# DORSET COUNTY COUNCIL PENSION FUND

## QUARTERLY REPORT Q4 2017

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# 1. EXECUTIVE SUMMARY: Q4 2017

## MARKET

The UK economy continues to do well, despite political travails and Brexit-related uncertainty. It is being helped by a strengthening global economy and a weak currency, which has stimulated manufacturing and boosted tourism. GDP growth in the order of 1.8% has proved sufficient to support most segments of the property market.

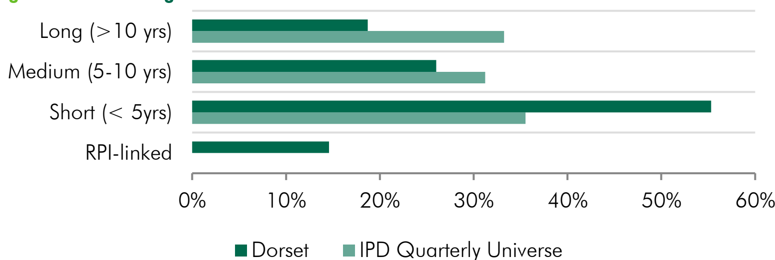
Two of the key trends that dominated last year should continue into 2018: well-located core real estate will be sought by discerning tenants but difficult to acquire, while secondary real estate will struggle to resonate and be difficult to sell. At an aggregate level this should mean that rental growth will moderate and yields soften gradually. This combination will result in capital values being broadly flat during 2018, giving a base case All Property total return in the 4.5-5% p.a. range.

## PORTFOLIO

The portfolio's void rate reduced to 1.9% from 5.2% over the quarter following a new letting at the retail park in Norwich and the sale of the vacant industrial building on Great Suffolk Street, London. It remains well below the market average of 6.9%. The purchase of the industrial estate in Greenford completed for £8.4m and the sale of 131 Great Suffolk Street completed for £4.95m. Since the end of the quarter, we have completed the purchase of four public houses and a restaurant in Central London for £14.6m. Three properties staircased from the Derwent Shared Ownership portfolio during the quarter.

Following the purchase of the pub portfolio, we have approximately £40m remaining to invest from the new allocation. We have agreed terms to buy a Marks & Spencer food store next to Archway underground station in North London for £7.85m and are reviewing a number of further opportunities.

### Figure 1 Lease Length




### Figure 2 Geographical Structure

| Region | % |
|---|---|
| London & SE | 47% |
| Eastern | 16% |
| South West | 10% |
| Midlands | 7% |
| North | 12% |
| Rest of UK | 7% |

### Overview

The target is to achieve a return on Assets at least equal to the average IPD Quarterly Universe Portfolio Return including Transactions and Developments for a rolling five year period commencing 1 January 2006.

### Portfolio

| | Value | Assets |
|---|---|---|
| UK Direct | £237.1m | 25 |
| UK Indirect | £40.0m | 3 |
| Total value of portfolio | £277.2m | |

| | | |
|---|---|---|
| NIY/EY | 4.6% | 5.9% |
| Vacancy rate | 1.9% | |
| AWULT to expiry (lease to break) | 8.9yrs | (8.3yrs) |
| Largest asset | Woolborough Lane, Crawley (£23.4m/9.9% of direct portfolio value) | |
| Largest tenant | ACI Worldwide EMEA (£1,070,000/9.2% of direct portfolio rent) | |

### Performance

Target: To achieve a return on Assets at least equal to the average IPD Quarterly Universe.

| | Portfolio | Target | Relative |
|---|---|---|---|
| Q4 2017 % | 2.7 | 2.9 | -0.1 |
| 1 Yr % | 10.7 | 10.3 | 0.4 |
| 3 Yr % p.a. (2015-2017) | 9.5 | 9.0 | 0.4 |
| 5 Yr % p.a. (2013-2017) | 11.9 | 11.1 | 0.8 |

### Transcations

| | Q4 2017 |
|---|---|
| Money available | £47.8m |
| Purchases | £8.4m |
| Sales | £4.95m |

# 2. MARKET COMMENTARY

## UK ECONOMIC OUTLOOK

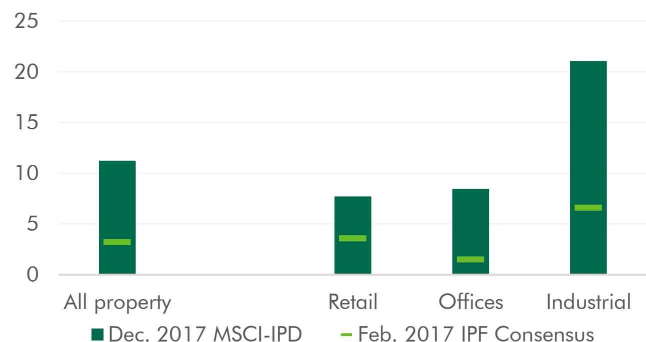
While the UK economy lost momentum from the G7 topping pace of 2016 it has held up surprisingly well, especially given political travails and Brexit-related uncertainty. To be fair the UK is being propped up by a strengthening global economy, which is best positioned since the Global Financial Crisis. Also a weak currency has stimulated an export-led manufacturing sector and boosted tourism. Regardless of the mechanics, GDP growth in the order of 1.8% has proved sufficient to support most segments of the property market.

For 2018, we anticipate a broadly similar economic climate to last year. Businesses will remain wary of investing until there is greater clarity on Brexit negotiations. Inflation will bite, but should begin to slow due to base effects and strengthening sterling. Such forces should enable a flexible approach to monetary policy. Forecasters are divided on how many, if any, rate rises will occur during 2018 but the pace of tightening is likely to be very gradual. Taken together, the consumer should play an important role driving the economy. Whilst there is no shortage of risks that could challenge this prognosis, we are increasingly acknowledging the possibility of an even brighter near term outlook. Tight labour markets spurring real wage growth, certainty of a prolonged Brexit transition period or an even stronger global economy could fuel a late cycle UK economy and supercharge the property market.

## UK PROPERTY PERFORMANCE

While economic growth has fallen below trend, property returns have been favourable relative to history. According to the MSCI/IPD Monthly Index, the All Property total return for 2017 was 11.2%. In December alone, the market returned 1.4%, making it the strongest month in the past three years. It should be noted that given the composition of the annual index, the outturn will not be quite as strong. Irrespective, the UK property market performed well in 2017 and significantly ahead of what was anticipated a year ago.

Figure 1 Year to date total returns vs. Feb. 2017 consensus, %. Source: MSCI-IPD Monthly Index, IPF




Across the sectors, industrials continue to be the standout performer. In many parts of the country rents have been increasing at their fastest rates since the 1990s. Yields have compressed as investors have increased their expectations of future growth. Consequently the industrial sector will see total returns of around 20% for 2017. Given the structural forces that are impacting the office and retail sectors, occupier and investor interest has not been as universally robust (Figure 1). As such, performance was weaker in both sectors than the all property average, a trend which is likely to endure this year.

### Occupier Markets

Despite the momentum that many property segments sustained in the final quarter of 2017, there are more signs that the bargaining position is shifting from landlord to tenant. Incentives are becoming more generous, good space is taking longer to let and tenants are increasingly successfully negotiating shorter leases. Given the Brexit-related uncertainties on the horizon, which London remains vulnerable to, enquiries for traditional office space have softened. Quite strikingly, however, serviced offices are emerging as a credible alternative for tenants reluctant to commit to long leases and willing to embrace a new way of working.

In 2017 well capitalised operators expanded in an attempt to gain market share, which helped the serviced office segment achieve 14% of total take-up in London, up from low single digits less than a decade ago. A stark ramification is that sub-5,000

square foot offices are now struggling to let and traditional office tenants are becoming accustomed to greater flexibility (Figure 2).

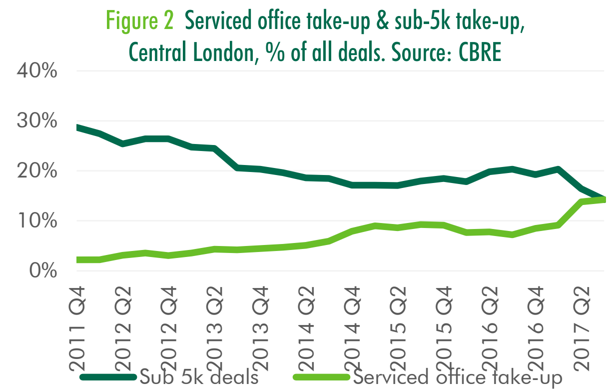


Figure 2 Serviced office take-up & sub-5k take-up, Central London, % of all deals. Source: CBRE

South East industrials have been a preferred play as the sector benefits from a strong structural story: e-commerce is forcing retailers to expand distribution networks while competing land uses are eating away at existing stock. This phenomenon has been most pronounced within Inner London where certain units have been able to achieve office-like rents. However, the occupational picture is not as universally strong as capital markets might suggest. At an aggregate level, it appears demand is plateauing and given the evolution of rents over the past three years, new construction is picking up.

Emblematic of the polarisation that besets the retail sector, the all-important Christmas trading season delivered a mixed bag of trading results. Grocers and the UK's largest integrated retailers performed ahead of expectations while multi-brand department stores really struggled, raising speculation that at least one long-standing chain will go into administration in the near future. Given the lack of new retailing entrants and ample availability of space, the broader sector will face formidable headwinds for the foreseeable future. Food and beverage operators are facing similar obstacles. Rampant debt-backed expansion, increased cost pressures and a pinched consumer are translating to dwindling new requirements and the shuttering of once popular brands. Given these forces, we are resolute in our decision to down weight retail sector exposure from our portfolios.

## Capital Markets

UK property investors have not been deterred in the face of uncertainty: political, economic or otherwise. These factors have been more than outweighed by property's current yield advantage over other asset classes and this is a key reason why UK domiciled investors, in particular, are maintaining their real estate allocations. The corollary is that there are few motivated sellers of good property and even fewer viable alternatives to redeploy capital.

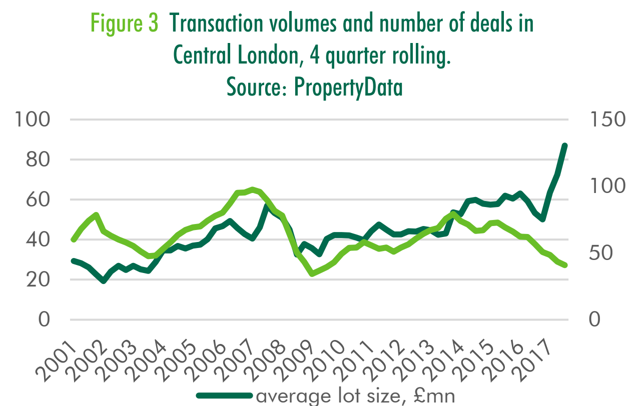


Figure 3 Transaction volumes and number of deals in Central London, 4 quarter rolling. Source: PropertyData

Unsurprisingly 2017 was a year of relatively muted transaction numbers offset by very large average lot sizes (Figure 3). Chinese and Hong Kong capital sources precipitated this as they dominated London office buying activity. More interestingly, is that of the £8.1bn that this investor group transacted during the year, nearly 90% went to new entrants to the UK market. There are clearly myriad push and pull factors dictating investment decisions.

UK institutions on the other hand were out of the London office market and fiercely competing for South East industrials and secure inflation-linked income. Pricing in both segments has reached historic proportions. However, the lack of differentiation in pricing for prime and secondary industrial units raises red flags. Structural voids are seemingly being ignored as aggressive rental growth rates are being universally applied. We see this as an opportune time to dispose of assets whose deficiencies might be overlooked in the current environment.

## Outlook

Our medium term outlook for UK property has not changed materially over the past quarter. We continue to have concerns about the absolute level of pricing in the property segments that have recently seen the greatest buying activity, though we fully recognise that property's income advantage and prospect of a stable return profile are compelling.

Two of the key trends that dominated last year should continue into 2018: well-located core real estate will be sought by discerning tenants but difficult to acquire while secondary real estate will struggle to resonate and be difficult to sell. At an aggregate level this should mean that rental growth will moderate and yields soften gradually. This combination will result in capital values being broadly flat, giving a base case All Property total return in the 4.5-5% p.a. range. Politics is the greatest risk to the UK, both to the upside and downside. A swift decision on a probable Brexit transition period would energise a late cycle property market. Conversely, another snap election and resultant emboldening of the current opposition party could abruptly bring what has been an effervescent market to a screeching halt.

# 3. STRATEGY

| | |
|---|---|
| Size | ▪ Target portfolio size £325m – split £270m conventianal portfolio and £55m new allocation. Currently £277.2m.<br>▪ New allocation for 2% of Dorset's overall portfolio, which equates to approximately £55m to target properties with secure long income streams. |
| Performance | ▪ Coventional portfolio: To achieve a return on assets at least equal to the average IPD Quarterly Universe Portfolio Return including Transactions and Developments for a rolling five year period commencing 1 January 2006.<br>▪ New allocation: **Benchmark to be confirmed.** |
| Income yield | ▪ Maintain the portfolio income yield at a higher level than the IPD index net initial yield.<br>▪ Continue to focus on maintaining a low void rate and a resilient income yield.<br>▪ Ensure held properties / new acquisitions have strong rental growth prospects, long leases and an element of indexation. |

## ALLOCATION

| | |
|---|---|
| Property type | ▪ Conventional portfolio: Remain diversified while seeking to increase the average lot size and tenancy size via sales and purchases target core property holdings in good locations with a proportion of exposure to properties that will allow active management to generate outperformance.<br>▪ We anticipate maintaining a total of between 25 and 30 assets with an average lot size of between £8m and £10m.<br>▪ Invest indirectly to gain exposure to sectors or lot sizes that the fund would be unable to achieve through direct investment e.g Shopping Centres.<br>▪ New allocation: Targeting lot sizes between £3m and £20m with an average lease length in excess of 15 years with approximately 70% of the portfolio having index linked rent reviews. |
| Geographic allocation | ▪ Diversified by location but with a bias towards London and the South East. |
| Sector allocation | ▪ Diversified by sector with a maximum of 50% in any single sector.<br>▪ Target a lower than average weighting to Offices and Retail and a higher than average weighting to Industrial and Other commercial.<br>▪ Source suitable SLI* investments that could be available in any sector. |

*SLI stands for Secure Long Income property. SLI property generates long-term predictable cash-flows. It is characterised by long lease lengths (15+ years) often with a link to a reference rate (RPI).

## OTHER RESTRICTIONS AND GUIDELINES

| | |
|---|---|
| Investment size | ▪ Target a maximum of 10% in any single asset |
| Tenants | ▪ Maximum rent from any single tenant 10% of rental exposure.<br>▪ Target financial strength better than the benchmark. |
| Lease length portfolio | ▪ Target new assets where the lease expiry profile fits with the existing profile of the fund.<br>▪ Seek to maintain expiries in any one year below 10% of the fund's lease income.<br>▪ Target an average unexpired lease term in excess of the benchmark. |
| Development | ▪ Development may be undertaken where the major risks can be mitigated and the risk/reward profile is sufficient to justify it. |
| Debt | ▪ Avoid debt exposure. |
| Environmental and Social Governance ("ESG") | ▪ Energy performance: to improve EPC ratings where it is financially viable and, where applicable, apply for certification. |

# 4. PORTFOLIO OVERVIEW

| | | |
|---|---|---|
| UK direct* | £237.1m | 86% |
| UK indirect** | £40.0m | 14% |
| Total value of portfolio | £277.2m | 100% |

*See Appendix 3 for full property list and performance over the quarter by asset
**See Appendix 2 for more information on the indirect performance over the quarter.

## RISK CONTROL MEASURES

| | Fund (Direct property only) | Aim |
|---|---|---|
| Number of assets | 25 | 25-30 |
| Number of tenancies | 80 with a further 1 unit void | 70-100 |
| Net initial yield | 4.6% p.a. | Above benchmark |
| Vacancy rate (% of rent) | 1.9% | Below benchmark |
| Rent with +10 years remaining | 18.1% of total rent | Minimum 20% of total rent |
| Rent with +15 years remaining | 7.2% of total rent | Minimum 10% of total rent |
| Largest property (% of direct value) | 9.9% (Woolborough Lane IE, Crawley ) | Below 10% |
| Largest tenant (% of direct rent) | 9.2% (ACI Worldwide EMEA Ltd, Watford) | Below 10% |
| Tenure (Freehold/Leasehold) | 81% / 19% | Minimum 70% freeholds |

## PROPERTY / TENANT DIVERSIFICATION

**AIM – Maintain a diversified tenant base with individual tenancies providing rent rolls in excess of £25,000 pa.**

The portfolio is currently well diversified with a range of tenants and a well balanced rental income stream.

ACTION:
To maintain a diversified tenant mix.

## NET INITIAL YIELD

**AIM – Maintain a net initial yield above the benchmark.**

The IPD Quarterly Universe net initial yield is 4.7% as at Q4 2017. The portfolio net initial yield as measured by IPD is currently 4.6%. The portfolio yield has reduced during the year due to stronger market conditions and the acquisition of a lower yielding property. The transactions have added to the quality of the income stream from the portfolio.

**ACTION**

The portfolio's initial yield is currently 10 basis points below the Benchmark IPD Quarterly Universe. In order to reduce the yield gap our focus is to enhance the portfolio income by:

1. letting vacant space;
2. pursuing lease renewals with existing tenants at the earliest opportunity;
3. settling rent reviews where there are outstanding reversions;
4. closely monitoring non recoverable expenditure.

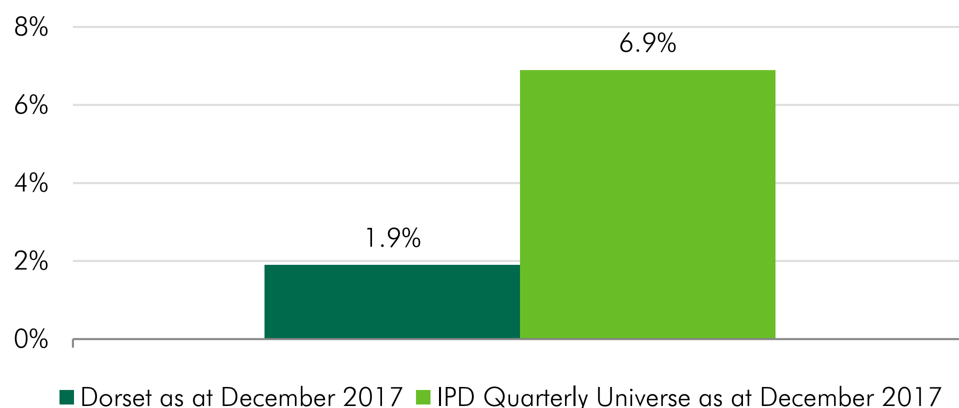
| | Portfolio | IPD Quarterly Universe |
|---|---|---|
| Initial yield p.a. | 4.6% | 4.7% |
| Equivalent yield p.a. | 5.9% | 5.6% |
| Income return over quarter | 1.1% | 1.1% |

## VACANCY RATE

**AIM – maintain a low void rate through letting vacant space and mitigating future expiry risks.**

The vacancy rate reduced to 1.9% from 5.4% during the quarter, following the letting of a unit at the retail park in Norwich and the sale of the vacant industrial property on Great Suffolk Street. The vacancy rate comprises two floors at the office property in Aberdeen. The vacancy rate remains well below the market average (6.9%).

Figure 5 Vacancy Rate




**ACTION**

Seek to let vacant space through using best in class letting agents and proactively manage upcoming lease expiries (see Appendix 1 for the list of void properties).

## LEASE LENGTH AND EXPIRY PROFILE

**AIM – To maintain a well diversified lease expiry profile and keep the portfolio's average lease length in excess of the benchmark lease length.**

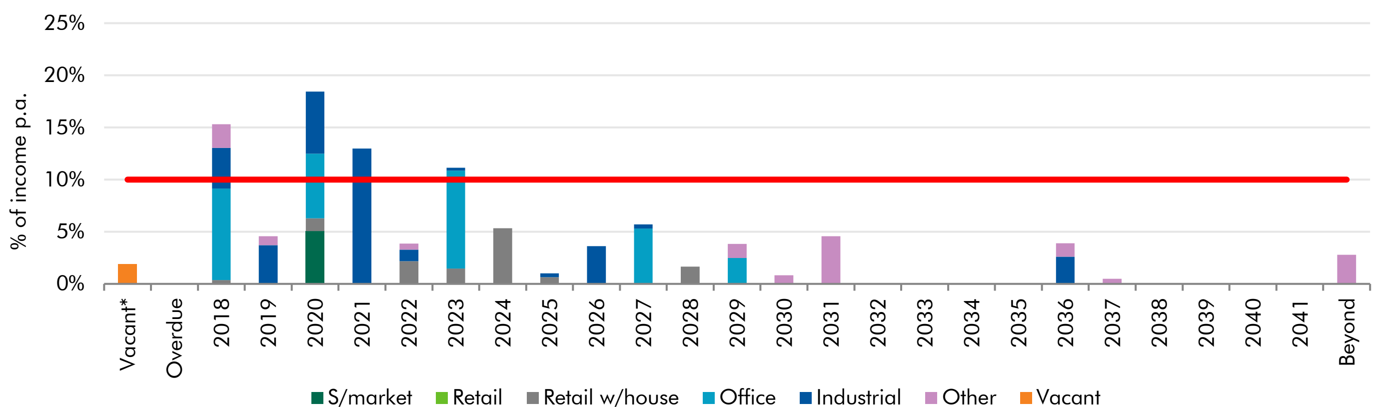
### UNEXPIRED LEASE TERM, YEARS

| | PAS assumption* | Incl All Breaks | Excl. all breaks |
|---|---|---|---|
| Fund | 8.9 | 8.3 | 8.9 |
| Benchmark | 12.6 | 11.7 | 13.0 |

*Breaks are assumed to be executed if the lease is overrented and the break is at the option of the tenant or mutual. The figures exclude indirect assets. The new Park Plaza hotel indirect asset, if included, would increase the average unexpired lease term of the portfolio to over 14 years.

The average lease length of the Fund using the PAS assumption is in a reasonable position relative to the Benchmark. The main risk is the 2020 expiry spike. We are already talking to the majority of tenants with leases that expire that year. Neogtiations continue with Tesco to agree a new lease on their unit in Sheffield. Their existing lease expires in October 2020 but we are in the process of agreeing a lease of fifteen years starting in 2020. This represents 5.1% out of the 18.4% of income currently expiring in 2020. Terms have also been agreed with Majestic Wine and UK Bathroom Village to extend their leases which also expire in 2020.

Figure 6 Lease Expiry Profile




*Vacancy expressed as percentage of ERV

**ACTION**

Seek to extend the average lease length through the active management of lease events in the portfolio. Aim to establish a "dumbbell" shaped expiry profile to allow short term asset management to be balanced by long term secure income.

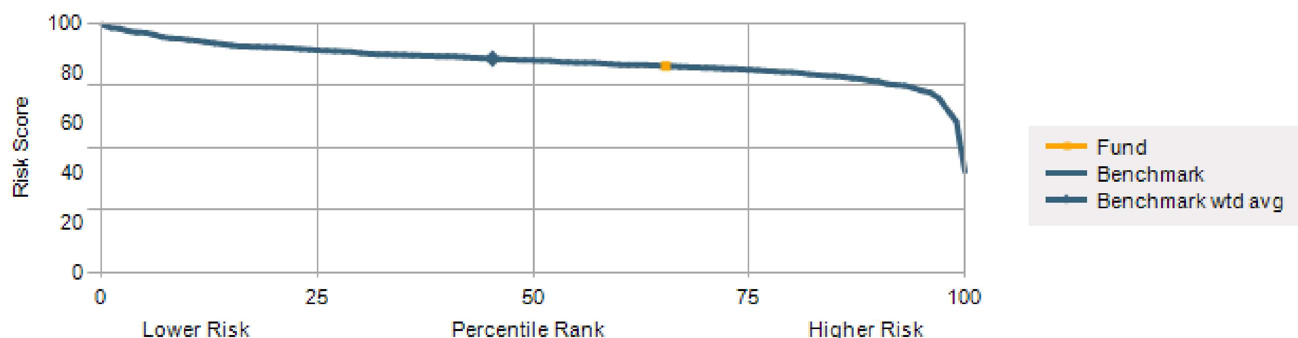
With the inclusion of Waterloo in the graph the proportion of income expiring beyond 2041 increases to 5.9%.

## TENANT FINANCIAL STRENGTH

**AIM – maintain covenant strength better than the benchmark**

The graph overleaf compares the covenant risk score of the portfolio compared to the Benchmark as at 31 December 2017. The Fund is now in the mid quartile with a Weighted Risk Score on the 65th percentile and is now behind the benchmark (45.3) demonstrating that the covenant risk of the portfolio is marginally above the average benchmark risk. IPD IRIS risk weightings are as at December 2017.

Figure 7 Ranking Of Weighted Risk Score




ACTION
Seek to improve the covenant risk profile of the portfolio through letting activity and ensuring tenants are properly classified by IPD.

## INCOME AND LEASE TYPE

**AIM – maintain the weighting to SLI* income within the conventional portfolio in excess of 15% of that portfolios income.**

**Open market income** – this is the standard rent review structure for UK direct property leases and makes up the majority of the portfolio income. It generally involves a five yearly open market rent review, which is upwards only.

***SLI income** – defined as properties let on long leases, usually with inflation-linked rent review structures and those which have defined uplifts (fixed increases) periodically. This type of income is effective in generating a consistent real return.

The portfolio meets this target. At 17% the SLI component of the income means a good proportion of the portfolio provides some form of index linkage. This has increased from 14% with the inclusion of the income from Park Plaza, Waterloo.

| % of DIRECT portfolio income | Q4 2017 |
|---|---|
| Open market income | 86% |
| RPI/Index linked income | 14% |

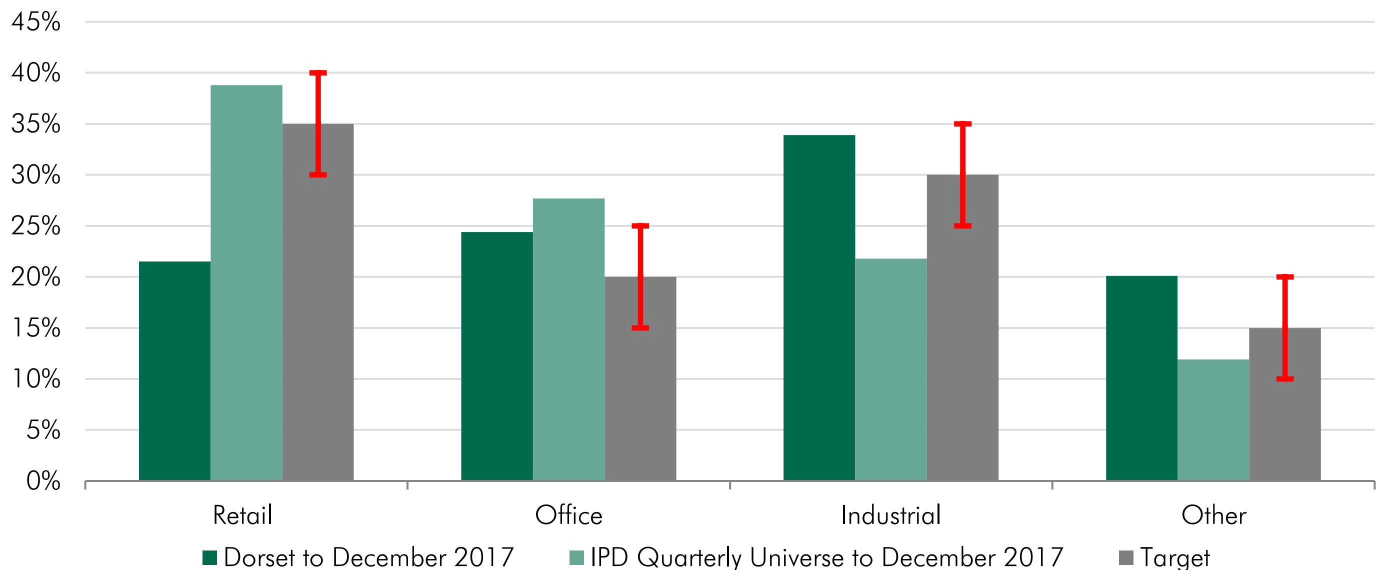
| % of TOTAL portfolio income | Q4 2017 |
|---|---|
| Open market income | 83% |
| RPI/Index linked income | 17% |

ACTION
Continue to monitor SLI ratio to Open Market income when considering purchases or sales.

## SECTOR AND GEOGRAPHICAL STRUCTURE

**AIM – to maintain a well diversified portfolio as part of our overall risk management strategy.**

Figure 8 Portfolio Sector Weightings




The portfolio sector weightings are displayed above in comparison to the benchmark with a target range depicted in red in line with houseview recommendations. The portfolio sector split has continued to be beneficial with the low retail weighting and below benchmark weighting to offices, given that overall these two sectors have been the poorest performing sectors over the past 12 months. Over the longer term proceeds of sales from the office sector may be redistributed into retail, industrial or the other sector. The geographical split as shown on page 1 is well diversified at present. There is a large London and South East weighting which has particularly aided performance over the last year. There is also a large Eastern weighting; Cambridge falls into this region albeit it has historically performed more like the South East market and is therefore considered a positive risk when compared to the Index.

**ACTION**
Ensure that purchases and sales maintain the geographical and sector diversity within the portfolio having due regard to the current point in the economic cycle.

## DEVELOPMENT

**AIM – to maintain a development exposure below 10% of the value of the portfolio.**

There is currently no speculative development ongoing within the portfolio. The development at Cambridge Science Park progressed during Q4 with no major issues. The decked car park has been completed and the ground works for the new office building are ongoing. The identified ground contamination which was the major outstanding project risk was no worse than anticipated. The building is on currently on budget and on program.

**ACTION**
Development may be undertaken where the major risks can be mitigated and the risk/reward profile is sufficient to justify it having due regard to local supply/demand dynamics and the point in the economic cycle.

# 5. UK DIRECT PORTFOLIO ACTIVITY

Below are examples of key asset management activity within the Fund over the last quarter:

| Address | Woolborough Lane Industrial Estate, Crawley |
|---|---|
| Sector | Industrial |
| Valuation Q4 2017 | £23.4m |

- During the quarter, we completed a rent review at Unit B with Varian Medical Systems UK Ltd at £148,000 p.a. (£9.55 psf) with effect from 24th June 2017.
- The review reflects rental growth of 36.3% over the previous rent of £7.00 psf.
- Rental growth and significant investor demand for industrial drove performance over the quarter, with this asset being the porfolio's top performer. It provided a weighted contribution of 0.5% to overall fund performance and recorded a total return of 9.8%.

| Address | Cathedral Retail Park, Norwich |
|---|---|
| Sector | Retail Warehouse |
| Valuation Q4 2017 | £15.3m |

- During the quarter, we completed the letting of Unit C to Peacocks Stores Ltd for a ten year term with a tenant break on the 5th anniversary of the start date at £170,000 p.a. (£19.00 psf). This rent is 6.6% higher than the previous tenant was paying (£17.82 psf).
- Toys R Us, who occupy Unit A, completed a CVA over the quarter to help restructure their business in the face of fierce competition from the internet. They would like to downsize their unit at the property, but for a considerably lower rent. We are marketing the unit to ensure we get the best terms and have received good interest from operators such as Decathlon and Pounstretcher for a split of the unit.
- While the property did not perform well over the quarter (total return of -3.0%), dragged down by the CVA at Toys R Us, there is an opportunity to secure stronger tenants for the unit which would provide a more robust base for performance in the future.

# 6. TRANSACTIONS

## TRANSACTIONS COMPLETED DURING THE QUARTER

### PURCHASES

| Address | 401-409 Oldifeld Lane, Greenford, London |
|---|---|
| Sector | Industrial |
| Purchase price | £8.4m |
| Conventional / SLI | Conventional |

- During the quarter, we completed the purchase of 401-409 Oldfield Lane, Greenford, Greater London for £8.4m which reflects a net initial yield of 3.9% and reversionary yield of 5.5%.
- This industrial Estate comprises four units extending to 38,367 sq ft let to three tenants at rents equating to between £8.90 psf and £9.50 psf. The current Market Rents of the units are between £12,50 and £13.50 psf.
- The site extends to 1.4 acres and is adjacent to the Grand Union Canal. It is opposite a new 2,000 residential unit scheme being built by Greystar.

### SALES

| Address | 131 Great Suffolk Street, London SE1 |
|---|---|
| Sector | Industrial |
| Sale price | £4.95m |
| Conventional / SLI | Conventional |

- During the quarter, we completed the sale of 131 Great Sufflolk Street, London SE1.
- The property was purchased in 2014 for £2.35m as a short term hold because we believed it was undervalued.
- The industrial unit extends to 8,000 sq ft over two floors and was formerly occupied by a printers. It was vacated in April 2017.
- The property was sold for £4.95m, which reflects £619 psf.
- The sale price was 111% above the purchase price and the property was income producing between acquisition and April 2017.

## STAIRCASINGS FROM THE DERWENT PORTFOLIO OVER THE QUARTER

| | |
|---|---|
| Address | 21 Alexandra Mill, Derby |
| Sector | Residential – Derwent Portfolio |
| Transaction | Full Staircasing of a 2 bed flat |
| Dorset's Purchase Price* | £34,217 (gross of all fees) |
| Net Dorset Sale Receipt* | £40,231 |

*The values reported are for the Fund's 50% share.

| | |
|---|---|
| Address | 18 Crystal Close, Derby |
| Sector | Residential – Derwent Portfolio |
| Transaction | Full Staircasing of a 3 bed house |
| Dorset's Purchase Price* | £30,415 (gross of all fees) |
| Net Dorset Sale Receipt* | £83,463 |

*The values reported are for the Fund's 50% share.

| | |
|---|---|
| Address | 25 Spinneybrook Way, Derby |
| Sector | Residential – Derwent Portfolio |
| Transaction | Full Staircasing of a 3 bed semi |
| Dorset's Purchase Price* | £60,830 (gross of all fees) |
| Net Dorset Sale Receipt* | £83,463 |

*The values reported are for the Fund's 50% share.

# TRANSACTIONS COMPLETED POST QUARTER END

## PURCHASES

| | |
|---|---|
| Address | 4 public houses and 1 restaurant in Central London |
| Sector | Other/ public house |
| Purchase price | £14.55m |
| Conventional / SLI | SLI |

- Since the end of the quarter, we have completed the purchase of 4 public houses and a restaurant in affluent Central London locations for £14.55m which reflects a net initial yield of 3.4% and reversionary yield of 3.7%.
- The properties are all held on leases of 17 years or more with Open Market rent reviews to good covenants such as Ei Group Plc. The restaurant (Casa Cruz) has reviews to the higher of OMRV and RPI capped at 3.5% p.a., with a collar of 1.5% p.a.
- The assets are expected to be long term holds for the portfolio to take advantage of the strength of demand for well located London pubs and their historic inflation tracking rental characteristics which is expected to continue in the future.
- The purchase prices are supported by both vacant possession pub values and residential alternative use values.
- The assets provide portfolio diversification in a different SLI sector. We believe they are an ideal fit for the new SLI allocation.
- The five properties are:-
  1. Builders Arms, Chelsea: £4.37m/ 3.2% NIY - 18 yrs to Ei Group Plc;
  2. Elgin Bar & Grill, Maida Vale: £2.85m/ 3.5% NIY – 18 yrs to Urban Leisure (AGA Ei Groupl Plc);
  3. Red Lion, St James: £2.8m/ 3.0% NIY – 18 yrs to Ei Group Plc;
  4. Uxbridge Arms, Notting Hill: £2.45m/ 3.8% NIY – 18 yrs to Ei Group Plc;
  5. Casa Cruz, Holland Park: £2.08m/ 3.9% NIY – 17 yrs to Casa Cruz London Ltd.

# TRANSACTION PLAN

### The key objectives are as follows:-

- Maintain exposure to quality assets with a suitable risk profile across all sectors. Our focus is to ensure that the portfolio remains in a strong position to capture rental growth.
- During the quarter, the Fund completed the purchase of the industrial estate in Greenford, Greater London for £8.4m.
- The sale of 131 Great Suffolk Street, London SE1 also completed during the quarter. This asset was purchased as a relatively short term hold in 2014. The asset was marketed for offers in excess of £4.5m and achieved a final sale price of £4.95m.
- Since the end of the quarter, we have completed the purchase of 4 public houses and a restaurant in Central London for £14.55m. The investment characteristics are ideal for the new SLI allocation.
- We are monitoring further opportunities for the new allocation, approximately £40m remains following the purchase of the pub portfolio.
- We continue to monitor the two shopping centre indirect holdings. Lend Lease is expected to wind down during 2018, with Bluewater, which represents approximately two thirds of the holding, under offer for sale. It is not however our intention to fully divest from shopping centre indirect exposure as we will retain the holding in Standard Life. See Appendix 2 for further information about the indirect holdings.

# TRANSACTIONS UNDER OFFER

## PURCHASES

| Address | M&S, Archway, London N19 |
|---|---|
| Sector | Industrial |
| Purchase price | £7.85m |
| Conventional / SLI | SLI |

- We have agreed terms to buy a Marks & Spencer food store next to Archway underground station in North London for £7.85m which reflects a net initial yield of 4.2% on a forward commitment basis.
- The Agreement for Lease with M&S is due to exchange shortly and we do not intend to begin incurring costs until it has exchanged.
- The unit totals approximately 9,500 sq ft of ground floor retail and the fund will acquire a 999 year long leasehold interest. The developer has converted the upper parts to 150 luxury apartments which are selling for around £1,000 psf.
- The property will be let to M&S (upon completion of Landlord redevelopment works) on a 20 year lease with tenant break in year 15 expected to be from July 2018 at a starting rent of £350,000 p.a. (£37 psf). The lease will have 5 yearly rent reviews compounded annually, linked to RPI 1-4% p.a.
- The property has many of the characteristics we look for when acquiring retail and SLI investments. The unit is well configured and located in an affluent catchment, positioned by the entrance to a London Underground station, close to a hospital and in an area with limited competing supply.

# 7. UK DIRECT PERFORMANCE

## PERFORMANCE OBJECTIVE

The target is to achieve a return on Assets at least equal to the average IPD Quarterly Universe Portfolio Return including Transactions and Developments for a rolling five year period commencing 1 January 2006.

| Q4 2017 | Portfolio | Benchmark | Relative |
|---|---|---|---|
| Capital growth | 1.6% | 1.7% | -0.1% |
| Income return | 1.1% | 1.1% | 0.0% |
| Total return | 2.7% | 2.9% | -0.1% |

Source: CBREGI and IPD Quarterly Benchmark Report

The portfolio underperformed over the last three months, with a total return of 2.7% against the Benchmark return of 2.9%. The underperformance was the result of the indirect holdings which produced a total return of just 0.9% over the quarter and the impact of transaction costs. The direct portfolio outperformed by 0.2% with a total return of 3.1%. The direct standing investments (properties held throughout the year, ignoring transactions) were stronger still with 3.4% over the quarter, 0.5% ahead of the Benchmark.

The portfolio's industrials continued to be the best performing assets, with a total return of 6.4% over the quarter, which was 0.4% higher than the industrials in the IPD Quarterly Universe. As we stated in the market commentary, in many parts of the country rents have been increasing at their fastest rate since the 1990s and yields have compressed as investors have increased their expectations of future growth. The strongest individual asset was the estate in Crawley, which recorded a total return of 9.8% over the quarter driven by capital growth of 8.6%. Find more details in the Asset Management section on page 12.

| 12 months to Q4 2017 | Portfolio | Benchmark | Relative |
|---|---|---|---|
| Capital growth | 5.7% | 5.4% | 0.2% |
| Income return | 4.8% | 4.6% | 0.1% |
| Total return | 10.7% | 10.3% | 0.4% |

Source: CBREGI and IPD Quarterly Benchmark Report

| 3 yrs to Q4 2017 | Portfolio | Benchmark | Relative |
|---|---|---|---|
| Capital growth | 4.3% | 4.1% | 0.2% |
| Income return | 5.0% | 4.7% | 0.3% |
| Total return | 9.5% | 9.0% | 0.4% |

Source: CBREGI and IPD Quarterly Benchmark Report

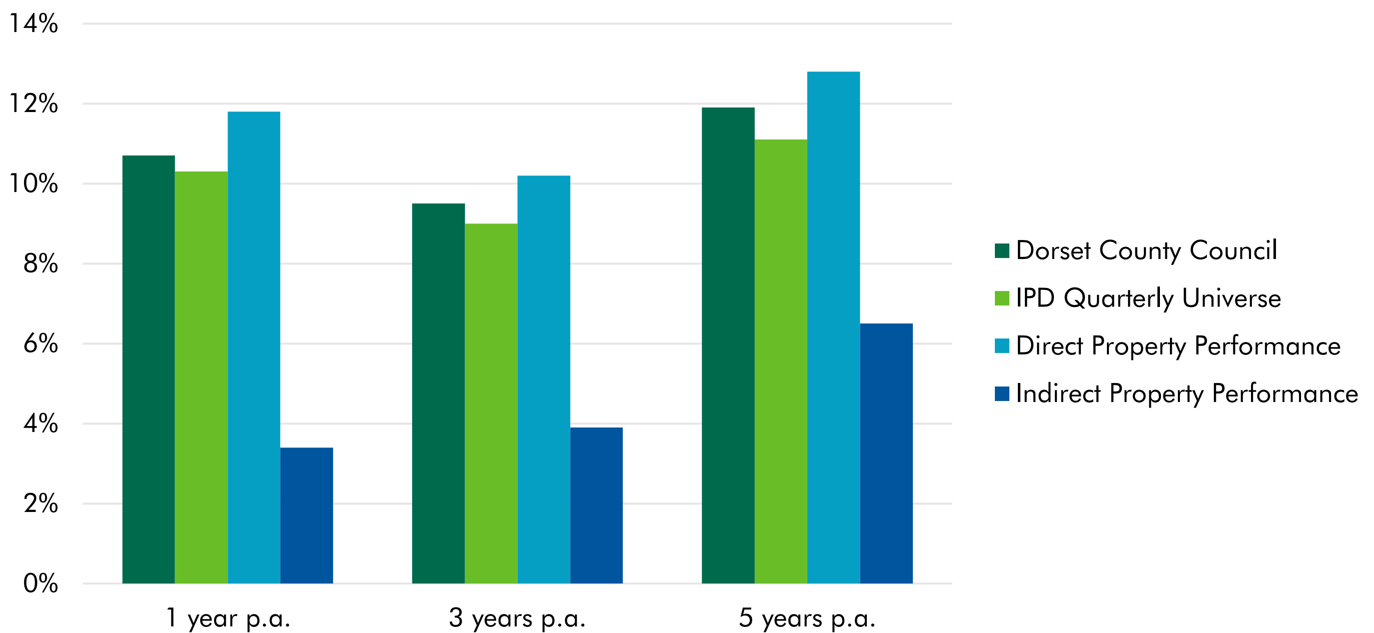
| 5 yrs to Q4 2017 | Portfolio | Benchmark | Relative |
|---|---|---|---|
| Capital growth | 6.1% | 5.8% | 0.3% |
| Income return | 5.5% | 5.0% | 0.5% |
| Total return | 11.9% | 11.1% | 0.8% |

Source: CBREGI and IPD Quarterly Benchmark Report

The portfolio is outperforming over 1, 3 and 5 year periods. Performance has been driven by both the strong income return and capital growth over the longer time periods. The longer term performance is of particular note given the amount of acquisition activity over this time frame. The figures also demonstrate the advantage over the longer term of running a higher income strategy, provided the quality of the properties within the portfolio is maintained.

## ROLLING PERFORMANCE FIGURES

Figure 9 Annualised Total Return Rolling Performance




The portfolio is outperforming over 1, 3 and 5 year rolling periods. This chart includes all benchmarked assets, therefore comprising all direct and indirectly held assets during each time horizon. The direct property performance has continued to outperform the benchmark over the rolling timeframes shown above. The indirect property performance has been weaker than the direct holdings across the timeframes shown. The indirect property holdings owned over these timeframes comprise Shopping Centre exposure; the assests in these vehicles are generally very prime and provide access to a market that we would not purchase directly for a Fund of this size given their scale. The portfolio's indirect holdings are considered to be defensive within the portfolio in the event of a weaker economic climate.

The Fund continues to achieve its key objective on the five year rolling performance measure.

# 8. ACCOUNTING AND ADMINISTRATION

## RENT COLLECTION AND ARREARS

The three measures listed below; the arrears level, speed of rent collection and service charge account closure position, are designed to be "litmus" tests showing the health of the accounting and administration of the portfolio.

The targets are designed to be demanding, however, we would expect to hit GREEN a large proportion of the time.

### ARREARS LEVEL (RENT, SERVICE CHARGE, INSURANCE OVER THREE MONTS OLD)

| Target | | | |
|---|---|---|---|
| GREEN | Max. £25,000, no single item over £10,000 | | |
| AMBER | Max. £75,000 | | |
| RED | Above £75,000 | | |
| RESULT | 31 December 2017 | GREEN | £4,022.83* |
| | 30 September 2017 | RED | £161,035.34 |
| | 30 June 2017 | RED | £138,472.92 |
| | 31 March 2017 | RED | £131,467.29 |

* This follows the write off of Charlotte House arrears during Q4.

### SPEED OF RENT COLLECTION

| Target | | | |
|---|---|---|---|
| GREEN | 90% of collectable rent banked by 6th working day after the quarter day, 95% by 15th working day | | |
| AMBER | 80% by 6th working day, 90% by 15th | | |
| RED | Worse than Amber | | |
| RESULT | 31 December 2016 | GREEN | (93.9% collected in 6 days, 94.7% by 15th day) |
| | 30 September 2017 | GREEN | (99.3% collected in 6 days, 99.3% by 15th day) |
| | 30 June 2017 | GREEN | (95.5% collected by 6 days, 98.7% by 15th day) |
| | 31 March 2017 | GREEN | (99.3% collected by 6 days, 98.0% by 15th day) |

### SERVICE CHARGES – ACCOUNT CLOSURE POSITION

| Target | |
|---|---|
| GREEN | all service charge accounts closed within 3 months of the year end |
| RED | any account not closed |
| | |
| RESULT | GREEN |

# 9. SUSTAINABILITY

The ESG Risk Mitigation Programme has been designed to address the risk presented by the Energy Act 2011 which stipulates that from 2018, it will be prohibited to lease a building with poor energy performance.

**Figure 10 Change in level of risk across all units (left) and value (right) within the Fund**

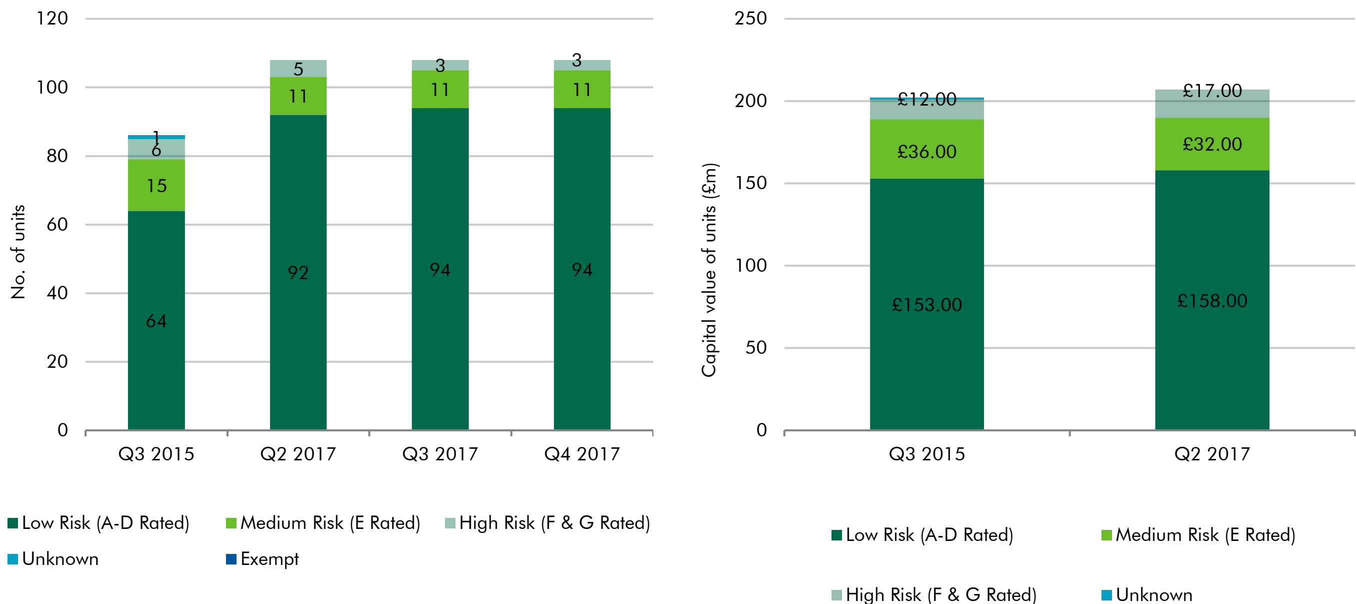


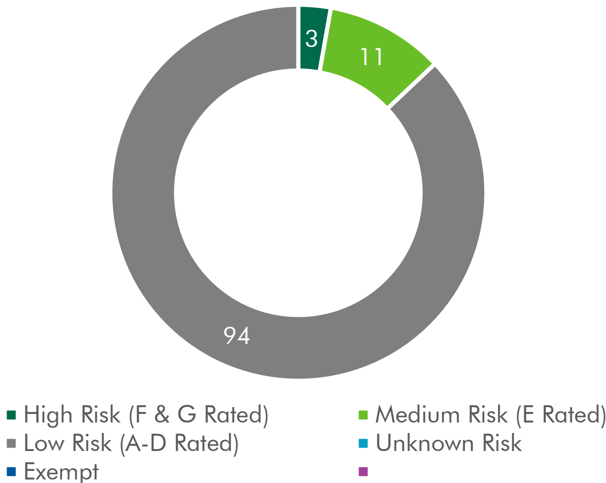

Figure 10: Change in level of risk across all units (left) and value (right) within the fund; Valuation data is updated annually in Q1.

## COMPLETED PROJECTS: Q4 2017

| Size | Unit | Action | Outcome |
|---|---|---|---|
| **All** | All | Tenant engagement | Identified priority sites and tenants to engage with over the next 6 months to increase energy efficiency in the selected properties. |
| **Refurbishment and Fit Out Guide** | All | Launch of our new Refurbishment and Fit Out guide | Guide to be implemented on all refurbishments and fit outs moving forward. Fund target to be agreed |

# ACTIONS FOR MITIGATING RISK ACROSS THE PORTFOLIO

Figure 11 Strategy For Risk Mitigation For Remaining Medium And High Risk Units




| Action plan for Medium / High Risk units | Number of units |
|---|---|
| Carry out high quality EPC | 1 |
| Scottish properties | 2 |
| Tenant engagement | 10 |
| Monitor – potential sale | 0 |
| Consult on current works | 1 |

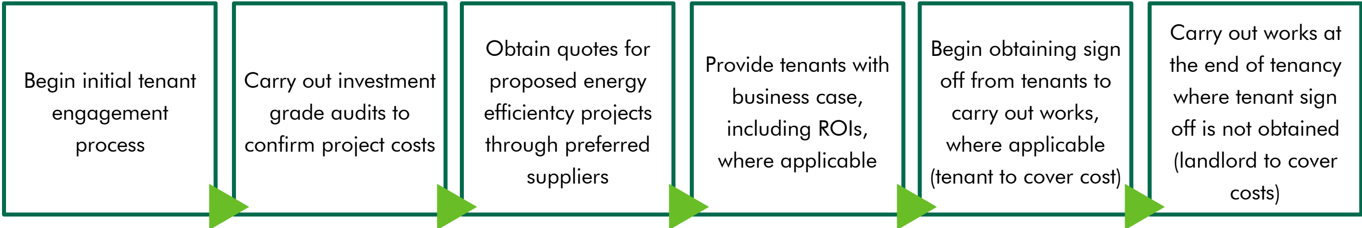
Figure 11 outlines the actions that have been identified to improve the EPC ratings of all units with E, F, or G ratings. Managed risk refers to all units that will be upgraded at the end of current tenancies, prior to the legislation taking effect.

# RISK MITIGATION PROCESS

Where possible, tenants will be engaged to help spread the cost of investment and mitigate risk.

Figure 12 illustrates the process that will be undertaken throughout the year to engage with tenants.

Figure 12 Process For Carrying Out Risk Mitigation Actions



# PLANNED PROJECTS: Q1 2018

| Size | Unit | Action | Outcome |
| --- | --- | --- | --- |
| Beckett Retail Park, Northampton | Unit 5 | EPC | Have an EPC carried out to confirm the risk rating of the unit. |
| South Bristol Trade Park, Bristol | Unit 3B | EPC | Have an EPC carried out to confirm the risk rating of the unit. |
| Various | Various | Reclassification of risk | 3 Units have been reclassified from high risk to managed risk. This is due to the lease length, sublet tenancy, etc. Ongoing efforts will still be made to engage with tenants and improve units. |
| Various | Various | EPCs | Confirmation of estimated low risk sites to ensure quality EPCs have been carried out for each unit within portfolio. |

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# APPENDIX 1

## SCHEDULE OF VACANCIES

| Property | Sq.ft. to let | % of Portfolio ERV | Total Void Rent | Status |
|---|---|---|---|---|
| Pilgrim House, Old Ford Road, Aberdeen | 8,863 | 1.9% | £276,100 | Continue to market |
| **TOTAL PORTFOLIO VOID** | | **1.9%** | **£276,100** | |

# APPENDIX 2

## INDIRECT PORTFOLIO

## PORTFOLIO COMPOSITION

The Dorset portfolio is invested in the following funds which as at 31 December 2017 had a value of £40.0 million.

The performance of the Dorset indirect portfolio was 1.1% over the last quarter and 3.7% over the last 12 months. This return is based on November 2017 prices. The table below reflects the valuations based on these reporting cut-off dates.

| Fund Name | Manager | Sector | LTV | Value (£m) |
|---|---|---|---|---|
| CBRE UK Long Income Property Club No.1 Unit Trust | CBRE Global Investors | Hotels | | 16,074 |
| Lend Lease Retail Partnership | Lend Lease | Shopping Centres | 2.3% | 9,295 |
| Standard Life UK Shopping Centre Trust | Standard Life | Shopping Centres | | 14,670 |
| **Total** | | | | **40.037** |

## INVESTMENT ACTIVITY

There was no investment activity over the quarter.

## COMMENTARY

The Dorset indirect property portfolio has three indirect holdings. These are specialist funds that provide the portfolio with exposure to the shopping centre sector and the hotel sector. The combined indirect investments have a value of £40 million. The Shopping Centre holdings have a combined 0.9% look-through exposure to gearing (excluding cash).

## LEND LEASE RETAIL PARTNERSHIP

Lend Lease Retail Partnership returned 0.0% over the quarter and -1.7% over the last year.

Over the last year, the value of the fund's 25% holding in the Bluewater shopping centre, Kent declined by 4.1%, while the value of the fund's second asset, Touchwood in Solihull declined by 6.5%, resulting in an overall 5% fall in fund NAV. The decline is reflective of the weak capital market interest for assets in the UK shopping centre sector and benign forecasts for retail growth in the UK.

At quarter end the fund had a net asset value of £785.2 million with the portfolio providing exposure to two shopping centres across the UK. The fund remains lowly ungeared and the portfolio has a weighted average unexpired lease term of 6.6 years, a void rate of 4.6% and 387 underlying tenants.

The manager has been pursuing a wind-down strategy since November 2017, with the fund's 25% interest in Bluewater shopping centre put on the market for sale. We understand negotiations with a prospective purchaser are at an advanced stage. We expect the sale to complete within H1 2018. The manager is also considering sale options for its 100% ownership of Touchwood SC, Solihull.

During the quarter, the manager progressed a number of management initiatives at the two schemes:

- At Bluewater, the manager completed/ exchanged on six new lettings, one lease renewal and three rent reviews. Additionally planning was granted to accommodate a new MSU unit for Primark where the works include combining six new units and an extension. Primark is expected to take occupation in January 2019 on a 20-year lease.

- At Touchwood five new lettings, three lease renewals and one rent review was completed/agreed. In anticipation of a sale, further discussions to bring in a new owner to deliver the proposed SC extension have taken place between the Manager and Solihull Metropolitan Borough Council.

The fund has low leverage of 2.4% and a distribution yield of 3.6% p.a. although distributions will now be withheld pending the repayment of a small debt facility.

## STANDARD LIFE UK SHOPPING CENTRE TRUST

Standard Life UK Shopping Centre Trust produced a total return of 1.8% over the quarter and 5.6% over the last 12 months.

Over the quarter, performance was driven by a marginal uplift in valuation and income distribution. The valuations of the fund's regionally dominant assets were up slightly over the year, whereas the values of the secondary assets such as Stirling and Enfield saw a downwards adjustment.

At quarter end the fund had a net asset value of £1.6 billion with the portfolio providing exposure to six shopping centres across the UK. The fund remains ungeared and the portfolio has a weighted average unexpired lease term of 7.8 years, a void rate of 4.3% and 600 underlying tenants. A number leases completed during the quarter, including:

- New lease to Zara and a lease re-gear with H Samuel at Churchill Square, Brighton.
- New lettings to Ernest Jones, Herbal Inn and Cath Kidson at Brent Cross, London. Further progress was made with pre-lettings to M&S and John Lewis Partnership at the proposed new extension.
- At Centre Court, Wimbledon, the fund completed a letting to Darwin & Wallace and a successful re-gearing of the lease to Boots.
- At Stirling, a new letting was agreed with Candy Plus, a rent review completed with River Island and a lease re-gear was agreed with WH Smith.

Regarding development opportunities, the fund is looking to retain a long-term exposure to both Brent Cross and Churchill Square, Brighton and to participate in the development of both assets. With regards to the extension at Brent Cross, further negotiations are ongoing with Fenwicks and heads of terms are being negotiated on a cinema pre-letting. In parallel, the manager is in discussions with two parties to progress a JV partnership to fund the extension works, requiring c. £1.0bn of capital over a four year period.

There were no acquisitions or sales over the quarter. However post quarter end, the fund completed the sale of Palace Gardens, Enfield for a price of £51.5m reflecting a net initial yield of 6.5%. This was identified as a weak asset in the portfolio and was sold below valuation. The fund currently has an available cash balance of £65.7m, which will be retained to finance capital expenditure across the portfolio.

## CBRE UK LONG INCOME PROPERTY CLUB NO.1 UNIT TRUST ('CBRE UK LIPC NO.1 UT')

As at 31 December 2017 Gerald Eve valued the property at £175.0m, which is unchanged from the end of Q3 valuation. The Unit Trust delivered an income return of 1.4% in Q4 2017 (including income collected in Q3, but distributed in Q4).

Since inception in July 2017, capital growth on the gross purchase price (including purchaser's costs) has been 2.2%. Allowing for income, CBRE UK LIPC No.1 UT has produced a nominal total return of 3.6% since inception.

| CBRE UK LIPC No.1 UT Performance – Q4 2017 * | Quarter ** | 12 Months | Three years (p.a.) | Five years (p.a.) | Since inceptin (p.a) |
|---|---|---|---|---|---|
| Total Return | 1.4% | - | - | - | 3.6% |
| Income Return | 1.4%** | - | - | - | 1.4% |
| Capital Growth | 0.0% | - | - | - | 2.2% |

** calculated by CBRE Global Investors, January 2018*
*** calculated on an accruals basis (N.B. distributed income equates to 0.6%)*

## HOTEL KEY PERFORMANCE INDICATORS

In 2017 the hotel's occupancy level averaged 88.8% and revenue generation from rooms exceeded Park Plaza's budget by 2.6%.

Despite trade being in build-up phase, occupancy has been better than the wider London hotel average, and revenue generation per available room ('RevPAR') has been in line with the market average.

| KPIs | Park Plaza, Waterloo | London Hotel Market |
|---|---|---|
| Occupancy | 88.8% | 81.9% |
| Average Daily Rate | £138 | £149 |
| RevPAR | £122 | £122 |

** Park Plaza, YTD December 2017*
*** STR Global, YTD October 2017*

# APPENDIX 3

## PORTFOLIO VALUATION

## Valuation Schedule (UK Property)
## Q4 2017

| Property Address | December 2017 | Qtr Total Return [1] | Annual Income | OMRV | Net Initial Yield [2] |
|---|---|---|---|---|---|
| **OFFICES** | | | | | |
| Aberdeen, Pilgrim House | £5,750,000 | -1.9% | £318,862 | £517,414 | 5.2% |
| Cambridge, The Eastings | £3,650,000 | 4.2% | £190,500 | £230,600 | 4.9% |
| Cambridge, 270 Science Park | £16,350,000 | 4.5% | £341,616 | £1,070,616 | 2.0% |
| London EC1, 83 Clerkenwell Rd | £17,700,000 | 1.2% | £836,000 | £1,034,000 | 4.4% |
| London N1, 15 Ebenezer St & 25 Provost St | £8,900,000 | 2.9% | £304,175 | £712,700 | 3.2% |
| Watford, Clarendon Road | £15,250,000 | 1.8% | £902,750 | £1,189,000 | 5.5% |
| **TOTAL OFFICES** | **£67,600,000** | **2.2%** | **£2,893,903** | **£4,754,330** | **4.2%** |
| **RETAIL WAREHOUSE** | | | | | |
| Northampton, Becket Retail Park | £6,650,000 | 3.2% | £431,000 | £429,700 | 6.1% |
| Norwich, Cathedral Retail Park | £15,250,000 | -3.0% | £914,500 | £1,076,700 | 5.6% |
| Rayleigh, Rayleigh Road | £3,625,000 | 1.5% | £222,783 | £222,783 | 5.8% |
| **TOTAL RETAIL WAREHOUSE** | **£25,525,000** | **-0.8%** | **£1,568,283** | **£1,729,183** | **6.2%** |
| **SUPERMARKET** | | | | | |
| Tesco, Sheffield | £10,350,000 | -0.8% | £680,000 | £680,000 | 6.0% |
| **TOTAL SUPERMARKET** | **£10,350,000** | **-0.8%** | **£680,000** | **£680,000** | **6.0%** |
| **INDUSTRIAL** | | | | | |
| Bristol, South Bristol Trade Park | £5,400,000 | 6.2% | £267,725 | £318,779 | 4.7% |
| Crawley, Woolborough IE | £23,400,000 | 9.8% | £957,357 | £1,358,400 | 3.8% |
| Croydon, 75/81, Sumner Road | £3,750,000 | 11.5% | £137,000 | £177,500 | 3.4% |
| Greenford, Oldfield Lane | £8,600,000 | -3.4% | £351,100 | £434,600 | 3.8% |
| Heathrow, Skylink | £5,100,000 | 1.6% | £125,478 | £256,300 | 2.3% |
| London, Phoenix Park, Apsley Way | £13,150,000 | 4.8% | £525,689 | £658,413 | 3.7% |
| London, Apsley Centre | £4,450,000 | 8.3% | £165,900 | £217,500 | 3.5% |
| Sunbury, Windmill Road | £12,500,000 | 5.6% | £659,750 | £735,650 | 4.9% |
| Swindon, Dunbeath Court | £5,200,000 | 5.6% | £312,716 | £339,800 | 5.6% |
| Swindon, Euroway IE | £12,400,000 | 3.0% | £803,422 | £817,935 | 6.1% |
| **TOTAL INDUSTRIAL** | **£93,950,000** | **5.2%** | **£4,306,137** | **£5,314,877** | **4.4%** |
| **OTHER** | | | | | |
| Derwent Shared Ownership | £10,640,000 | 3.6% | £376,880 | £376,988 | 3.5% |
| Glasgow, Mercedes | £11,000,000 | 6.3% | £614,002 | £566,600 | 5.3% |
| Leeds, The Calls | £7,500,000 | 1.6% | £487,724 | £487,950 | 6.1% |
| Macclesfield, Hope Park | £6,350,000 | 0.9% | £236,964 | £236,964 | 3.5% |
| Newcastle, Charlotte House | £4,200,000 | 0.2% | £115,178 | £304,800 | 2.6% |
| **TOTAL OTHER** | **£39,690,000** | **2.4%** | **£1,830,748** | **£1,973,302** | **4.4%** |
| **TOTAL DIRECT PROPERTY** | **£237,115,000** | **2.7%** | **£11,279,071** | **£14,451,692** | **4.5%** |
| **INDIRECT PROPERTY** 4 | | | | | |
| Lend Lease Retail Partnership | £9,294,540 | 0.0% | £300,666 | | |
| Standard Life Investments UK Shopping Centre Trust | £14,669,536 | 1.8% | £570,761 | | |
| CBRE UK Long Income Property Club No.1 Unit Trust | £16,073,119 | 0.6% | £408,850 | | |
| **TOTAL INDIRECT PROPERTY** | **£40,037,195** | **0.9%** | **£1,280,277** | | **3.2%** |
| **GRAND TOTAL** | **£277,152,195** | **2.7%** | **£12,559,348** | **£14,451,692** | |

Notes:

1. Total returns for both the direct and indirect properties for the quarter to December 2017 as reported by IPD (Direct Property Standing Investments). Indirect Funds Total returns for the quarter to December 2017 as reported by CBRE Global Investors (UK Funds) Ltd (CBREGIF) / CBRE Global Investors in respect of the indirect portfolio.
2. Net Initial Yields as reported by BNP Paribas and Allsop LLP (Independent Valuers for the Fund) in respect of the direct portfolio. Net Initial Yields as reported by CBRE Global Investors in respect of the indirect portfolio.
3. Valuation figures provided by CBRE Global Investors (UK Funds) Ltd (CBREGIF) are the November 2017 valuations; these are always marginally in arrears due to early reporting deadlines required by IPD.
4. Indirect income estimated from Q4 2017 actual figures.

# APPENDIX 4

## AFFILIATED SERVICES

| Property | Fee | Service |
|---|---|---|
| Crawley, Woolborough Lane | £2,195.87 | Rates reduction report |
| Portfolio | £1,850.00 | ESG – Q3 2017 |
| **Q4 2017 Total** | **£4,045.87** | |

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