Agenda Item 10

CBRE

# TEESSIDE PENSION FUND
# Q1 2023

## Quarterly Report
Prepared: 14th June 2023

## 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 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 31st March 2023, the portfolio comprised 31 mixed-use properties located throughout the UK, with a combined value of £378.9m. This reflects an overall Net Initial Yield of 5.56%, and an Equivalent Yield of 5.57%.

The portfolio comprises principally prime and good secondary assets. High Street retail, retail warehouse and industrial comprise 92% of the portfolio by capital value. There are 86 demises and a total net lettable area of 2,676,364 sq ft.

The portfolio has a current gross passing rent of £22,522,679 per annum against a gross market rent of £22,257,625 per annum, making the portfolio broadly rack-rented in nature.

The weighted average unexpired term is 6.8 years to the earlier of the first break or expiry, and 8.0 years to expiry, ignoring break dates.

## Fund Summary

| | |
|---|---|
| **Total Pension Fund Value** (December 2022) | **£4,953m** |
| Real Estate Weighting (long term target allocation) | 7.6% (10%) |
| Direct Portfolio Value (March 2023) | £378.9m |

## Direct Portfolio

| | |
|---|---|
| **Direct Portfolio Value** (March 2023) | **£378.9m** |
| Number of Holdings | 31 |
| Average Lot Size | £12.2m |
| Number of Demises | 86 |
| Void rate (% of ERV) (Estimated UK Benchmark) | 0.7% (7.0% – 9.0%) |
| WAULT to Expiry (break) | 8.0 years (6.8 years) |
| Current Gross Passing Rent (Per Annum) | £22,522,679 |
| Current Gross Market Rent (Per Annum) | £22,257,625 |
| Net Initial Yield | 5.56% |
| Reversionary Yield | 5.50% |
| Equivalent Yield | 5.57% |

## Portfolio Highlight (Q1 2023) – Gateshead

The Fund has completed the September 2020 rent review with Royal Mail at £5.17 psf, a 19% increase on the passing rent of the unit. The Fund were required to instruct an Independent Expert to determine the rent review. The settlement figure was in the Fund's favour.

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## UK Economic Commentary

- Economic output increased by 0.1% in the three months to March, and the economy is now above its pre-Pandemic levels. In March, monthly GDP decreased by 0.3%, driven by a fall in the services sector.
- Headline inflation declined to 8.7% in April, a decrease from its October 2022 peak of 11.1%. This was driven by cheaper energy and despite increases in food prices.
- It is anticipated that inflation will maintain its steady downward trajectory throughout 2023 and 2024, ultimately reaching the 2% target in early 2025.
- Unemployment climbed to 3.9% in the three months to March. However, vacancies have been decreasing for nine consecutive months. While nominal pay has increased by a healthy 5.9%, it has not kept up with inflation, meaning that real pay has declined. Unemployment is projected to peak at 4.2% in early 2024 before coming down.
- As the UK economy slows down in 2023, retail sales volumes are expected to decline, but they are projected to start growing again in 2024 when inflation normalises.
- Although inflation is currently on a downward trajectory, it will persist at higher levels for some time, limiting growth to 0.1% for 2023. As inflation subsides, GDP is expected to rebound, with projected growth of 1.2% in 2024 and 2.3% in 2025.
- The Bank of England raised the Bank Rate to 4.50% in May. Furthermore, the Spring Budget unveiled a loosening of fiscal policy, incorporating measures to bolster household finances and business investment. This is why we think the UK economy will avoid recession in 2023.
- The banking sector's instability has been mitigated by the decisive actions of policymakers in the United States and Europe. Another significant financial crisis seems improbable due to improved regulation and bank management. However, it is anticipated that credit for real estate will be considerably more constrained than if the instability episode had not occurred.
- Several risks could potentially impact this outlook, including a prolonged slowdown in the global economy, a steeper-than-anticipated drop in housing prices, and a rise in corporate insolvencies following the removal of COVID-related support measures. These factors could collectively prolong the recession and hinder the recovery process in 2024 and 2025.

## UK Real Estate Market Commentary

- Q1 2023 saw £8.1bn in transactions of investment properties, down from £10.3bn in Q4 2022 and a lot lower than the £21bn that transacted in Q1 of 2022.
- While a fall in transaction activity has been widely reported, our data indicates that the office and retail sectors saw increases in volumes for Q1 2023 compared to Q4 2022. Offices accounted for the largest proportion of Q1 volumes at £2.3bn, 28% of the total (compared to £1.7bn in Q4).
- Residential investment volumes fell in Q1 2023 compared to Q4 2022, but we noted last quarter that the Q4 total for the sector was boosted by portfolio deals. Yet, at £2.0bn, the residential sector still accounted for 25% of Q1 volumes.
- Foreign investment was relatively low in Q1 2023, with c. 30% of volumes attributable to foreign acquisitions. The share was higher for the office sector at c. 55%. Asian and North American investors were the dominant sources of foreign capital, with 80% of foreign investment in Q1 coming from these two regions.
- The quarterly total return for All UK Property for in Q1 2023 was 1.1% (-0.3%* capital return, 1.4%* income return)**. Industrial total returns were 1.2% (0.0% capital return, 1.2% income return), retail total returns were 2.3% (0.5% capital return, 1.8% income return) and office total returns were -0.3% (-1.5% capital return, 1.2% income return).
- Rental values for All UK Property increased 1.1% the March quarter of 2023. All-property growth was driven by the Industrial sector which saw 2.0% rental growth for Q1, while office and retail rents increased 0.3% and 0.2%.
- All property yields stabilised throughout Q1 2023, increasing 7bps. This means yields have increased 113bps since March 2022. The mild yield shift in Q1 is reflected in capital values only declined -0.3%. This follows the -14.6% decrease in values through Q4 2022.

* 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 March 2023

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# Investments

## Sales

No sales this period.

## Acquisitions

No Acquisitions this quarter.

The Fund agreed terms to purchase a 67,757 sq ft Retail Park located in the south-east of England.

# Direct Portfolio Analysis

## Top Ten Holdings (by Capital Value)

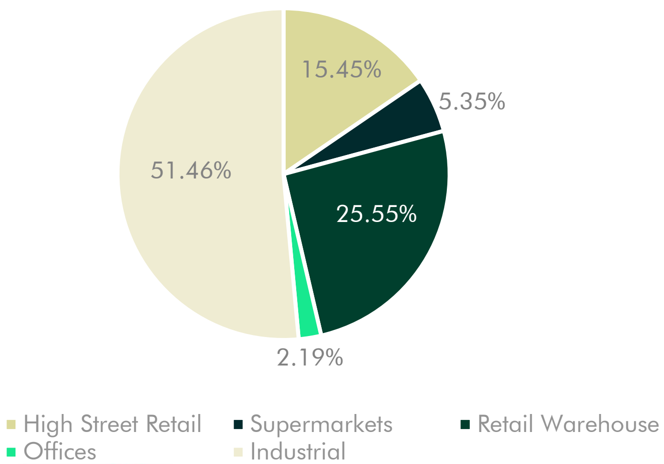
| No. | Asset | Sector | Value | % of Direct Portfolio |
|---|---|---|---|---|
| 1 | THORNE - Capitol Park | Industrial | £31,200,000 | 8.2% |
| 2 | SWINDON - Symmetry Park | Industrial | £31,150,000 | 8.2% |
| 3 | LONDON - Long Acre | High Street Retail | £31,000,000 | 8.2% |
| 4 | BIRMINGHAM - Bromford Central | Industrial | £20,200,000 | 5.3% |
| 5 | GATESHEAD - Team Valley | Industrial | £20,100,000 | 5.3% |
| 6 | TONBRIDGE - Tonbridge Retail Park | Retail Warehouse | £20,050,000 | 5.3% |
| 7 | PARK ROYAL - Minerva Road | Industrial | £19,500,000 | 5.1% |
| 8 | RUGBY - Valley Park | Industrial | £18,300,000 | 4.8% |
| 9 | PARK ROYAL - Coronation Road | Industrial | £16,300,000 | 4.3% |
| 10 | SWADLINCOTE - William Nadin Way | Industrial | £15,450,000 | 4.1% |
| | | **Total** | **£223,250,000** | **58.9%** |

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

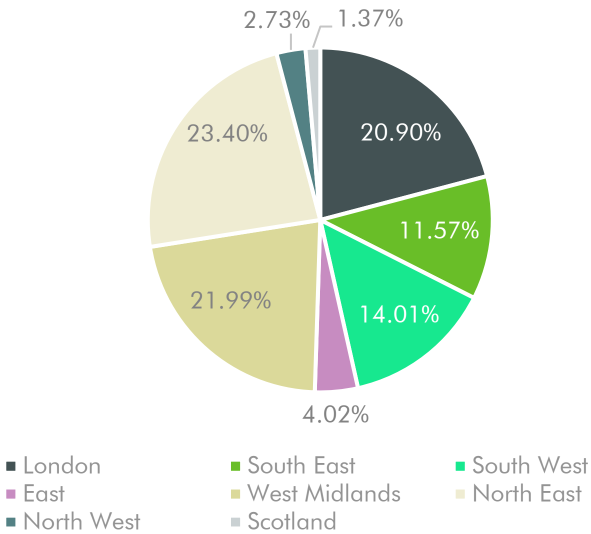
In addition to recommendations on industrial purchases, we may also recommend alternative and long-let investments that offer good covenants, attractive yields and long unexpired terms; these may include hotels, car showrooms, healthcare, leisure, supermarkets and student housing.

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 86 different demises let to 66 tenants. The largest tenant is Iceland Food Limited which accounts for 8.0% of the annual contracted income. Experian currently lists Iceland as representing a “Very Low Risk” of business failure.

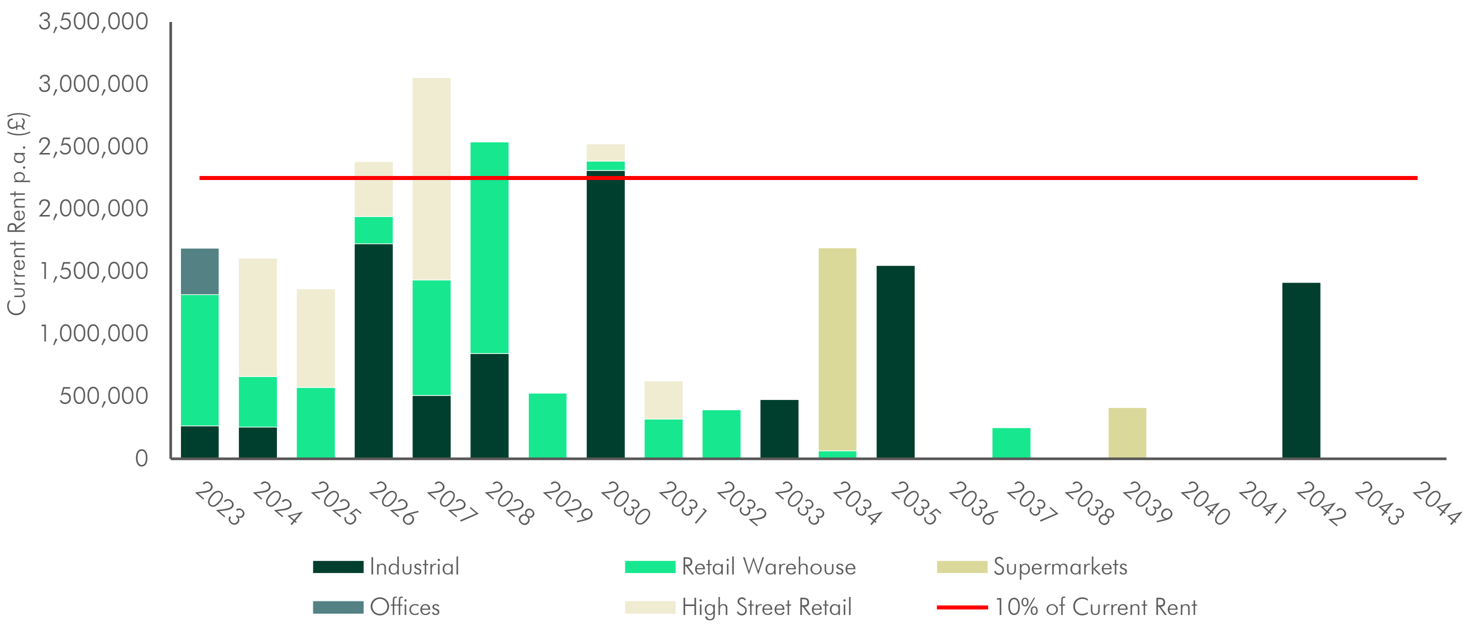
As a significant portion of the portfolio income will be from the top ten tenants, we will monitor their covenant strength and flag any potential issues. Our most recent assessment shows a large majority of these tenants are classed as having a “Very Low Risk” of business failure.

Top Ten Tenants (by Contracted Rent)

| # | Tenant | Sector | Number of Leases | Contracted Rent p.a. | % of Portfolio Rent | Risk Rating (Experian) |
|---|---|---|---|---|---|---|
| 1 | Iceland Foods Limited | Industrial / Retail | 2 | £1,798,211 | 8.0% | Very Low Risk |
| 2 | Zara UK Limited | Retail | 2 | £1,580,000 | 7.0% | Very Low Risk |
| 3 | Omega Plc | Industrial | 1 | £1,413,689 | 6.3% | Very Low Risk |
| 4 | Unipart Logistics Limited | Industrial | 1 | £1,077,000 | 4.8% | Very Low Risk |
| 5 | Royal Mail Group Limited | Industrial | 1 | £1,074,000 | 4.8% | Very Low Risk |
| 6 | B&Q plc | Retail | 2 | £997,000 | 4.4% | Very Low Risk |
| 7 | H&M | Retail | 1 | £918,123 | 4.1% | Maximum Risk |
| 8 | B&M Retail Limited | Retail | 3 | £863,400 | 3.8% | Very Low Risk |
| 9 | Libra Textiles Limited | Retail | 1 | £850,000 | 3.8% | Very Low Risk |
| 10 | Brunel Healthcare | Industrial | 1 | £843,761 | 3.7% | Very Low Risk |
| | | | Total | £11,415,184 | 50.7% | |

## 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 2023 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 Mar 22 - Mar 23 | | | 3 Year (p.a.) Mar 20 – Mar 23 | | | 5 Year (p.a.) Mar 18 – Mar 23 | | |
|---|---|---|---|---|---|---|---|---|---|
| | TPF | Index | Variance | TPF | Index | Variance | TPF | Index | Variance |
| Income Return | 5.2% | 5.0% | +0.2% | 5.5% | 5.3% | +0.2% | 5.6% | 5.4% | +0.2% |
| Capital Return | -9.3% | -16.8% | +7.5% | 2.5% | -2.0% | +4.5% | 0.1% | -2.5% | +2.6% |
| Total Return | -4.3% | -12.6% | +8.3% | 8.3% | 3.2% | +5.1% | 5.7% | 2.7% | +3.0% |

* 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

### Toni & Guy, Gloucester Road – February 2023

The Fund has completed a Lease renewal with Toni & Guy for a term of 10-years reflecting an average of £90.22 psf, a 5% increase on the passing rent of the unit. The tenant will benefit from a stepped rent and a break on the 5th anniversary of the Lease commencement date.

### Unipart, Rugby – February 2023

The Fund has completed the October 2021 rent review with Unipart at £7.15 psf, a 23% increase on the passing rent of the unit.

### Royal Mail, Gateshead – January 2023

The Fund has completed the September 2020 rent review with Royal Mail at £5.17 psf, a 19% increase on the passing rent of the unit. The Fund were required to instruct an Independent Expert to determine the rent review. The settlement figure was in the Fund's favour.

### 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 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 passing rent of the unit. The tenant will benefit from a rent-free period of 4-weeks.

## Portfolio Arrears Update – 12th June 2023

The below table details the collection statistics for Q1 2023. Rent due for the quarter totalled £5,408,286 of which £5,370,186 has been collected, reflecting a difference of £38,100.

| Collection Milestones | Rent Due 25/03/2023 | Quarter Date 25/03/2023 | Week 1 01/04/2023 | Week 2 08/04/2023 | Week 3 15/04/2023 | Week 4 22/04/2023 | After 22/04/2023 | Difference |
|---|---|---|---|---|---|---|---|---|
| Total (£) | 5,408,286 | 3,489,144 | 884,659 | 612,016 | 100,765 | 112,500 | 171,100 | 38,100 |
| Collection Target (%) | | | 92.00% | 96.00% | 98.00% | 99.00% | | |
| Total Collections (%) | | 64.51% | 80.87% | 92.19% | 94.05% | 96.13% | 99.30% | |

The rent collection across the entire portfolio in the previous three quarters has reflected the following.
December 2022 – 99.3%
September 2022 – 100.0%
June 2022 – 100.0%

The total Collectable Arrears on the entire portfolio is £334,026 as at 12th June 2023.

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 seven tenants account for 82.8% (£276,692) of the total collectable arrears:

Royal Mail Group Limited (Gateshead) – Total arrears of £100,247 (30.0% of the collectable arrears). This relates mainly to two years insurance premiums. A lot of work has been undertaken to rectify and agree the reinstatement values. This has now been completed and the correct premiums charged. This is now being relayed to the tenant to obtain their agreement and then payment.

Iceland Foods Limited (Swindon) – Total arrears of £72,274 (21.6% of the collectable arrears). This relates solely to the annual insurance premium. The tenant has queried the increase (compared to the previous ownership), which is mainly due to an increase in the Reinstatement Cost Assessment (on purchase by Teesside).

B&Q plc (Arbroath) – Total arrears of £48,186 (14.4% of the collectable arrears). This relates solely to service charge arrears. B&Q have service charge queries and we are working with them to resolve. A measured survey is being considered to resolve issues over disagreed floor areas.

Pizza Hut (UK) Limited (Ipswich) – Total arrears of £20,463 (6.1% 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.

Knight Frank (Old Brompton Road) – Total arrears of £13,880 (4.2% % of the collectable arrears). This relates solely to the latest annual insurance premium.

American Dry Cleaning Company Limited (17/23 Gloucester Road) – Total arrears of £11,073 (3.3% of the collectable arrears). These arrears relate to many charges including part of the December 2022 and March 2023 quarter's rent, insurance and superior landlord's service charges. We are working with the tenant to get these cleared.

Matalan Retail Limited (Northwich) – Total arrears of £10,570 (3.2% % of the collectable arrears). This relates mainly to the latest annual insurance premium.

The remaining £57,334 (17.2% of the collectable arrears) of arrears is spread across thirty-three tenants, ranging from £9,933 to 29p.

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## 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.

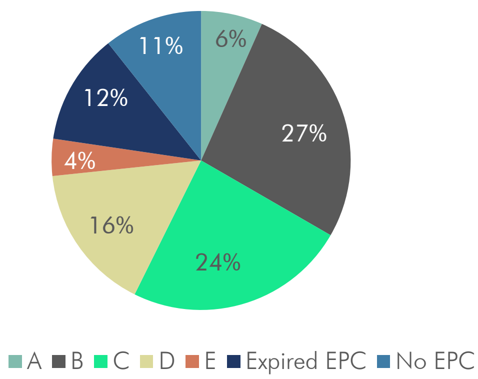
**Social** - real estate's impact on the local community and on a company's workforce are becoming equally important. Buildings that contribute positively to the world are therefore likely to be more resilient than those that do not, and as such are likely to benefit from increased occupier demand, leading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

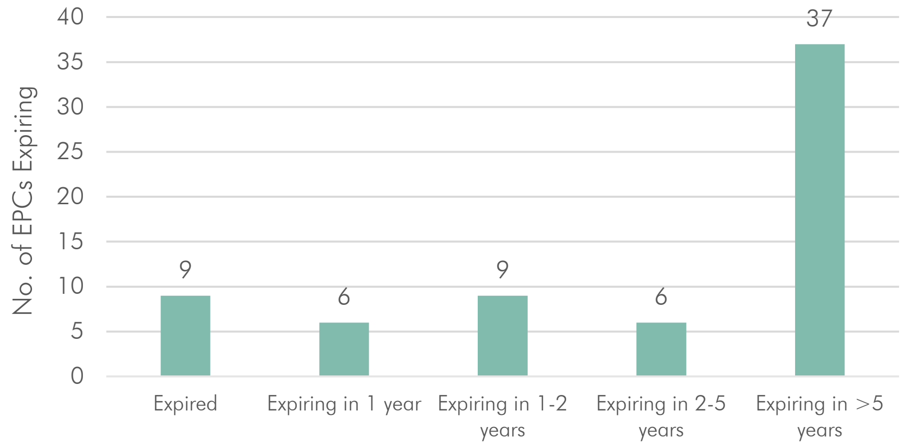
### Minimum Energy Efficiency Standards (MEES)

Teesside Pension Fund's property Portfolio currently complies with MEES regulation. The Fund has undertaken a strategic review of the Portfolio to ensure continued compliance with incoming regulation in 2025. Energy Performance Certificates (EPCs) are used to measure compliance. A breakdown of the current ratings and expiry profile across the Portfolio is detailed below:

Current EPC Ratings




EPCs by Expiry

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