CBRE

TEESSIDE PENSION FUND

Quarterly Portfolio Strategy Report

26TH OCTOBER 2017 – 24TH JANUARY 2018

PREPARED FOR

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1 EXECUTIVE SUMMARY

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EXECUTIVE SUMMARY
Portfolio Strategy

You have advised us of your objective to increase the property portfolio towards £300m in a risk controlled manner.

CBRE Recommended Strategy

- To diversify the portfolio by spread of property types, unit sizes, occupier businesses, quality, income expiry and geographical regions.
- To make acquisitions and disposals to balance the lease expiries within the portfolio.
- Seek a long term overweight position in industrial and retail aligned with an underweight position in offices.
- Acquire prime, well let properties, together with some RPI linked assets.
- Keep the vacancy rate consistently lower than average whilst reducing income risk in particular years.

SECTOR	CURRENT	TARGET
Industrial	47.1%	35%
Retail Warehouse	24.9%	35%
Long Income	14.4%	15%
Offices	3.0%	5%
High Street Retail	10.6%	10%
	100%	

EXECUTIVE SUMMARY
Portfolio Profile

Current portfolio

- At 31st December 2017 the portfolio comprised 26 mixed-use properties located throughout the UK with a value of £249.98m. This reflects an overall Net Initial Yield of 5.36%, and an Equivalent Yield of 5.58%.
- The portfolio comprises principally prime and good secondary assets. High Street retail, retail warehouse and industrial comprise 82.7% of the portfolio by capital value. There are 63 demises and a total net lettable area of 1,804,217 sq ft.
- The weighted average unexpired term is 9.4 years to the earlier of first break or expiry, and 10.9 years to expiry, ignoring break dates.
- The portfolio also has the following characteristics:
    - The vacancy rate is currently 0.9% of Estimated Rental Value. The 'IPD Quarterly Index Q3 2017' confirmed an average void rate of 7.03% by ERV.
    - The top ten tenants constitute 53.7% of the total gross annual income of the portfolio, while the top twenty tenants constitute 76.5%.
    - Current gross passing rent is £14,193,622 per annum, against a gross current market rent of £14,729,839 per annum.

EXECUTIVE SUMMARY
Portfolio Activity

Portfolio activity

Sales

- There were no sales in Q4 2017.

Acquisitions

- The Fund recently completed the purchase of Omega Plc in Thorne, Doncaster. The Fund purchased the property at 5.75% NIY which equates to a £22,800,000 net purchase price.
- This report does not include the purchase of B&Q, Stoneferry Road, Hull, which unconditionally exchanged on the 22nd December 2017 and completed on the 12th January 2018. The Fund purchased the property at 6.00% NIY, which equates to a net purchase price of £11,640,000 on a topped up basis.

EXECUTIVE SUMMARY
Portfolio Activity And Strategy

Portfolio arrears at 15th January 2018

The total Collectable Arrears on the entire portfolio is £37,549.41 as at 15th January 2017. The Collectable Arrears exclude the following:

- Tenants that pay their quarterly rent in monthly instalments and are up to date with payments (Aurum Group Ltd and J.F. Stone Investments Ltd).
- Tenants that are insolvent (99p Stores Limited at Cirencester and Multiyork Furniture Limited at Ipswich).
- Tenants that have overall credit balances on their accounts.
- New charges that have been raised in the last 28 days.

Of the Collectable Arrears, 82.1% (£30,843.33) relate to the following 4 accounts:

- Pets at Home (Dorchester) – Total arrears of £19,700.19 (52.5% of collectable arrears). This relates solely to service charge which is disputed by Pets at Home. Freeths are instructed and are continuing to liaise with the tenant over this ongoing dispute.
- B&Q (Arbroath) – Total arrears of £5,545.94 (14.8% of collectable arrears). This is a single quarter's service charge, which was previously billed at the wrong rate. This is now correct and we are awaiting payment.
- Nuffield Health (Guildford) – Total arrears of £4,045.55 (10.8% of collectable arrears). This relates solely to head landlord's service charge, which was recharged to the tenant and we are chasing for payment.
- Toni & Guy (Gloucester Road) – Total arrears of £1,551.65 (4.1% of collectable arrears). This relates solely to head landlord's service charge, which was recharged to the tenant and we are chasing for payment.

The remaining 17.9% of the Collectable Arrears (£6,706.08) relate to 14 different tenant accounts; all of which are being chased.

EXECUTIVE SUMMARY

Rent Collection Statistics

			Targets	92.00%	96.00%	98.00%	99.00%		
Debtor Name	Rent Due 25 December	Collectable Rent	Quarter Date up to and including 25/12/2017	Week 1 up to and including 01/01/2018	Week 2 up to and including 08/01/2018	Week 3 up to and including 15/01/2018	Week 4 up to and including 22/01/2018	Payment after 22/01/2018	Difference
	3,359,878.45	3,262,023.45	3,057,239.84	45,179.00	136,329.50	23,264.00	0.00	0.00	11.11
Non Collectable Total		97,855.00							
Collections Including non collectables			90.99%	92.34%	96.39%	97.09%	97.09%	97.09%	
Collections Excluding non collectables			93.72%	95.11%	99.29%	100.00%	100.00%	100.00%	

These figures relate to rents that only became due on the December English Quarter Day (25th December 2017).

The non-collectable sum (£97,855) relates to Aurum Group Ltd, who pay rent on a monthly basis and Multiyork Furniture Limited, who are in administration.

Duff & Phelps are acting agents for Multiyork Furniture Limited and are seeking a buyer for the business. Recovery options are being pursued.

2 ECONOMIC PERFORMANCE AND PROPERTY MARKET

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PROPERTY MARKET & SECTOR FORECASTS
Economic Performance Q4 2017

- 2017 was not a stellar year for GDP growth. Recent data compares poorly with 2016's outturn of 2.2% against an expectation of 1.5% for 2017. Stronger inflationary pressures, driven by currency depreciation, coupled with modest earnings growth have led to weak and in some months falling retail sales volumes. This has resulted in a reduction of consumer expenditure throughout 2017.
- The second half of the year saw consumer expenditure overcome rising inflation and broadly make modest improvements, rising 0.9% in the three months to November on the previous year (fuel sales excluded). The impact can be seen in quarterly GDP growth, which rose to 0.4% in Q3 and is expected to be at least as high as this in Q4.
- Somewhat surprising is that the labour market remains very tight, with the unemployment rate holding at 4.3% for the three months to October. This level has been held since July. One explanation is weak productivity performance which has tempered wages and increased job numbers. Some pressure on earnings is to be expected with inflation elevated.
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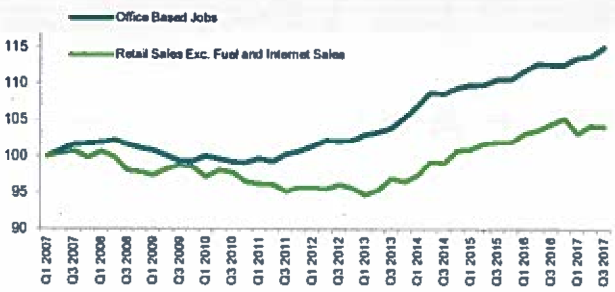
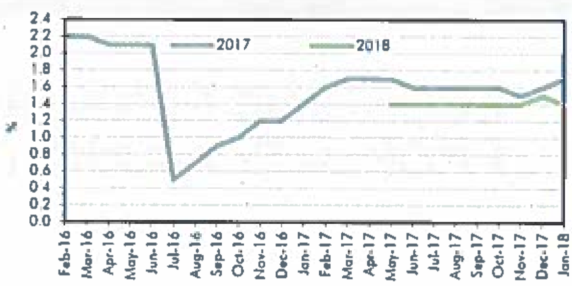
Economic Drivers of Commercial Property Demand



Source: CBRE, Oxford Economics, ONS

Evolution of UK GDP Growth Forecasts

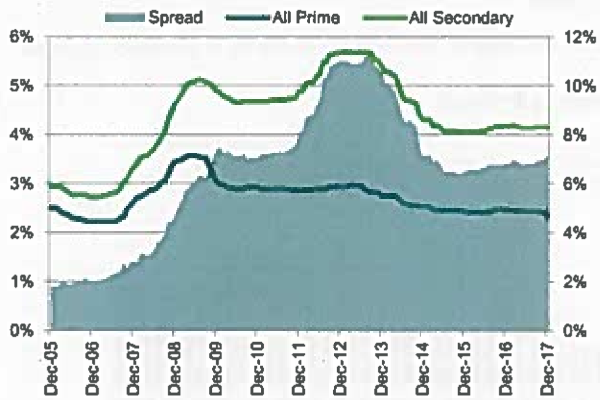


Source: HM Treasury Consensus

PROPERTY MARKET & SECTOR FORECASTS
Property Market Q4 2017

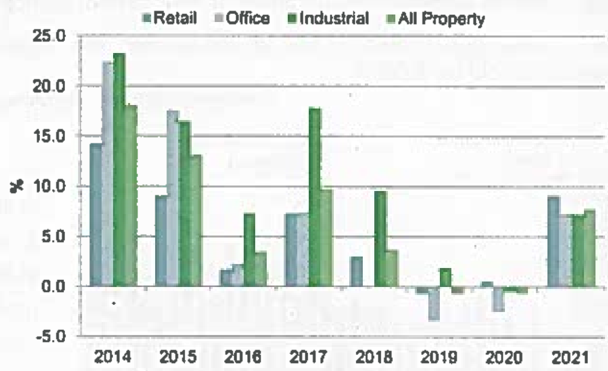
- Total Returns for All UK Property were 11.8% for the period Q4 2016 to Q4 2017*. Capital values for Q4 recorded a 1.9% increase over the quarter.
- Industrials again recorded a strong performance compared with other sectors in Q4 2017. Total return and capital value growth were 6.4% and 5.0% respectively for the quarter.
- Rental values increased by 0.5% in the fourth quarter of 2017. Rental value growth for the same period in 2016 was 0.3%. The highest rental value growth in Q4 was recorded for Industrials at 1.6%.

Prime Vs Secondary All Property Yields (excl. Central London)



Source: CBRE Monthly Yields, December 2017

Property Total Returns



Source: IPD, CBRE, Nov 2017

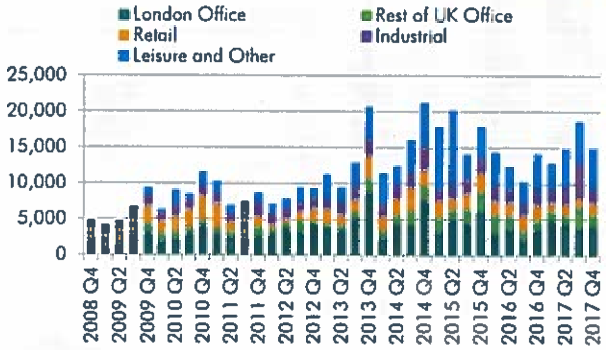
* Based on CBRE Monthly Index, all property total returns Dec 2017

PROPERTY MARKET & SECTOR FORECASTS

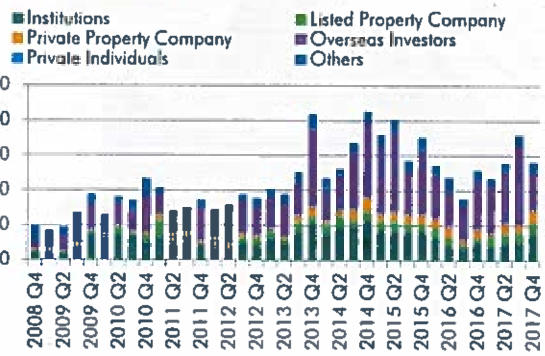
Property Market Q4 2017 Transactions

- In Q4 2017 investors recorded a total transaction volume for 'All Property' of £14.9bn, down from the £18.8bn reported in Q3 2017.
- In Q4 2017, 36% of investors came from overseas, representing a decrease from last quarter's reported figure of 61%. The continuation of overseas investor interest has likely been driven in part by the devaluation of Sterling following the referendum result. UK institutions recorded market participation of 24% in Q4 2017 which amounts to c. £3.4bn of investment. This is up from the previous quarter's reported figure of 13%.
- Investment transactions for 'All Offices' totalled £5.5bn in Q4 2017. Central London office investment recorded £3.6bn in investment, accounting for c.66% of total office investment for the quarter. The highest transaction during this quarter was the purchase of Devonshire Square Estate for £580m.
- The Industrial sector saw £2.1bn in transaction activity in Q4 2017, reflecting the continued interest in this sector. The biggest deal of Q4 was Ares' purchase of an Industrial portfolio for £200m.
- Retail transactions totalled £2.6bn for the quarter. The biggest deal of the quarter was the purchase of a portfolio of Boots Pharmacies sold for £260m.

<u>Commercial Property Investment Transactions (£millions)</u>



Source: : CBRE, Property Data, December 2017



Source: CBRE, Property Data, December 2017

PROPERTY MARKET AND SECTOR FORECASTS

UK Returns Forecast

	2017	Forecast * 2018	2019	2020	2021	2022	2018-2022
Total return: % per year							
Retail	7.3	3.0	-0.7	0.6	9.1	9.7	4.3
Office	7.5	0.0	-3.4	-2.5	7.3	11.0	2.3
Industrial	17.8	9.6	1.9	-0.4	7.2	7.9	5.2
All Property	9.8	3.8	-0.7	-0.6	7.8	9.4	3.9
Income return: % per year							
Retail	5.2	5.1	5.2	5.5	5.5	5.3	5.3
Office	4.1	4.0	4.1	4.3	4.3	4.1	4.1
Industrial	5.1	4.8	4.9	5.2	5.3	5.2	5.1
All Property	4.8	4.6	4.6	4.9	4.9	4.7	4.7
Capital growth: % per year							
Retail	2.0	-2.0	-5.6	-4.7	3.5	4.2	-1.0
Office	3.3	-3.9	-7.1	-6.5	2.9	6.6	-1.8
Industrial	12.1	4.5	-2.8	-5.4	1.8	2.6	0.1
All Property	4.8	-0.8	-5.1	-5.2	2.7	4.5	-0.8
Nominal rental value growth: % per year							
Retail	1.3	0.4	0.0	-0.1	0.4	1.6	0.4
Office	0.5	-3.8	-3.5	-2.5	0.2	3.1	-1.3
Industrial	5.1	5.6	4.0	1.5	-0.1	0.2	2.2
All Property	1.9	0.3	0.0	-0.3	0.4	1.8	0.4
Equivalent Yields - % at end year							**Change pp**
Retail	5.7	5.8	6.0	6.2	6.0	5.8	0.1
Office	5.9	5.9	6.2	6.4	6.2	5.9	0.0
Industrial	5.7	5.7	6.1	6.4	6.2	6.0	0.2
All Property	5.7	5.7	5.9	6.1	5.9	5.7	0.1

*** Forecast figures based on Q3 2017 quarterly valuations**

Source: CBRE, Nov 2017

2017 has surprised on the upside and may continue to do into 2018. However, future economic uncertainty will present downside risks. Our property forecasts are now based on the CBRE Houseview. Our view is that 2019-20 will see a significant slowdown in the US economy, which will not only impact the UK, but also globally.

As mentioned previously, total returns for All UK Property were 11.8% for the period Q4 2016 to Q4 2017, based on the CBRE Monthly index to December 2017. Capital values for Q4 recorded a 1.9% increase over the quarter.

The Industrial sector is expected to outperform both Retail and Offices until 2019.

Rental growth falls are predicated in the Office sector – while Industrial and Retail rents hold up in nominal terms. There remains heightened uncertainty around the forecasts as a result of the UK's current economic climate.

However, as certainty returns in the future, an improvement in the rental growth outlook is expected.

3 PORTFOLIO STRATEGY AND FORECASTING

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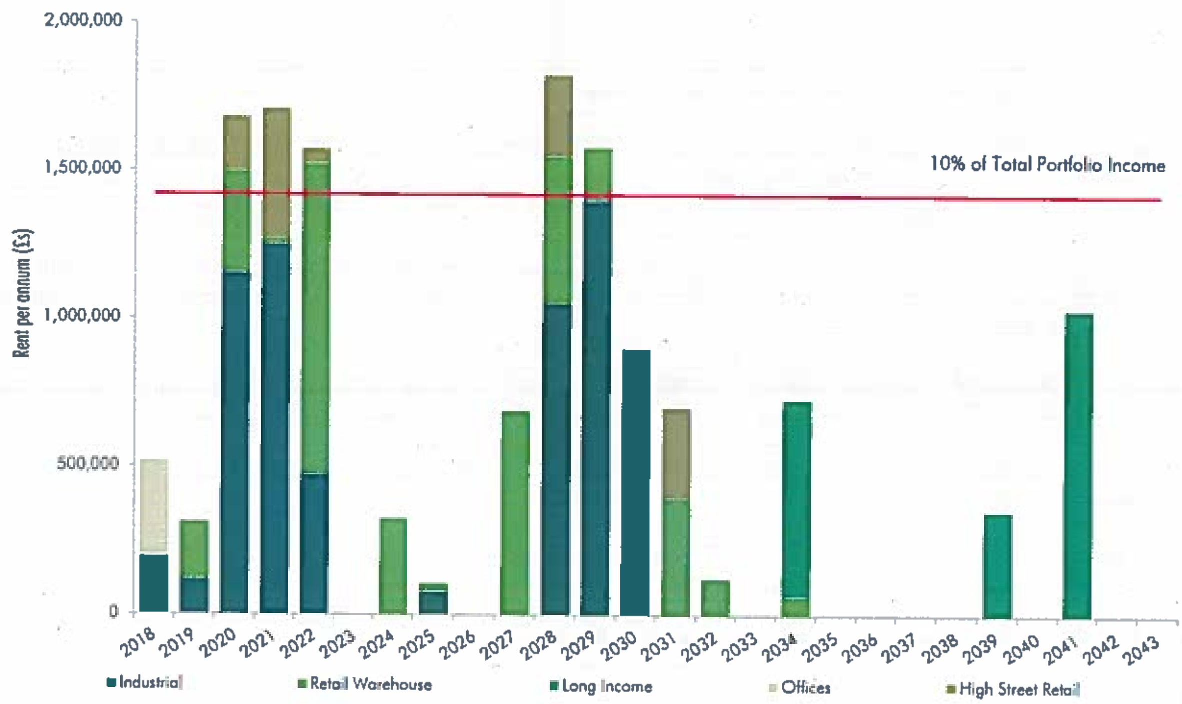
PORTFOLIO STRATEGY AND FORECASTING
Portfolio Strategy

TOP DOWN STRATEGY

- The Teesside Pension Fund was valued at approximately £4.00bn (October 2017). The direct property portfolio held by the Fund was valued at £249.98m (December 2017). The Fund's real estate exposure (6.25% of assets) is significantly underweight, compared with similar pension funds.
- We will seek to extend the weighted average unexpired lease term (WAULT) of the portfolio as well as diversifying the lease expiry profile. We have identified a high level of lease expiries between 2020 and 2022, as well as in 2028 and 2029. We are seeking purchases with expiries which will both extend the WAULT and diversify lease expiries.
- In addition to recommendations on industrial and retail purchases, we may also recommend alternative investments that offer good covenants, attractive yields and long unexpired terms; these may include hotels, car showrooms, healthcare, leisure and student housing.
- Set against a backdrop of mediocre economic growth, we will seek to make purchases where supply and demand conditions are stronger. This will ensure that purchases are accretive to the portfolio's performance.
- As we continually assess all of the properties within the portfolio, we will also consider sales based on asset specific considerations.
- The key driver of the portfolio performance will come from effective asset management of the existing stock to maximise rental income and extend lease lengths.
- A graph showing the expiry profile, per sector, is shown overleaf.

PORTFOLIO STRATEGY AND FORECASTING
Portfolio Strategy

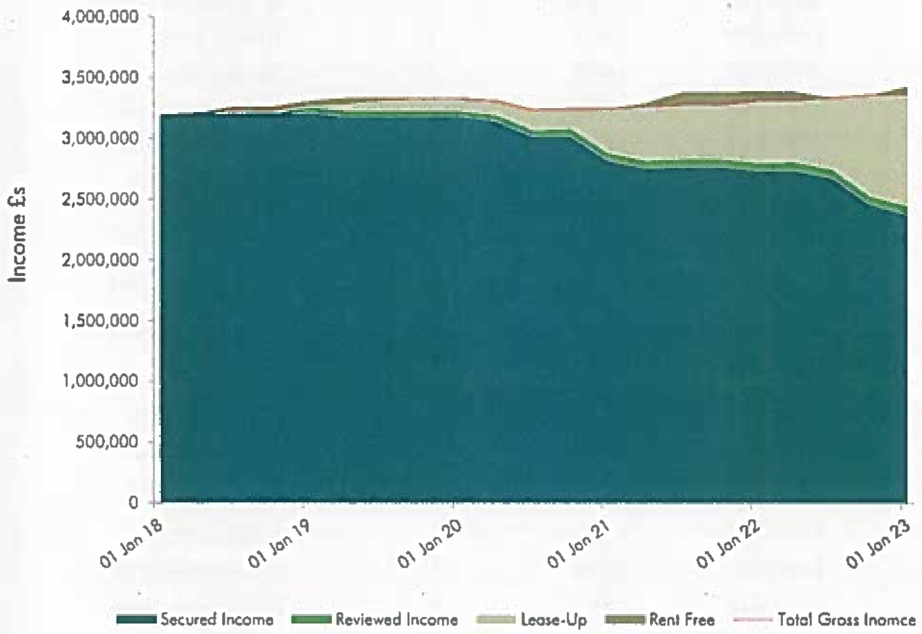
Graph outlining income expiry risk to the earlier of break or lease expiry.



PORTFOLIO POSITIONING AND FORECASTING

Portfolio Analysis

Portfolio Income Profile



The income forecast includes our current rental growth projections.

The CBRE forecasted rental growth figures have been taken as a starting point and have been adapted to more accurately reflect anticipated rental movement, based on the quality of individual assets and their estimated rental growth prospects.

REGION	% OF PORTFOLIO CAPITAL VALUE
London	12.2%
South East	11.7%
South West	5.2%
East	8.7%
West Midlands	26.8%
North East	27.0%
North West	6.4%
Scotland	2.2%
Total	100%

SECTOR	% of Portfolio (rental value)
Industrial	47.8%
Retail Warehouse	27.7%
High Street Retail	8.7%
Long Income	13.2%
Offices	2.6%
Total	100%

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TOP 20 TENANTS (BY CURRENT RENT)

TOP 20 TENANTS	TOTAL AREA	CURRENT RENT (£PA)	ERV (£PA)	% OF PORTFOLIO	NO. OF LEASES	FIRST LEASE EVENT
Omega Plc	320,815	£1,400,000	£1,400,000	9.86%	1	09 September 2029
Libra Textiles	129,952	£1,035,000	£1,040,000	7.29%	1	04 April 2041
Royal Mail Group Ltd	207,572	£899,161	£985,000	6.33%	1	23 September 2030
DHL Supply Chain Ltd	146,138	£868,635	£875,000	6.12%	1	28 September 2021
Brunel Healthcare	136,342	£751,223	£650,000	5.29%	1	10 April 2028
Tesco Stores Limited	25,084	£664,016	£570,000	4.68%	1	28 July 2034
P&O Ferrymasters Ltd	122,157	£662,000	£685,000	4.66%	1	25 December 2020
Matalan Retail	51,753	£500,000	£500,000	3.52%	1	27 November 2028
HSBC Bank Plc	2,016	£440,000	£460,000	3.10%	1	18 October 2021
Wickes Building Supplies Ltd	28,338	£396,750	£396,750	2.80%	1	28 September 2031
DSG Retail Ltd t/a Currys/PC World	25,000	£375,000	£375,000	2.64%	1	28 September 2022
B&M Retail Ltd t/a B&M Homestore	25,000	£375,000	£375,000	2.64%	1	28 September 2022
Nuffield Health	26,458	£354,715	£331,000	2.50%	1	04 April 2039
Homebase Ltd	25,000	£343,750	£362,300	2.42%	1	16 October 2027
Pets at Home Ltd	15,577	£325,825	£325,500	2.30%	2	05 January 2024
Institute of Cancer Research	9,502	£325,000	£370,000	2.29%	1	17 February 2018
Aurum Group Limited	1,440	£305,000	£305,000	2.15%	1	01 March 2031
Bonhams 1793 Ltd	38,722	£300,000	£485,000	2.11%	1	22 December 2028
River Island Clothing Co Ltd	1,270	£275,000	£280,000	1.94%	1	30 November 2028
Halfords Ltd	11,547	£255,220	£221,000	1.80%	3	23 June 2020
TOTAL	1,349,683	£10,851,295	£10,991,550	76.5%	23	

4 PORTFOLIO ACTIVITY

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PORTFOLIO ACTIVITY
ASSET MANAGEMENT/TRANSACTION COMMENTARY

Thorne, Doncaster

- The fund recently completed the purchase of Omega Plc in Thorne Doncaster. The Fund purchased the property at 5.75% NIY equating to a £22,800,000 net purchase price.

B&Q, Hull

- B&Q, Stoneferry Road, Hull, unconditionally exchanged on the 22nd December 2017 and completed on the 12th January 2018. The Fund purchased the property at 6.00% NIY, which equates to a net purchase price of £11,640,000 on a topped up basis.

Cirencester

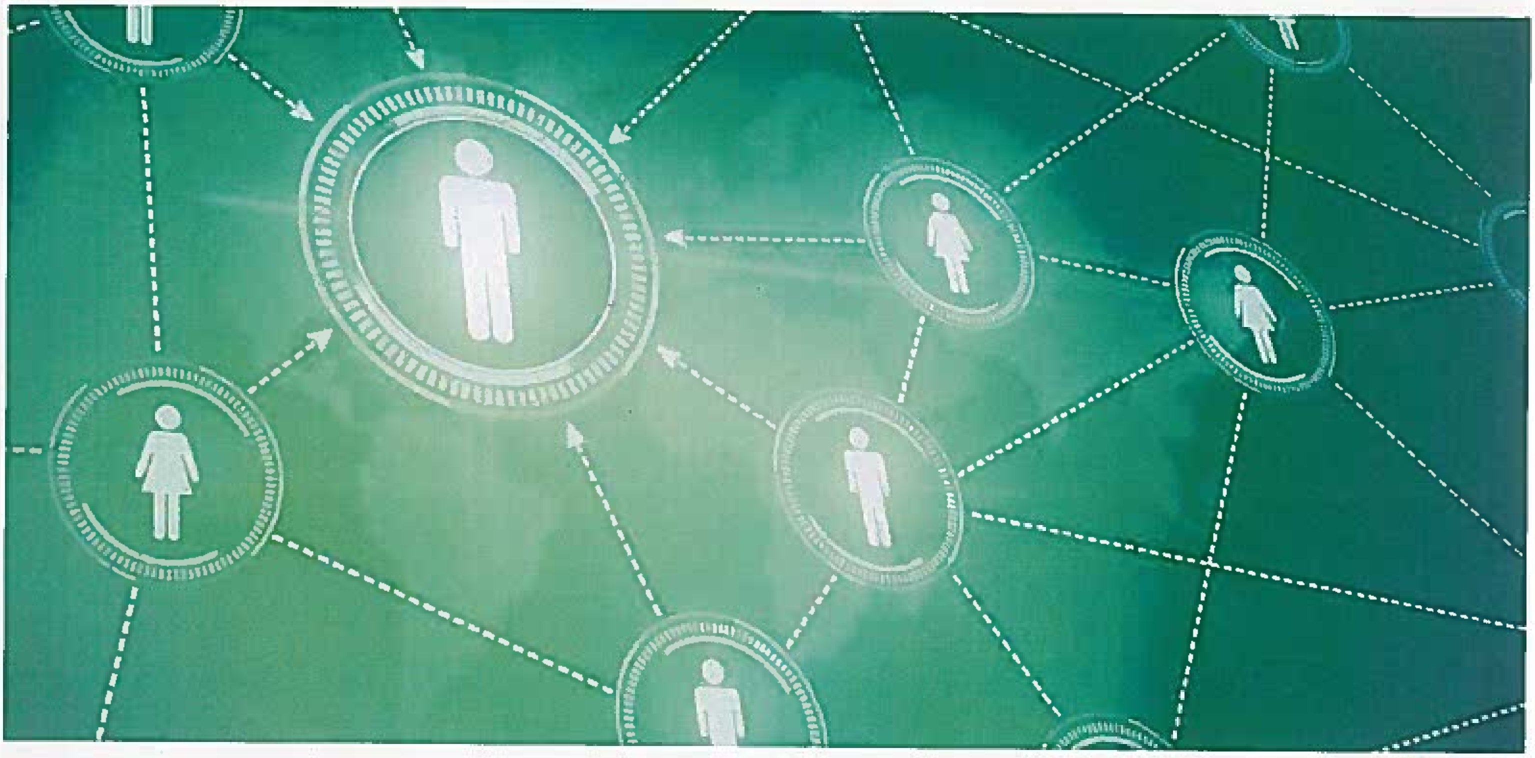
- 99p Stores have vacated their unit on the park. Freeths have been engaged to pursue all possible recourse for the recovery of outstanding rent, service charge and dilapidation claims. ESH have been engaged to re-let the unit with a possible sub-division or mezzanine being considered.

Bromford Central, Birmingham

- Rent review agreed on Unit 3, reflecting an 18.5% increase on the passing rent. The rent review on Unit 6 has been confirmed, equating to a 40% uplift on the passing rent. Rent reviews on the other units are ongoing.

Arbroath

- McDonalds have applied for planning permission to expand their unit's drive thru to incorporate two lanes. The Fund are amenable to the works and are awaiting further correspondence on the outcome of the planning application.



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