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REAL ESTATE ADVISORS

"Intelligence"

Scottish Investment Market

Quarterly Review
December 2022

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WELCOME

“Intelligence”

“Don’t pass up something that’s attractive today because you think you will find something better tomorrow”

– Warren Buffet

If 2022 has taught us anything (and there have been a number of painful lessons), it is that trying to accurately forecast fluctuations in the investment market is particularly difficult. The speed and extent of the pricing correction that has taken place since the summer has caught even the most seasoned experts by surprise.

Finding good news in the latter half of 2022 was not easy but, as with most market shocks, there comes opportunity. One of Warren Buffet’s other famous quotes was “the best chance to deploy capital is when things are going down.” With values adjusting anywhere between 10-30% across different sectors, it feels like the opportunity has arrived quicker than anticipated. Trying to second guess if the correction has fully played out is not easy but those best capitalised and bravest will be first to move and likely to find best “value”. Even if pricing moves further, the opportunity to acquire better quality assets in a less competitive buying environment will prove attractive to investors and we anticipate a more liquid market in 2023.

With this backdrop, in addition to our regular quarterly market analysis, our focus in this review will be looking forward to 2023. In “our view” we will give our opinion on a range of topics including:- how strong will investor appetite be, which sectors will be targeted and will there be a more settled lending environment. To help shape our thinking, we are pleased to share a question and answer piece with Tom Hoye, Real Estate Transaction Director at Redevco UK.

2022 threw at us the remnants of Covid, War in Ukraine, energy crisis, double digit inflation, rising interest rates, not to mention Truss & Kwarteng — our wish for 2023 is a little bit of calm...

Market overview.

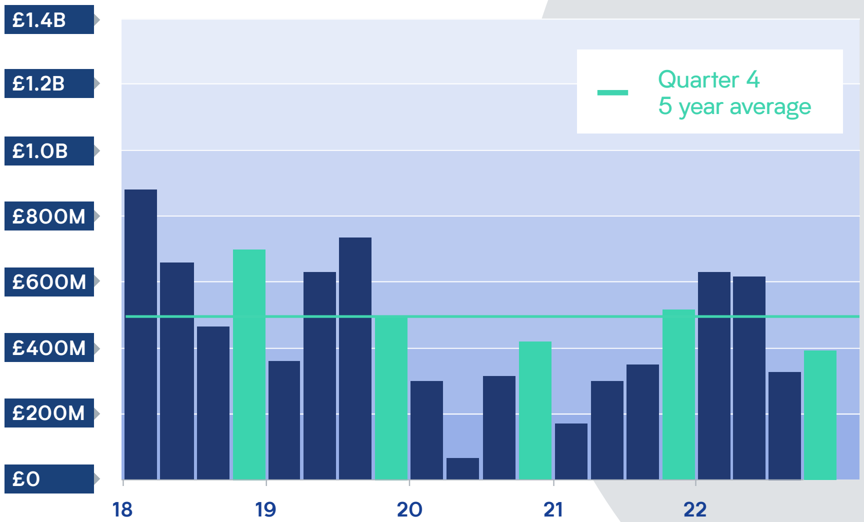
Key themes

- **Pricing correction** — prime yields across the office, logistics and retail warehousing sectors have softened anywhere between 150-200 bps, with high street retail seeing even more movement. The Q4 regular Fund valuations will see further meaningful adjustments which should help bridge the current gap between buyers and sellers.
- **Shopping centre exodus** — the pace of owners (lenders) looking to exit the sector has increased. Prime centres offering double digit returns are attracting attention, but secondary centres are seeing pricing reflecting lower than VP value as buyers look at alternative use angles.
- **Income rather than capital growth** — rental growth is being seen in some sectors (prime office and value retail warehousing) and with income expected to be the driver for returns over the next 12 months, it will be those investors focusing on asset management who are likely to see best performance.
- **Cost of debt stabilising** — with a 270 bps rise in base rates during 2022 (and set to go further), the correlating all in cost of debt for good quality assets has risen somewhere between 6-7%, making accretive borrowing difficult. If the economic forecasts are correct and the pressure on interest rates eases during 2023 and gilt rates continue to fall then debt terms will continue to stabilise and perhaps even improve towards the second half of the year.
- **Operational real estate market thriving** — Demand for prime PBSA and BTR opportunities has been particularly resilient, underpinned by a significant undersupply of accommodation in Edinburgh and Glasgow. Strong rental growth is managing to off-set the rise in operational expenditure.

Transaction volumes

- Q4 saw £396m traded, down 24% on Q4 2021.
- Q4 volumes were 20% below the 5 year average, on a par with the Covid affected Q4 2020.
- Despite the recent market volatility and subdued final quarter, total volumes for 2022 will end up close to c£1.77bn, an increase of 32% on the total for 2021. Overall, a reasonable outcome.

Sale volumes



Pricing

- The PBSA and BTR markets have proved most resilient with least volatility and prime yields softening by no more than c50 bps in the best Edinburgh and Glasgow locations. Demand for the best development sites remains very competitive.
- Logistics have moved swiftly, prime Eurocentral yields are now c5.5%, against a peak of sub 4%.
- Retail warehousing yields have softened by c175bps but those anchored by food stores and in strong urban locations have remained robust.
- The office sector is currently the hardest to price accurately, with a lack of transactions over the last quarter resulting in anecdotal 'evidence' suggesting yields have softened by at least 150 bps.

Investor activity

- For the majority of institutional investors it has been a case of hunkering down and seeing what 2023 will bring. Some of the open-ended retail Funds have been actively selling and this is likely to continue into next year. The Annuity buyers have paused for breath as Gilt rate volatility has curtailed their investing.
- Core plus debt backed buyers have had little success as the rise in the cost of debt has stymied any accretive benefit of borrowing. There are some signs that this is changing as debt markets start to settle and value corrections are bringing their financial modelling back into focus.
- Opportunistic capital particularly from North America, Hong Kong and Singapore (cash buyers) are best placed to take advantage of the current market dynamics over the coming months. It is not the GFC but many of the Private Equity and sovereign wealth houses are eyeing the market with interest.

Key recent transactions.

Despite a quieter end to the year than hoped, Q4 saw some interesting themes and significant transactions which we have highlighted below:

10 McNeil Drive, Eurocentral:

"Prime logistics pricing softens"

- Vendor — Clydebuilt Limited Partnership c/o Ediston
- Purchaser — Private investor
- Let to WM Morrisons Supermarkets Ltd
- Price/Yield — £7.9m / 7%
- Date — December 2022

Orchard Brae House, Edinburgh:

"US private equity acquires Edinburgh out of town office"

- Vendor — CL Selby Holdings Ltd c/o Palm Capital
- Purchaser — VCM Global Asset Management
- Multi let
- Price/Yield — £18.6m / 6.9%
- Date — December 2022

St James Retail Park, Dumbarton:

"Dominant food anchored retail park trades off market"

- Vendor — L&G UK Property Unit Trust
- Purchaser — US investor
- Multi let anchored by Asda, M&S and B&M
- Price/Yield — c£30m / c8%
- Date — December 2022

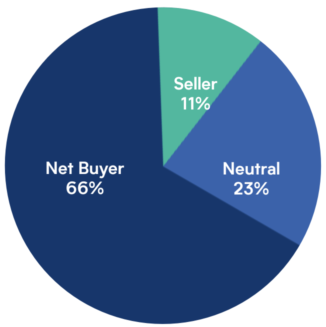
Travelodge, Cameron Toll, Edinburgh:

"Overseas investor appetite remains for long leases with RPI linked reviews"

- Vendor — Lothbury IM
- Purchaser — Priory Real Estate
- Let to Travelodge for 22.6 years
- Price/Yield — £10.05m / 6%
- Date — December 2022

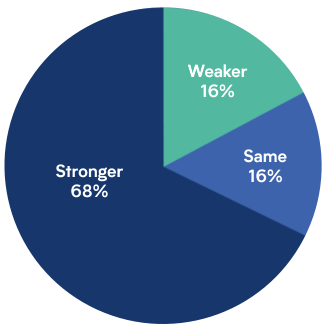
The investor view on the market.

1) In 2023 are you likely to be a net buyer, seller or neutral?



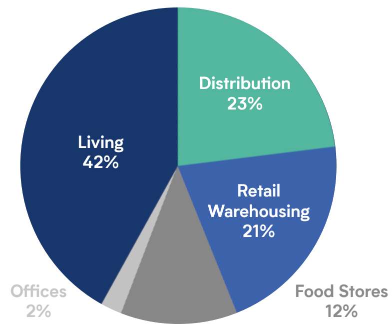
- A significant majority (65%) of respondents expect to be net buyers in 2023, with only 12% expecting to be sellers. It was noted by a number of respondents that their buying activity would likely commence in Q2, with the first few months of 2023 expected to see minimal stock traded.
- Property companies and investment managers look to be most acquisitive with 84% and 74% respectively expecting to be acquisitive over the next 12 months. It looks like a watching brief from the funds in 2023 with only 13% expecting to be net buyers and 50% neutral.
- Only 11% of respondents expect to be net sellers, suggesting a year of reduced transactions and off-market opportunities rather than a glut of open marketing campaigns.

2) By the end of 2023, do you expect market sentiment to be generally stronger, weaker or the same as currently?



- Looking into their crystal ball, 68% of investors anticipate an improvement in market sentiment by the end of 2023.
- An equal number expect sentiment to remain the same or weaken. It was noted by a few respondents that there is potential for a swifter bounce back in sentiment should the macro-economic environment continue to stabilise during Q1 2023.
- Investment Managers are almost unanimous (90%) in their expectation of sentiment improving, whilst over 50% of funds and property companies respondents expect sentiment to improve.

3) What will be the top performing property sectors over the next year:



- The three top performing sectors are expected to be Living, Food Stores and Distribution. The Living sector was selected by 42% as the top performing sector, with growth driven by an undersupply of PBSA, BTR and senior living accommodation in key cities. BTR is increasingly attractive to end users and investors alike in an environment of dwindling PRS stock as Landlords remove accommodation from the market due to a range of factors including rents no longer meeting mortgage costs and new entrants facing an increase in the additional dwelling supplement.
- The least supported sectors were the Office and High Street Retail sectors which received only 7% and 3% respectfully of the total selections in the top 3. The structural shift of working from home is expected to impact office rental growth in the short to medium term. High Street retail could be the dark horse for 2023 with retailers having success in driving shoppers to shops through promotional activity and free returns whilst the business rates revaluation coming into effect in April 2023 offers significant reductions in their total occupational costs.
- Funds were the biggest backers of food stores in the top three sectors with comments citing an expectation of further sale and leaseback transactions by the big four supermarkets and continued buoyancy in the sector over the last 2 years.

An expert view on what to look out for during 2023...

Tom Hoye
Real Estate Transaction Director at Redevco UK

Significant Scottish Holdings

Minerva Way, Glasgow

40 Princes Street, Edinburgh

Princes Square, Glasgow

Various blocks on Buchanan Street, St Vincent Place and Argyle Street, Glasgow

Do you see 2023 as a buying opportunity?

Yes. The market was already softening over the summer last year, but it moved pretty spectacularly during the disastrous 'mini-budget'. There are a lot of economic challenges ahead, inflation, Ukraine, cost of living crisis and we are fundamentally all adjusting to a re-normalising of interest rates having had these so low for so long. But markets tend to over-react and in that sense any downturn represents a good buying window. The question is how long will that window be open for and when is the optimum time to get back in, especially in the wider context of there being a lot of equity available. At the moment a lot of investors are taking stock and we're definitely in a period of 'price discovery', but I expect there to be more activity in the second half of the year. There will be some forced sellers as fixed loan terms expire and debt costs look unattractive - cash is king again and I'm optimistic that we will be well placed for the year ahead.

As a business, you have been targeting BTR as a growth sector in the UK — can you explain the rationale behind this move?

As a wider European business we've been looking to diversify our holdings for some time and have four established investment themes across the platform which now has circa €10bn AuM - Repurposing (mainly of retail into mixed-use), Retail Warehouse Parks, Leisure and Hospitality and Residential. We started investing in residential some time ago and bought a scheme in Dusseldorf and a number of forward fundings and conversions in The Netherlands. The rationale for residential is twofold. Firstly it's a sector that fits neatly with our retail led city centre heritage and expertise as there is a huge amount of synergy between BTR and the wider city centre placemaking that we have done as a business for years. Secondly, the simple occupier story of basic supply and demand. It has different drivers and nuances across countries but the fundamental mis-match between occupier demand and stock supply is prevalent in the locations we are targeting and in most cases becoming more acute.

In the UK the supply — demand dynamic for residential rental property is as imbalanced as anywhere and we've done a lot of work on how we think this will play out going forwards. Not enough housing of any type has been built in the UK and with tax changes on private PRS landlords now starting to bite as debt costs increase, we anticipate a major shift in people renting from individual privately owned stock into well run, well managed institutionally owned schemes. The challenge, especially in the top cities, will be building these quickly enough to satisfy demand. We acquired a couple of assets last year in these top cities and with a substantial development pipeline. Our catalyst deal was the acquisition of Templars Square in Oxford which completed last March, where we have significant plans for a long-term, residential-led, mixed use scheme that will put placemaking and ESG at the centre of our business case. This includes our acquisition of Minerva Way in Glasgow, which is a Nuffield Health centre with a planning consent for a residential scheme we hope to optimise and improve the sustainability credentials. The business has substantial growth ambitions so we will be looking to acquire similar assets this year as well as bringing in more third-party capital to make our equity go further. We're very close to signing a JV agreement with a major European Investor for Glasgow and we are actively looking for more similar product.

Retail has seen a dramatic structural change, accelerated by Covid, do you envisage further challenges for the sector in 2023?

Yes is the short answer. Economically, 2023 is going to be tough and retail is always going to be a sector impacted by this. I think a lot of real estate looks pretty challenged at the moment and major events such as covid really shine a spotlight on what buildings are for and how we use them. Having said that retail had already started to undergo major changes and I think a lot of the bad news is now behind us. There is no doubt more to come, more corporate failures are inevitable this year in the economic environment, but the majority of those that are still standing are more solid, purposeful businesses who have less competition. Rents have already largely been rebased to affordable levels, vacant space is slowly being repurposed away from traditional retail and into other uses and the reduction in rates will be a very welcome boost to retailer performance.

From an investment perspective it therefore looks interesting. Wherever you sit on the 'is WFH going to impact the office market' debate, there is clearly a debate here which will impact investor appetite for offices. Logistics still have a great story in terms of rental growth, but you've got to be very confident of achieving this if the returns are going to work with yields where they currently sit, even allowing for the repricing seen in Q4. The right retail offers pretty robust income at anywhere between 6-10%+ and that now starts to look attractive.

What other sectors or type of product are you looking at?

We can look at anything which fits within the 4 themes we have and that gives us a huge amount of flexibility. We have a pretty flat structure and are nimble enough to react to opportunities as and when they arise. For example we recently launched a leisure and hospitality strategy, centred around the 'Next Gen Stays' joint venture platform, focusing on sustainable, tech-savvy, high-end hostels or boutique-style hotels. Initially this has been in the Iberian market where we've acquired six seed assets for over €80 mln, but is something we are exploring elsewhere. We are having a good look at large central London blocks where we can repurpose these into mixed use assets.

You have a number of live development projects on-going, what are you seeing in terms of build costs?

TPI has been pretty scary over the last 12 months and it undoubtedly has a major impact on development viability and ultimately will limit the locations where development activity works. Residential is already very challenging to make stack up in all but the top locations, especially when there are (rightly) increased regulatory demands from both sustainability and health and safety perspectives.

Redevco has always prided itself as being a responsible investor — how important will "making a difference" be to future investment decisions?

This has been part of our investment process as far back as I can remember — there is always a 'whats the Force for Good' question in our ICs. The business is driven to make urban areas more vibrant, sustainable and liveable. This is a central strand running through each of our 4 investment themes, be that retaining the embedded carbon of existing building stock as we repurpose, installing PVs and EV charging across our retail warehouse park portfolio or simply by providing good quality homes to meet demand with careful and inclusive placemaking development.

“Our view” on what to look out for during 2023...

Lismore Real Estate Advisors

The Living sector will continue to attract significant capital

Focused firmly on Glasgow and Edinburgh, appetite from UK Funds, US private equity and Middle Eastern investment managers will continue.

PBSA will be most in demand as the strong demand /supply imbalance continues. Rental growth is managing to off-set operational cost increases hence the investment rationale remains positive and development appraisals for new stock are continuing to make sense.

BTR — the letting success of the Drum/L&G “Solasta Riverside” development in Glasgow has given a clear indication that demand for quality new product exists. We anticipate more clarity around the current rental freeze legislation which will hopefully lead to a sensible debate around capping growth, a policy which is seen in many other overseas mature BTR markets and should give investors more confidence to push ahead with a number of new schemes in both Glasgow and Edinburgh.

More “encouraged” sellers?

Those who have borrowed in the last 3-5 years and now needing to re-finance during 2023 will find it challenging. In the absence of significant cash injections it is likely that there will be an increase in lenders putting pressure on borrowers unable to meet these requirements. Some of the more significant office transactions in Edinburgh, Glasgow and Aberdeen fall into this category and we anticipate more activity as a result.

Prospects for the development market to improve

The dramatic rise in construction costs during 2022 has stymied a number of significant new developments across all sectors. Costs have started to plateau during Q4 2022 and while the development finance market will remain challenging, we anticipate that contractors will start to have to tighten margins which should help to ease the worst of the rises in cost.

Most tenants (certainly in the office and logistics markets) are accepting that if they are to secure the very best, ESG compliant space, higher rents are inevitable. This increase in rents coupled with an easing in cost inflation should help stimulate a healthier development pipeline.

What will investor appetite look like?

UK Funds — more likely to be net sellers. The open-ended retail funds have been net dis-investors in Scotland for a number of years and we anticipate that this trend will continue. The better established segregated mandates may see the opportunity and the Annuity Funds are likely to become more active through the year as gilt rates settle and pricing becomes easier to place.

Far East — the Korean influx seen during 2019-21 has ceased (and they are now significant sellers) but we have seen increasing appetite from Hong Kong and Singapore, as investors look to move capital into the UK, including Glasgow and Edinburgh.

GCC — remains active, predominantly in the office and logistics sectors. With pricing softening, these investors who are predominantly reliant on debt, are becoming more competitive. Cash on cash returns in the order of 8%+ with acceptable debt terms and Shariah compliant opportunities make them one to watch.

North America — becoming increasingly active. Helped by a strong Dollar, the larger PE houses sense the opportunity, along with some more patient capital which really likes the Living sector in particular.

Sector comment

Sectors easier to call:

Retail warehousing — those parks that are food / value lead and contain an element of drive-thru still offer good value. Particularly if they are “urban” in location — often with the value heavily underpinned by alternative use. In addition, the demand/supply dynamics remain robust and rental growth is still being seen.

Urban Logistics — the sector has seen some of the sharpest outward movement in pricing (the real froth has gone). Similar to retail warehousing the occupational story remains strong and we anticipate that values for quality product will find their level quicker than some other sectors. It will always remain high on investors lists — particularly around Edinburgh and Glasgow, where we envisage further rental growth.

Sectors harder to call:

Offices — there has been a dearth of meaningful transactions across Glasgow, Edinburgh and Aberdeen. The market still feels fluid with investors grappling to establish a solid prime benchmark in all the cities. We anticipate this will happen in Q1 (certainly in Edinburgh) and the deal-flow will improve. The focus will be at the prime end or those multi-let building offering sub 10,000ft floorplates that can be brought up to an acceptable ESG standard. Understanding the required level of capex will be critical.

High street retail — retailers should benefit from the Rating Revaluation in April 2023, with total occupational costs set to fall considerably as rates bills fall by c30-50%. Stock selection will be key, with re-based rents and well configured units an absolute essential. There will be attractive yields to be found in the sector but debt will be hard to come by, so those buyers in the sector will be looking for some real “value” to be tempted.

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