lenders started seriously focussing on ESG and EPC ratings. Certain uses have become increasingly hard to fund while poorer buildings need to have well funded business plans to improve performance. Green Loans may offer small margin reductions for hitting certain building efficiency levels.

Which sectors have seen the greatest impact on debt availability and pricing?

Debt liquidity across most asset classes remains strong, with the exception perhaps of the retail sector where challenges have been around for some time and for assets perceived to fall foul of ESG aspirations — petrol filling stations, defence, tobacco for example.

Lenders are generally positive on the Big 6 cites for well specified and well let offices but have limited appetite outside of these core locations. Industrial and logistics continue to be sought after by most lenders. Funding single assets and/or single tenants remains challenging unless the tenant is investment grade — perhaps less of an issue for logistics and industrial where demand remains strong.

The recent increase in interest rates is however universal and as well as impacting on leverage we are starting to see margin pricing moving as well.

Are you seeing LTV's drop in response to the market dynamics or is the additional macro risk being bundled up in in the lenders margin?

The increased interest cost is putting pressure on interest cover ratios. Lenders are now focussed on stress testing their facilities off higher interest rates to ensure rental income can service the facility in the event of an even higher interest rate environment. Lenders are also focussed on the facility expiry and want to allow for a loss of income (should some tenants cease trading) and what this does to the borrower's ability to refinance the debt.

This strong focus on interest cover is feeding through to lower leverage. Whereas earlier this year you might have seen 60% interest only on prime assets 55% is the new normal. Several lenders have already indicated that they won't consider facilities beyond 50% as a general rule.

Leverage is, to a much greater extent than even 12 months ago, being driven by the income and the interest cover ratios a lender requires.

On a £10m asset yielding 5% a year ago, with an all in interest rates of say 3% that income of £500k could easily support £6m / 60% LTV - with interest cover of 2.8x.

At today's rates of roughly 7% that same income can support just £4.8m / 48% LTV to give lenders a minimum 1.5x interest cover.

How long before you see some stability returning to the market?

The graph opposite shows the forward curve for SONIA — (the expectation for the SONIA floating rate at various points in the future). At the time of writing (late September 22) the market is suggesting that this could reach 5.92% by May 23 before falling back and flattening around 3.5% in late 2028. So, whilst there is the hope for some stabilisation around late 2028, what seems clear is that we won't be returning to the low interest rate environment we've been used to for the last decade.

Do you see the challenges of refinancing leading to some investors disposing of assets?

I think that seems inevitable but may not be as bad as feared depending on when you bought the property and if you have been driving income forward.

If you bought a prime logistics asset back in 2017 for, say £10m when yields were c5.25% borrowing 60% LTV and have benefitted from not only yield compression but also from rental growth, then your current debt metrics may not look too stressed even as yields move out.

If, however you had purchased the same asset in 2020 at a yield of say c3.75% and if we assume the SONIA curve is correct, when a refinance on the £6m is due in 2025, you will be seeing an all-in debt cost (at today's rates) of c7% (c5% swap rate and c2% margin) so will need strong rental growth to provide a lender not just with interest cover but to offset yield shift and keep senior debt LTV metrics.

Purchase Date	Loan Expiry	NIY	Current Yield	60% interest only debt on acquisition	Rental Income	Interest Cost at Refinance (6%)	Opinion
2017	2022	5.25%	4.75%	£6m	£525k (gross)	£420k	Could Refinance
2020	2025	3.75%	4.75%	£6m	£375k (gross)	£420k	No Refinance Ability

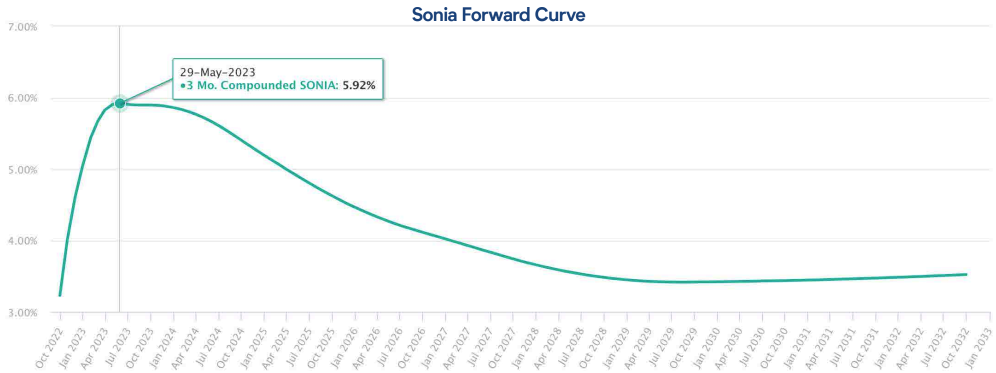
So, what does this all mean to real estate finance?

Certainly, in the short term, and as we are already seeing borrowers are facing a double hit of reduced leverage and higher borrowing costs. It seems inevitable that this will feed through to property yields — indeed we are already seeing it — and while inflation may come through in the rental market it is unlikely to be to levels sufficient to offset yield shift. If you acquired a property with debt in the past few years and haven't benefitted from rental growth and / or value uplifts then your covenants are going to start coming under pressure as yields move out. Our advice would be to engage with your lenders early.

In addition, the increased cost of debt for development will lead to smaller net loans and developers needing more equity or mezzanine debt to fund projects.

But, in addition, this will mean new opportunities present themselves as prices and yields correct to the new costs of borrowing. We may also see an increase in distressed assets come to market and land values for sites with planning should see some price reduction too.

The key point is to ensure you seek advice for your real estate debt requirements as well as for the bricks and mortar aspects. Having an experienced and well-rounded team of property professionals to help you navigate these choppy waters could be the difference of getting a great deal or no deal.



Source: www.chathamfinancial.com

"Our view on current market volatility..."

Richard Mackie
Director
Lismore Real Estate Advisors

Overview

Writing a piece about market conditions, in the midst of a particularly turbulent period, is not an easy task but, having been through a number of shocks and cycles before, we will try to give an honest assessment of where we are and how the future might play out.

Signs of a general market slow down were starting to show pre-summer. Global issues surrounding recovery from COVID, and the War in Ukraine had exacerbated some of the UK challenges around rampant inflation, rising interest rates and the looming energy crisis, meaning that we had started to see signs of investors becoming cautious and volumes slowed over the summer months.

Fast forward a month and add in the most recent ill-advised "Mini Budget" (with a partial U-turn), subsequent financial markets turmoil and Sterling collapse, then it is not entirely surprising that we have seen investor confidence wane, deals stall and values coming under pressure.

As the PM and Chancellor scramble to restore some sort of stability, this cocktail of difficult challenges has created a stand-off between buyers and sellers — what to do next? Previous shocks have shown that there is an initial period of inertia, as investors try not to make knee-jerk decisions, it is easier to do nothing than make the wrong call. We are currently in that period of stalemate.

What are the most significant headwinds going into Q4?

Setting aside the well documented wider macroeconomic challenges that have seen over the last 6 months, we see the most significant headwind facing the market in the short term as being the sharp rise in interest rates and subsequent rise in cost of debt. The "all in" cost of debt (ie: base borrowing rate plus margin) for traditional stock has risen c300-400 bps over the last 12 months. Coupled with pressure on LTV's, this will continue to put pressure on values, with falls anywhere in the order of 5-20% being experienced.

It is not only traditional stock that have come under pressure. With Gilt rates moving from c 1% to 4% over the last 12 months, this will affect the long income (annuity) buyers who model pricing off Gilt rates plus a perceived "illiquidity" premium on top.

In Scotland, a significant proportion of our buyer pool have been debt-backed, hence we will not be immune from the challenging debt finance conditions. Traditional (highly geared) property companies buying for a fairly swift "in and out" will find it most difficult and we see the more active buyers being more patient capital who are very capitalised, more below.

Where will the buyers come from?

Cash is king (again). Those investors who are very well financed and can act with speed will become active; investors who have recently been priced out of the market by highly-geared buyers but can now see some longer term value in a less crowded market.

The weight of overseas capital looking for a home (across the globe) has not eased dramatically but it has become more discerning when considering the UK, including Scotland. Particularly active sources of capital have been from the GCC and the Far East (Hong Kong and Singapore in particular). We see these investors as remaining active.

Closer to home, the mainland European investors (in particular, German) will still consider best in class offices but more likely focused on Edinburgh than any other market. UK Funds, in particular the open-ended retail Funds, are likely to be net sellers but closed Funds or third party mandates who have mature existing portfolios may see this as a good buying opportunity once more.

Perhaps most interesting will be the North American Private Equity houses, who were so prevalent after the GFC. While there is no immediate sign of distress, a number of large PE houses are watching the UK carefully and we fully expect them to become active in late 2022, early 2023.

Which sectors will offer opportunity?

It still feels early into the latest cycle but the difference in pricing between those markets with the strongest basic fundamentals of supply/demand and the weaker markets will be exacerbated, quickly.

Properly re-priced logistics in the central belt, quality retail warehousing, particularly if anchored by foodstores/value retailers and the living sector (in particular PBSA) feel like they have the strongest underlying fundamentals and for those investing for the long-term then they offer greatest security.

Offices and high street retail are likely to show the greatest returns but stock selection will need to carefully considered. Those hungry for yield will find it in these sectors but pricing will need to be particularly attractive as the availability of debt will be challenging.

At times of uncertainty there will be a flight to safety and the core markets of Edinburgh and Glasgow are likely to stabilise first with some opportunistic investors looking to good Aberdeen industrials for attractive cash on cash returns.

Looking to the future...

There is always a market, it is just a matter of pricing.

The challenge will be how quickly can investor confidence return and at what point can the current gap be bridged to create a fluid market. We envisage the next quarter to be fairly subdued as investors and lenders come to terms with the last shock.

The pricing adjustments that we have seen in certain sectors over the summer have been sharp and experience has shown that markets tend to overreact (both down and up). Trying to second guess the bottom of the market is a dangerous game but we see the canniest investors becoming more active into the new year. Those earliest in (will have to have deep pockets) but tend to find the best value.

Distress is unlikely but we are certainly envisaging more motivated sellers. For the better assets there will be a market but sellers aspirations will need to be very realistic in the short term.

In summary, there are more bumps to come before we return to some sort of more stable market conditions. For most investment agents, the remainder of 2022 is likely to be a grind but 2023 is likely to be much more interesting. A ray of hope in a fairly long tunnel...

"Intelligence"

Scottish Investment Market
Quarterly Review — September 2022

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

lismore
REAL ESTATE ADVISORS

Visit lismore-re.com