Agenda Item 10

# TEESSIDE PENSION FUND Q2 2022

CBRE

## Quarterly Report
Prepared: 7th October 2022


## Fund Objectives

Teesside's Pension Fund's primary objective is to create a sustainable income stream to match its long term pension liabilities. This is achieved through investing into a wide range of asset classes, of which Real Estate is one.

The objective of the direct property allocation is to create a portfolio which produces a consistent total return, over the long term, to meet Teesside Pension Fund's liabilities.

## Portfolio Strategy

The portfolio will hold core/core plus properties, over the long term, diversifying the portfolio through different property types, unit sizes, occupier businesses, income expiry and geographical regions.

Stock selection will be favoured over a default asset allocation bias, with a focus on maintaining a long term overweighted position in industrial and retail, alongside an under weight position in offices.

We will seek to extend the weighted average unexpired lease term (WAULT) of the portfolio, as well as diversifying the lease expiry profile.

Individual assets will be well suited to the current occupational market, whilst offering future flexibility. Properties will be leased to good quality businesses on institutional lease terms together with some index-linked assets.

## Responsible Investment

In line with Teesside's Pension Fund's Responsible Investment Policy, CBRE considers Environmental, Social and Governance issues (otherwise known as ESG criteria) as part of its decision making process.

## Executive Summary (Valuation)

As at 30th June 2022, the portfolio comprised 28 mixed-use properties located throughout the UK, with a combined value of £340.1m. This reflects an overall Net Initial Yield of 4.9%, and an Equivalent Yield of 4.8%.

The portfolio comprises principally prime and good secondary assets. High Street retail, retail warehouse and industrial comprise 89.2% of the portfolio by capital value. There are 75 demises and a total net lettable area of 1,959,078 sq ft.

The portfolio has a current gross passing rent of £17,421,167 per annum against a gross market rent of £17,481,795 per annum, making the portfolio broadly rack-rented in nature.

The weighted average unexpired term is 7.2 years to the earlier of the first break or expiry, and 8.3 years to expiry, ignoring break dates.

## Fund Summary

| | |
|---|---|
| **Total Pension Fund Value** (March 2022) | **£5,071m** |
| Real Estate Weighting (target allocation) | 6.7% (9%) |
| Direct Portfolio Value (June 2022) | £340.1m |

## Direct Portfolio

| | |
|---|---|
| **Direct portfolio value** (June 2022) | **£340.1m** |
| Number of holdings | 28 |
| Average lot size | £12.15m |
| Number of demises | 75 |
| Void rate (% of ERV) (Estimated UK Benchmark) | 0.9% (7.0% – 9.0%) |
| WAULT to expiry (break) | 8.3 years (7.2 years) |
| Current Gross Passing Rent (Per Annum) | £17,421,167 |
| Current Gross Market Rent (Per Annum) | £17,481,795 |
| Net Initial Yield | 4.86% |
| Reversionary Yield | 4.89% |
| Equivalent Yield | 4.82% |

## Portfolio Highlight (Q2 2022) – Bromford Central

In April 2022, the Fund completed a lease renewal with Harrow Green for a 10-year term with 3-months rent-free at £7.25 psf, a 23% rental uplift on the previous passing rent. The tenant benefits from a break on the 5th anniversary of the lease commencement.

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## UK Economic Commentary * Prepared pre mini-budget

- UK GDP is estimated to have contracted by 0.1% in Q2 2022, following growth of 0.8% in Q1 2022. GDP in Q1 2022 was 0.6% above its pre-pandemic (Q4 2019) level.
- Retail sales volumes rose by 0.3% in July 2022 following a fall of 0.2% in June 2022; sales volumes were 2.3% above their pre-pandemic February 2020 levels.
- The proportion of retail sales online rose to 26.3% in July 2022 from 25.3% in June. It remains substantially higher than pre-pandemic (19.8% in February 2020) but continues a gradual downward trend since February 2021 (37.5% of sales).
- The UK unemployment rate decreased by 0.2 percentage points to 3.6% in the three months to July 2022. Economic inactivity increased by 0.4 percentage points to 21.7% on the quarter in May-July 2022. The increase in inactivity was driven by increasing numbers of students and long-term sickness.
- The number of job vacancies in May to July 2022 rose to 1,266,000. This constituted a decrease of 34,000 from the previous quarter. It was also the largest quarterly fall in vacancies since June-August 2020, but vacancies are still above pre-pandemic levels.
- Average total pay (including bonuses) grew by 5.5% and regular pay (excluding bonuses) by 5.2% in May-July 2022. In real terms (adjusted for inflation), total pay fell by 2.6% and regular pay fell by 2.8%, compared to Q2 2021. The fall in real pay is due to accelerating inflation in recent months, and the inability of nominal wage growth to keep up with it.
- Looking forward, CBRE forecast UK GDP growth of 3.3% in 2022. The biggest risks to the outlook are a protracted war in Ukraine, leading to ever higher costs of energy and fuel. Unexpected lockdowns in China might further delay the recovery of global supply chains. An overreaction to inflation by central banks might also slow down the economy through excessively high borrowing costs.
- The Bank of England increased the Base Rate to 1.75% in August 2022. CBRE's base case is that short-term interest rates will continue rising throughout 2022 to around 2.3% by the end of the year. After peaking at around 3% in 2023, the Base Rate is expected to then gradually reduced to 2% by 2025.

## UK Real Estate Market Commentary

- Year on year total returns for All UK Property were 24.6% (18.8%* capital return, 5.0%* income return) for the period Q2 2021 to Q2 2022**. This was above the five year average and reflected especially strong performance from the industrial sector.
- The quarterly total return for All UK Property for Q2 2022 was 4.1% (3.0% capital return, 1.1% income return). Industrial total returns were 4.7% (3.8% capital return, 0.9% income return), retail total returns were 4.4% (2.8% capital return, 1.6% income return) and office total returns were 2.5% (1.5% capital return, 1.0% income return).
- Rental values for All UK Property increased by 1.0% over Q2 2022. This figure reflected strong quarterly rental growth of 2.2% in industrials, whereas rental growth in the office and retail sectors was 0.4% and 0.0%, respectively, during Q2.
- Much of the capital growth during 2022 has been yield driven and, with this in mind, it must be noted that yields moved out in July and August, causing values for All UK Property to fall by -0.5% and then -1.6% on the previous month. This reversal of the trend up to Q2 2022 was most pronounced in the industrial sector.
- In Q2, UK investment totalled £14.3bn, bringing H1 volumes for 2022 to £32.6bn. Around 40% of this total was purchased by UK-based investors.
- Nearly 24% of capital invested in H1 was attributed to North American buyers. This capital was mostly deployed in three sectors: Office, Industrial and Residential, with an average deal size of £80m. In Q2 alone, three US investors spent a combined £900m across 17 separate industrial transactions.
- In 2022 so far, £4.8bn was invested by Asian investors, making up around 15% of UK volumes. Three-quarters of this total was deployed into Central London Offices.
- European buyers invested 7% of the total capital into UK real estate in 2022 H1, with an average deal size of £40m.

* Return figures will not always sum due to the use of compounding calculations over an annual horizon

** Based on CBRE Monthly Index, all property total returns to June 2022


## Investments

### Sales

No sales this period.

### Acquisitions

No acquisitions this period.

During this quarter the Fund agreed terms in respect of two new assets. Firstly, a Central London flagship retail unit let for a further 7 years to two recognised national retailers. The second, is a retail park located within an affluent south-east commuter town, let to retailers such as M&S, Halfords and Home Bargains.

## Direct Portfolio Analysis

### Top Ten Holdings (by Capital Value)

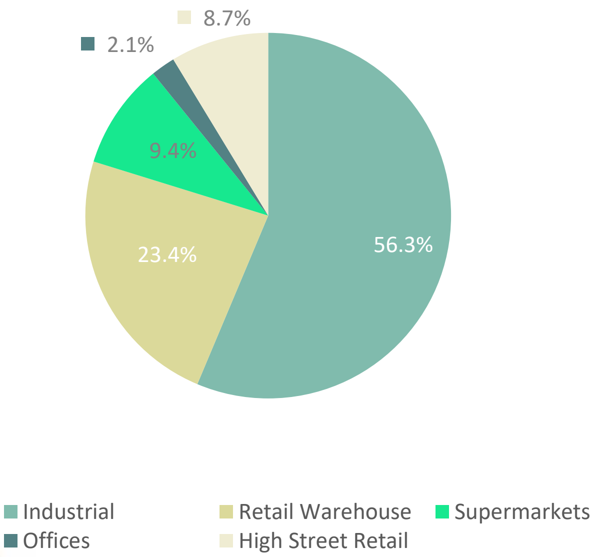
| No. | Asset | Sector | Value | % of Direct Portfolio |
|---|---|---|---|---|
| 1 | THORNE - Capitol Park | Industrial | £38,000,000 | 11.2% |
| 2 | BIRMINGHAM - Bromford Central | Industrial | £24,350,000 | 7.2% |
| 3 | GATESHEAD - Team Valley | Industrial | £23,600,000 | 6.9% |
| 4 | PARK ROYAL - Minerva Road | Industrial | £22,300,000 | 6.6% |
| 5 | LUTTERWORTH - Magna Park | Industrial | £20,100,000 | 5.9% |
| 6 | RUGBY - Valley Park | Industrial | £19,700,000 | 5.8% |
| 7 | PARK ROYAL - Coronation Road | Industrial | £18,600,000 | 5.5% |
| 8 | STOW-ON-THE-WOLD - Fosse Way | Supermarket | £15,500,000 | 4.6% |
| 9 | SWADLINCOTE - William Nadin Way | Industrial | £15,500,000 | 4.6% |
| 10 | EXETER - H&M High Street | High Street Retail | £14,200,000 | 4.2% |
| | | **Total** | **£211,850,000** | **62.3%** |

We will seek to extend the weighted average unexpired lease term (WAULT) of the portfolio, as well as diversifying the lease expiry profile.

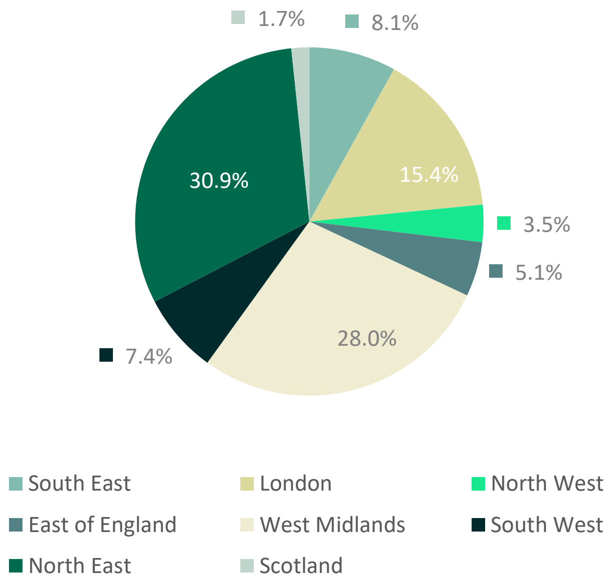
In addition to recommendations on industrial purchases, we may also recommend alternative and long-let investments that offer good covenants, attractive yields and long unexpired terms; these may include hotels, car showrooms, healthcare, leisure, supermarkets and student housing.

Set against a backdrop of low economic growth, we will seek to make purchases where both occupational and investment supply and demand conditions are positive. This should ensure that purchases are accretive to the portfolio's performance.

### Sector Allocation (by Capital Value)




### Geographical Allocation (by Capital Value)

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## Direct Portfolio Analysis (continued)

### Top Ten Tenants (by Contracted Income)

The portfolio currently has 75 different demises let to 61 tenants. The largest tenant is Omega Plc which accounts for c.8.2% of the annual contracted income. Experian currently lists Omega as representing a "Very Low Risk" of business failure.

As a significant portion of the portfolio income will be from the top ten tenants, we will monitor their covenant strength and flag any potential issues. Our most recent assessment shows that all of these tenants are classed as having a "low risk" of business failure.

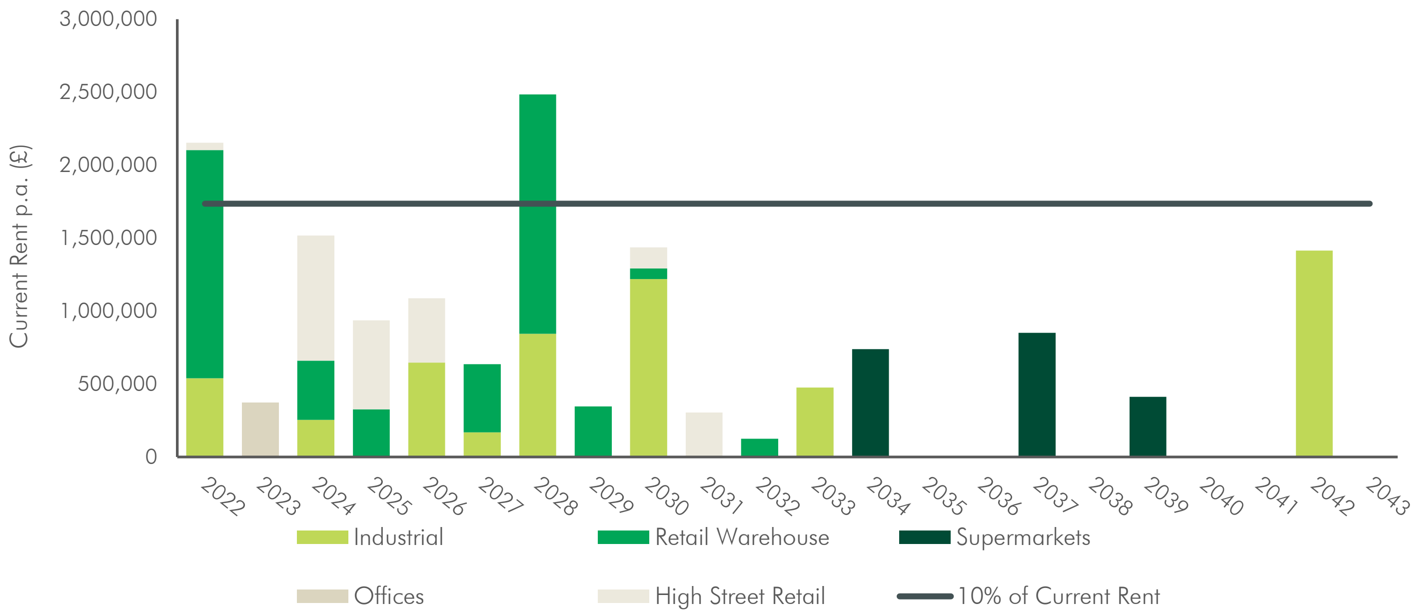
Top Ten Tenants (by Contracted Rent)

| # | Tenant | Sector | Number of Leases | Contracted Rent p.a. | % of Portfolio Rent | Risk Rating (Experian) |
|---|---|---|---|---|---|---|
| 1 | Omega Plc | Industrial | 1 | £1,413,690 | 8.2% | Very Low Risk |
| 2 | B&Q plc | Retail | 2 | £997,000 | 5.7% | Very Low Risk |
| 3 | Royal Mail Group Limited | Industrial | 1 | £899,162 | 5.2% | Very Low Risk |
| 4 | Unipart Logistics Limited | Industrial | 1 | £868,635 | 5.0% | Very Low Risk |
| 5 | B&M Retail Limited | Retail | 3 | £863,400 | 5.0% | Very Low Risk |
| 6 | Libra Textiles | Retail | 1 | £850,000 | 4.9% | Very Low Risk |
| 7 | Brunel Healthcare | Industrial | 1 | £843,761 | 4.9% | Very Low Risk |
| 8 | H&M | Retail | 1 | £837,242* | 4.8% | Very Low Risk |
| 9 | ASDA Stores Limited | Industrial | 1 | £755,000 | 4.4% | Very Low Risk |
| 10 | Tesco Stores Limited | Supermarkets | 1 | £737,823 | 4.3% | Very Low Risk |
| | | | Total | £9,065,713 | 52.3% | |

*Subject to inflation-linked rent review

### Key Lease Expiries / Income Risk

There is a focus to mitigate against lease expiry risk, by either purchasing properties where the lease expiry profile does not match that of the portfolio, or through active asset management. The graph below identifies the years where more than 10% of the portfolio income is due to expire. A number of the 2022 lease expiries are in negotiations or in solicitor's hands.




## Property Portfolio Returns

The below table demonstrates the Portfolio's return compared to a reference index over the past 1, 3 and 5 years. The CBRE Property Index* is provided for illustrative purposes only:

| | 1 Year Jun 21 - Jun 22 | | | 3 Year (p.a.) Jun 19 - Jun 22 | | | 5 Year (p.a.) Jun 17 - Jun 22 | | |
|---|---|---|---|---|---|---|---|---|---|
| | TPF | Index | Variance | TPF | Index | Variance | TPF | Index | Variance |
| Income Return | 5.4% | 5.0% | +0.4% | 5.6% | 5.4% | +0.2% | 5.6% | 5.4% | +0.2% |
| Capital Return | 21.2% | 18.8% | +2.4% | 5.1% | 3.3% | +1.8% | 2.7% | 2.6% | +0.1% |
| Total Return | 27.7% | 24.6% | +3.1% | 11.0% | 8.9% | +2.1% | 8.6% | 8.1% | +0.5% |

* Note that the CBRE Property Index is not the performance benchmark for the Portfolio.

## Investment Management Update

We continue to seek long-let institutional stock in a range of sectors, primarily industrial, retail warehousing and supermarket sectors to deliver the secure index-linked income streams identified within the Fund's strategy. The Fund's requirement has been articulated to the investment market and we are receiving a substantial number of investment opportunities each week.

## Asset Management Update

### Regatta Furniture, Ipswich – August 2022

The Fund has agreed terms with Regatta Furniture, the current sub-tenant of Wade Furniture (original tenant) for a new 10-year lease reflecting £17.25 psf, a 6% increase on the existing passing rent, the tenant will benefit from a rent-free period of 4-weeks.

### Rentokil, Bromford Central – August 2022

The Fund has agreed terms with Rentokil for a 10-year reversionary lease reflecting £7.65 psf, a 23% increase on the existing passing rent of the unit. The tenant will benefit from 4-months rent free and a break on the 5th anniversary of the lease commencement date.

### Tesco, Stow-on-the-Wold – June 2022

The Fund has completed the July 2022 inflation-linked rent review with Tesco, increasing the passing rent by 5%, in line with the RPI cap within the Lease.

### Royal Mail, Gateshead – February 2022

The Fund has instructed a rent review surveyor to agree the September 2020 outstanding rent review.

### Pets at Home, Arbroath – October 2021

The Fund has agreed terms with Pets at Home for a 5-year reversionary lease reflecting £12.00 psf, a 5% increase in the Retail Park's estimated rental value.

### Unipart, Rugby – August 2021

The Fund has instructed a rent review surveyor to agree the October 2021 rent review. An uplift in the passing rent is anticipated to be agreed.


# Portfolio Arrears Update – 28th September 2022

| | | | Targets | 92.00% | 96.00% | 98.00% | 99.00% | | |
|---|---|---|---|---|---|---|---|---|---|
| | Rent Due 24 June | Collectable Rent | Quarter Date up to and including 25/03/2022 | Week 1 up to and including 01/04/2022 | Week 2 up to and including 08/04/2022 | Week 3 up to and including 15/04/2022 | Week 4 up to and including 22/04/2022 | Payment after 22/04/2022 | Difference |
| | 4,698,294.03 | 4,698,294.03 | 3,419,695.02 | 453,154.31 | 599,295.00 | 0.00 | 12,400.00 | 202,364.70 | 11,385.00 |
| **Non Collectable Total** | | 0.00 | | | | | | | |
| **Collections Including non collectables** | | | 72.79% | 82.43% | 95.19% | 95.19% | 95.45% | 99.76% | |
| **Collections Excluding non collectables** | | | 72.79% | 82.43% | 95.19% | 95.19% | 95.45% | 99.76% | |

The rent collection across the entire portfolio in the previous three quarters has reflected the following.
June 2022 – 99.8%
March 2022 – 99.9%
December 2021 – 99.9%

The total Collectable Arrears on the entire portfolio is £245,410 as at 28th September 2022.

The Collectable Arrears exclude the following:

- Tenants that have overall credit balances on their accounts
- Tenants with recent charges raised within the last month

Below, is a summary of the tenants that have arrears in excess of £10,000. These eight tenants account for 84.5% (£207,432) of the total collectable arrears:

Royal Mail Group Limited (Gateshead) – Total arrears of £49,316 (20.1% of the collectable arrears). This relates solely to insurance. This is being reviewed due to a query with the reinstatement value and whether this should include tenant's fixtures.

Omega plc (Doncaster) – Total arrears of £43,420 (17.7% of the collectable arrears). This relates solely to insurance and the tenant is being chased.

B&Q plc (Arbroath) – Total arrears of £39,383 (16.0% of the collectable arrears). This relates mainly to service charge arrears. B&Q have service charge queries and we are working with them to resolve.

American Dry Cleaning Company Limited (Gloucester Road) – Total arrears of £22,125 (9.0% of the collectable arrears). This relates to a range of charges but the majority is the December 2021, March and June 2022 rents to which the tenant has made no payments towards.

Pizza Hut (UK) Limited (Ipswich) – Total arears of £20,660 (8.4% of the collectable arrears). Current rents are being paid and this relates to the period of insolvency. We are working with Pizza Hut to justify these arrears in line with their CVA and Deed of Variation to the lease.

Shoe Zone Retail Ltd (Congleton) – Total arrears of £11,550 (4.7% of the collectable arrears). This is the balance of remaining rent due, relating to December 2020.

River Island Fashion Limited (Lincoln) – Total arrears of £10,781 (4.4% of the collectable arrears). This relates mainly to the May 2022 rent, which has been incorrectly allocated. We are working with the tenant to resolve this.

Toni & Guy (South) Limited (Gloucester Road) – Total arrears of £10,198 (4.2% of the collectable arrears). This relates mainly to the March 2021 quarter's rent which they are paying in instalments.

The remaining £37,978 (15.5% of the collectable arrears) of arrears is spread across 27 tenants, ranging from £7,942 to £25.

## Responsible Investment Initiatives

Environmental, Social and Governance (ESG) criteria are having an increasingly prominent role in investment decision making and will influence the attractiveness of investments going forward. CBRE will ensure that responsible investment is put at the forefront of the strategy and that ESG factors are considered within each investment and asset management initiative. This will help ensure that the investment portfolio remains resilient over the long term.

We have summarised the relevant of each of the ESG factors below. These will be expanded upon with portfolio level principles and asset specific initiatives as the importance of ESG grows.

Environmental – sustainable factors will continue to play a part in the definition of 'prime' real estate, and buildings that don't meet the increasingly competitive standards are likely to become obsolete faster. Occupiers will demand their buildings adhere to the highest environmental standards.

Social - real estate's impact on the local community and on a company's workforce are becoming equally important. Buildings that contribute positively to the world are therefore likely to be more resilient than those that do not, and as such are likely to benefit from increased occupier demand, leading to future rental and capital growth.

Governance - market participants will increasingly question the governance and management practices of their partners and supply chain. Rigorous standards will mean businesses will need to become more transparent and engage with their stakeholders to ensure access to the best opportunities.

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