Agenda Item 9

CBRE

TEESSIDE PENSION FUND
Q3 2022

Quarterly Report
Prepared: 29th November 2022

Fund Objectives

Teesside 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 September 2022, the portfolio comprised 29 mixed-use properties located throughout the UK, with a combined value of £363.2m. This reflects an overall Net Initial Yield of 4.77%, and an Equivalent Yield of 4.92%.

The portfolio comprises principally prime and good secondary assets. High Street retail, retail warehouse and industrial comprise 89.3% of the portfolio by capital value. There are 78 demises and a total net lettable area of 1,975,960 sq ft.

The portfolio has a current gross passing rent of £18,488,273 per annum against a gross market rent of £18,814,795 per annum, making the portfolio reversionary in nature.

The weighted average unexpired term is 6.8 years to the earlier of the first break or expiry, and 7.9 years to expiry, ignoring break dates.

Fund Summary

Total Pension Fund Value (June 2022)	**£4,868m**
Real Estate Weighting (target allocation)	7.5% (9%)
Direct Portfolio Value (Sep 2022)	£363.2m

Direct Portfolio

Direct portfolio value (Sep 2022)	**£363.2m**
Number of holdings	29
Average lot size	£12.5m
Number of demises	78
Void rate (% of ERV) (Estimated UK Benchmark)	0.8% (7.0% – 9.0%)
WAULT to expiry (break)	7.9 years (6.8 years)
Current Gross Passing Rent (Per Annum)	£18,488,273
Current Gross Market Rent (Per Annum)	£18,814,795
Net Initial Yield	4.77%
Reversionary Yield	4.92%
Equivalent Yield	4.85%

Portfolio Highlight (Q3 2022) – Long Acre

The Fund has completed the purchase of a flagship High Street Retail asset located on Long Acre in Covent Garden, London. The property totals 16,882 sq ft and is let to Zara and Vodafone for an average unexpired term of 5.3 years. Purchased for £31.0m reflecting 5.32% NIY.

UK Economic Commentary

- 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 3.00% in November 2022. CBRE's base case is that short-term interest rates will continue rising throughout 2022. After peaking in 2023, the Base Rate is expected to then gradually reduce to 2% by 2025.

UK Real Estate Market Commentary

- Year on year total returns for All UK Property were 13.8% (8.7%* capital return, 4.8%* income return) for the period Q3 2021 to Q3 2022**. Industrial and retail reported the highest year on year total returns with 18.1% and 14.6% respectively. However, upward yield movement resulted in -4.0% quarterly total return for All UK Property for Q3 2022. Across the sectors, industrial total returns were -8.8%, retail total returns were -2.1% and office total returns were -1.3% for the quarter.
- Negative total returns over the quarter were driven by capital growth declines. All UK Property capital values to fall by 5.1% over the quarter, whilst the Industrial sector was most affected by yield movements and saw the largest capital value decline of 9.5%. Office and Retail capital value growth for the quarter was -2.3% and -3.6% respectively.
- Rental values for All UK Property increased by 1.1% over Q3 2022. All sectors reported positive rental value growth over Q3, with Industrials reporting the highest growth of 2.7%. The Office and Retail sectors also posted 0.4% and 0.1% growth respectively.
- There were £10.8bn of investment transactions in the UK in Q3 2022 compared to a revised estimate of £15.0bn in Q2. Q3 deals brought the 2022 YTD total to £44.3bn.
- £3.4bn (32%) of Q3 deals were in the office sector and £3.3bn (30%) were for Industrial assets, with Residential investment seeing the next highest share at £1.4bn (13%).
- 43% of deals in Q3 involved domestic buyers while 57% were cross-border acquisitions. Despite the drop in volume overall, relative shares for domestic and cross-border buyers were consistent with H1.
- North American and European purchasers each accounted for £1.7bn of deals in Q3. The average deal size for North American buyers was much larger at £53m versus £24m for their European counterparts.
- Asian investors accounted for a further £1.3bn of acquisitions in Q3. This was heavily concentrated in just a handful of transactions, with an average deal size of £133m.

* 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 September 2022

Investments

Sales

No sales this period.

Acquisitions

The Fund has completed the purchase of a flagship High Street Retail asset located on Long Acre in Covent Garden, London. The property totals 16,882 sq ft and is let to Zara and Vodafone for an average unexpired term of 5.3 years. Purchased for £31.0m reflecting 5.32% NIY.

The Fund has also agreed terms in respect of two new assets. Firstly, a Retail Park located within an affluent south-east commuter town, let to retailers such as M&S, Halfords and Home Bargains. Secondly, a 220,000 sq ft industrial unit, single-let to Iceland Foods.

Both transactions are expected to complete in Q4 2022.

Direct Portfolio Analysis

Top Ten Holdings (by Capital Value)

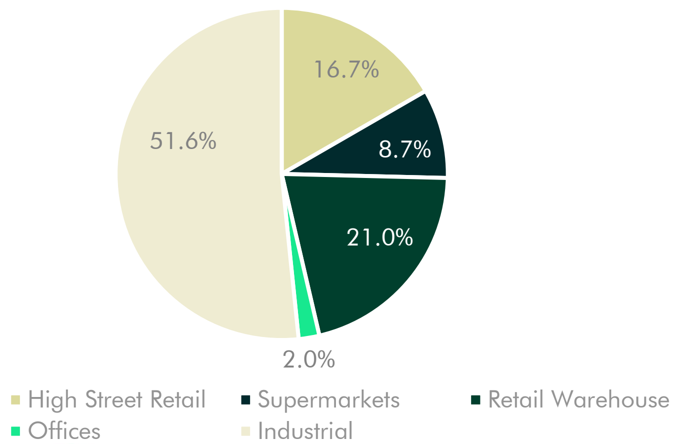
No.	Asset	Sector	Value	% of Direct Portfolio
1	THORNE - Capitol Park	Industrial	£37,100,000	10.2%
2	LONDON - Long Acre	High Street Retail	£31,000,000	8.5%
3	GATESHEAD - Team Valley	Industrial	£23,600,000	6.5%
4	BIRMINGHAM - Bromford Central	Industrial	£23,400,000	6.4%
5	PARK ROYAL - Minerva Road	Industrial	£22,100,000	6.1%
6	RUGBY - Valley Park	Industrial	£19,800,000	5.5%
7	LUTTERWORTH - Magna Park	Industrial	£18,500,000	5.1%
8	PARK ROYAL - Coronation Road	Industrial	£18,300,000	5.0%
9	STOW-ON-THE-WOLD - Fosse Way	Supermarket	£15,500,000	4.3%
10	SWADLINCOTE - William Nadin Way	High Street Retail	£15,500,000	4.3%
		Total	**£224,800,000**	**61.9%**

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

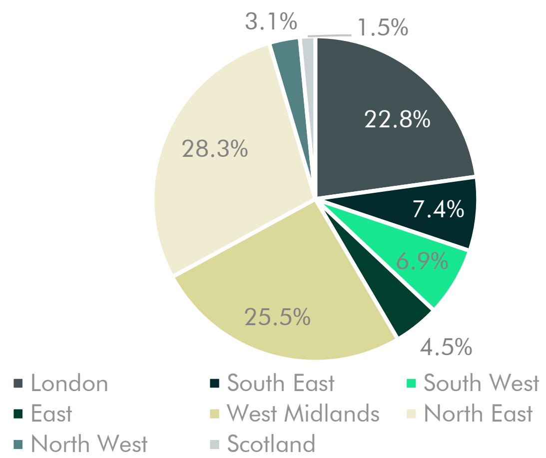
In addition to recommendations on industrial purchases, we may also recommend alternative and long-let investments that offer good covenants, attractive yields and long unexpired terms; these may include hotels, car showrooms, healthcare, leisure, supermarkets and student housing.

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)



Direct Portfolio Analysis (continued)

Top Ten Tenants (by Contracted Income)

The portfolio currently has 78 different demises let to 63 tenants. The largest tenant is Zara UK Limited which accounts for 8.2% of the annual contracted income. Experian currently lists Zara as representing a “Very Low Risk” of business failure.

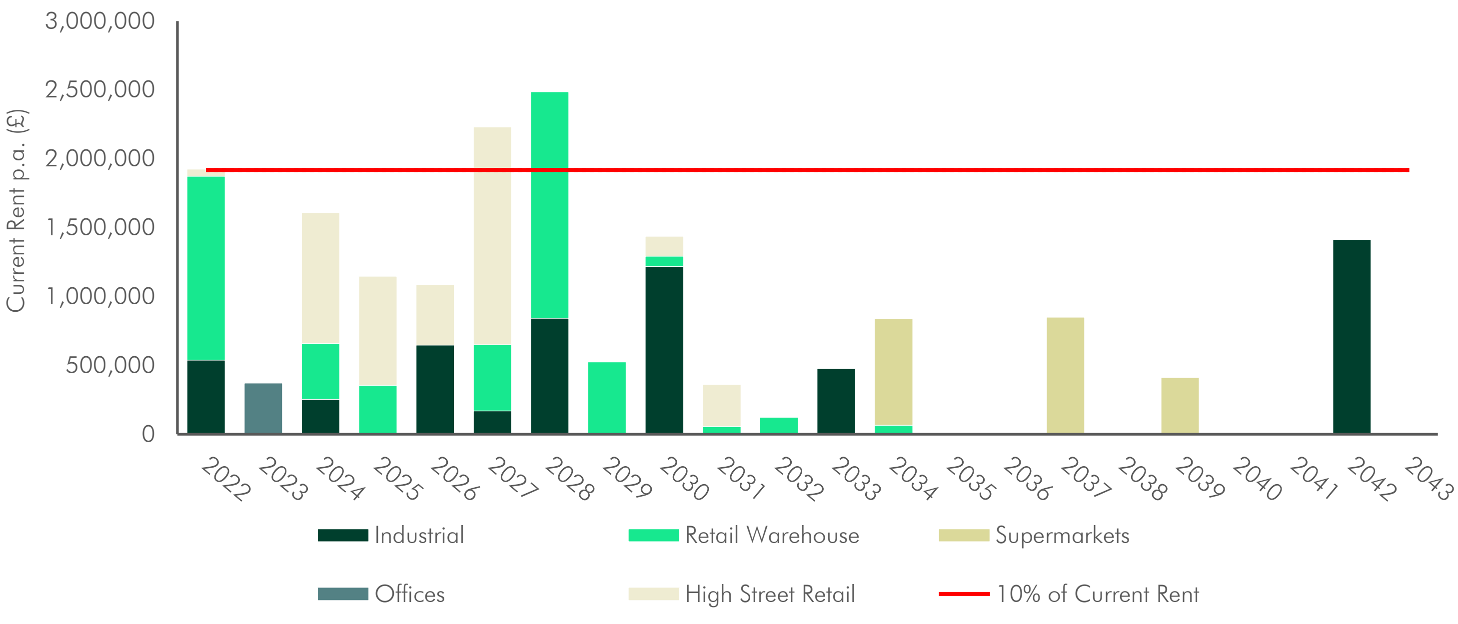
As a significant portion of the portfolio income will be from the top ten tenants, we will monitor their covenant strength and flag any potential issues. Our most recent assessment shows a large majority of these tenants are classed as having a “Low Risk” of business failure.

Top Ten Tenants (by Contracted Rent)

#	Tenant	Sector	Number of Leases	Contracted Rent p.a.	% of Portfolio Rent	Risk Rating (Experian)
1	Zara UK Limited	Retail	2	£1,580,000	8.2%	Very Low Risk
2	Omega Plc	Industrial	1	£1,413,690	7.4%	Very Low Risk
3	B&Q plc	Retail	2	£997,000	5.2%	Very Low Risk
4	Unipart Logistics Limited	Industrial	1	£985,000	5.1%	Very Low Risk
5	H&M	Retail	1	£918,123	4.8%	Below Average Risk
6	Royal Mail Group Limited	Industrial	1	£899,162	4.7%	Very Low Risk
7	B&M Retail Limited	Retail	3	£863,400	4.5%	Very Low Risk
8	Libra Textiles	Retail	1	£850,000	4.4%	Very Low Risk
9	Brunel Healthcare	Industrial	1	£843,761	4.4%	Very Low Risk
10	Tesco Stores Limited	Supermarkets	1	£774,714	4.0%	Very Low Risk
			Total	£10,124,850	52.8%	

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 Sep 21 - Sep 22			3 Year (p.a.) Sep 19 - Sep 22			5 Year (p.a.) Sep 17 - Sep 22		
	TPF	Index	Variance	TPF	Index	Variance	TPF	Index	Variance
Income Return	5.1%	4.8%	+0.3%	5.5%	5.4%	+0.2%	5.6%	5.4%	+0.2%
Capital Return	15.4%	8.7%	+6.7%	4.6%	1.8%	+2.8%	2.2%	1.2%	+1.0%
Total Return	21.5%	13.8%	+7.6%	10.4%	7.3%	+3.1%	8.0%	6.7%	+1.3%

* 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

H&M, Exeter – November 2022

The Fund has completed the June 2022 inflation-linked rent review with H&M, increasing the passing rent by 24%, in line with the RPI provision within the Lease.

Rentokil, Bromford Central – November 2022

The Fund has completed a Lease renewal with Rentokil for a term of 10-years 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.

Regatta Furniture, Ipswich – September 2022

The Fund has completed a new Lease with Regatta Furniture for a term of 10-years reflecting £17.25 psf, a 6% increase on the existing passing rent, the tenant will benefit from a rent-free period of 4-weeks.

Pets at Home, Arbroath – September 2022

The Fund has completed a Lease renewal with Pets at Home for a term of 5-years reflecting £12.00 psf, a 5% increase in the Retail Park's estimated rental value.

Tesco, Stow-on-the-Wold – June 2022

The Fund has completed the annual inflation-linked rent review with Tesco, increasing the passing rent by 5%, in line with the annual 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.

Portfolio Arrears Update – 28th November 2022

			Targets	92.00%	96.00%	98.00%	99.00%		
	Rent Due 29 September	Collectable Rent	Quarter Date up to and including 29/09/2022	Week 1 up to and including 06/10/2022	Week 2 up to and including 13/10/2022	Week 3 up to and including 20/10/2022	Week 4 up to and including 27/10/2022	Payment after 27/10/2022	Difference
	4,620,935.75	4,620,935.75	3,170,336.92	506,501.25	166,976.50	0.00	53,100.00	642,975.80	81,045.28
Non Collectable Total		0.00							
Collections Including non collectables			68.61%	79.57%	83.18%	83.18%	84.33%	98.25%	
Collections Excluding non collectables			68.61%	79.57%	83.18%	83.18%	84.33%	98.25%	

The rent collection across the entire portfolio in the previous three quarters has reflected the following.
September 2022 – 98.3%
June 2022 – 99.9%
March 2022 – 99.9%

The total Collectable Arrears on the entire portfolio is £247,783 as at 28th November 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 six tenants account for 78.2% (£193,794) of the total collectable arrears:

B&Q plc (Arbroath) – Total arrears of £49,448 (20.0% 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.

Royal Mail Group Limited (Gateshead) – Total arrears of £49,316 (19.9% 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.

Nuffield Health (Guildford) – Total arrears of £31,024 (12.5% of the collectable arrears). This relates mainly to the third monthly instalment of the September 2022 quarter's rent. Payment is expected week commencing 28th November 2022, which will leave them in an overall credit position.

Aurum Group Limited (Newcastle) – Total arrears of £30,500 (12.3% of the collectable arrears). This relates solely to the third monthly instalment of the September 2022 quarter's rent. Payment is expected is expected week commencing 28th November 2022.

Pizza Hut (UK) Limited (Ipswich) – Total arears of £21,120 (8.5% 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.

Boots UK Limited (Congleton) – Total arrears of £12,386 (5.0% of the collectable arrears). These arears are being resolved through the Lease renewal process. The new Boots Lease is being set-up on the system and we will work with the tenant to reconcile their old and new accounts, together with their rent free period.

The remaining £53,989 (21.8% of the collectable arrears) of arrears is spread across 29 tenants, ranging from £5,917 to 29p.

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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