DTZ INVESTORS

LEICESTERSHIRE CC
MARKET UPDATE

CONFIDENTIAL AND PROPRIETARY
SEPTEMBER 2023


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MARKET UPDATE

EXECUTIVE SUMMARY

1) The headwinds experienced across capital markets and the resulting outward movement in bond yields resulted in the **re-pricing of the real estate market, seen most markedly in Q4 2022**;

2) Uncertainty has persisted in the first half of 2023 as interest rates have risen further than previously forecast, as a result **capital values have moved out marginally** in the first half of the year.

3) Transactional volumes are subdued owing to wider economic uncertainty with fewer buyers, as well as sellers, active in the market;

4) Occupational markets are holding up better, in part due to limited new supply of stock;

5) We remain **cautious on pricing but see resilience across prime assets** with strong occupier fundamentals including **industrials** and convenience led retail across **retail warehousing** and **supermarket** sectors.

REAL ESTATE UPDATE

Commercial property performance was driven by income returns of 2.4% in H1 but offset by capital value falls of 1.8%. Capital returns were impacted over the quarter by uncertainty driven by persistent inflation and continued interest rate increases.

Market Performance H1-2023

- Commercial property performance was mildly positive in Q2, but was affected by June's 50bps base rate hike.
- Property yields moved out and capital values fell across most property sectors; the office sector saw the greatest fall of c.4% for Q2 2023.
- All property performance in H1 2023 was driven by an income return of 2.4% but offset by capital value falls of 1.8%.
- Total returns across the property segments were highly polarised in H1 2023, with sectors supported with a strong demand-supply imbalance and high yielding segments performing best (industrials, retail warehouses, leisure and shopping centres).
- Office segments recorded negative total returns in H1 as capital declines wiped out the positive gains received from income returns.

Investment Markets

- The higher cost of debt, the lack of activity across debt-backed buyers and reduced investor sentiment resulted in another quarter of subdued investment volumes.
- All property volumes totalled £7.4bn in Q2, which was 11% down on the previous quarter and 41% below the five-year quarterly average.
- The office sector was the main drag on Q2's figures with volumes of £2.0bn, 53% below average.
- Sectors underpinned by strong demand / supply dynamics (retail warehouses, industrials and some of the alternative segments) saw volumes improve between Q1 and Q2 but remained below the five year average.
- Looking ahead, the outlook for the investment market remains dependant on interest rates and inflation.

Economic / All Property Outlook

- The high inflationary environment will erode consumers' purchasing power reducing household spending, while higher interest rates are expected to discourage businesses from borrowing.
- These factors will dampen economic and occupier activity, causing the growth in All property rental values to slow over the remainder of this year.
- The base rate and gilt yields are expected to remain at elevated levels this year putting downward pressure on All property capital values in the short term.
- This will cause the All property equivalent yield to move out by 40bps this year, resulting in a 4% fall in capital values and total returns hovering at 0% for 2023.
- As inflation eases and interest rates and gilt yields moderate from 2024, yields should modestly compress which together with positive rental growth will push capital returns back into positive territory.

Source: MSCI, PMA, DTZ Investors

OCCUPIER MARKETS - RETAIL UPDATE

Retail footfall has improved, but confidence softened as persistent inflation and rising interest rates weighed on sentiment. The outlook for retail sales is expected to remain muted with demand driven by non-essential / convenience spend.

DEMAND

- Improved footfall across all retail segments.
- Softer consumer confidence and retail sales due to high inflation and rising interest rates.
- Outlook for retail sales to remain muted with spend; essential spend expected to surpass spend on discretionary goods.
- Retailer distress has reduced, with the number of CVA's administrations and closures down on last year.
- Retail openings on the rise following the rebasing of retail rents, with retailers considering all retail formats, but depth of demand remains limited.

SUPPLY

- Vacancy rates have moderated especially for retail parks at c.10% versus 15%+ for other segments.
- Development of new stores has dropped significantly with completions down over last 4 years; new supply has been limited to food stores.
- The re-purposing & reduction of retail space is ongoing, but the pace is likely to be slow (owing to construction and labour shortages and a lack of funding).

KEY RISKS

- Excess supply across the High Street
- E-commerce grows faster than expectations
- Increasing number of leases include turnover provisions
- Weaker household spending power

OUTLOOK

- Income return advantage
- Modest retail rental growth expected.
- Performance over the medium driven by income returns.
- Convenience retail (retail parks and foodstores) and high yielding retail segments forecast to perform best.

Source: PMA, DTZ Investors

OCCUPIER MARKETS - OFFICE UPDATE

The rise in hybrid-working and higher capital expenditure costs due to tighter ESG requirements will weigh on office performance. The sector has become increasingly two-tiered with the best in-class space that meets ESG requirements outperforming the rest.

DEMAND

- Central London office take up totalled 2.0 million sqft in Q2, 34% below the long-term average.
- Take-up across Big 9 regional markets remains subdued at 1.6 millon sqft in Q2, 4% lower than Q1's total and 19% down on the 10-year average.
- Demand is increasingly polarised; greatest demand for best-in-class space, higher quality, ESG compliant space.

SUPPLY

- Central London availability stood at 25.5 million sq ft at the end of Q2, which was above the 10-year average of 16.6 million sq ft. Second-hand space dominates Central London supply, accounting for 67% of availability at the end of Q2.
- Big Nine's total availability rate increased slightly this quarter to 8.5%, vacancy rates vary by market from a low of 5% and 10%.

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KEY RISKS

- Structural changes to demand due to the rise in hybrid working.
- Higher energy efficient standards will lead to increased obsolescence risk and capital expenditure requirements for landlords
- A two tiered office market is emerging; Grade A best in class ESG compliant assets vs those requiring repositioning.

OUTLOOK

- Weak outlook expected for all office segments as structural changes create uncertainty in occupier markets and increased capital expenditure costs reduces future returns.
- Office total returns expected to lag All Property Average
- Grade A stock will be the strongest performer in the sector while prices are expected to further moderate to reflect weaker occupational demand and capital expenditure requirements.

Source: PMA, CBRE, Avison Young, DTZ Investors

INDUSTRIAL UPDATE

Post pandemic demand has been impacted by high inflation and rising interest rates, but strong occupational fundamentals will support the sector leading to continued rental growth (albeit more moderate)

DEMAND

- Post-pandemic demand impacted by high inflation and rising interest rates, logistics take up was down 16% and standard industrial take up was down 18% over the quarter to Q2.
- Structural tailwinds should support future rental growth with e-commerce and the on-shoring / reshoring of occupiers inventory to improve supply chain resilience expected to support industrial demand and rental growth
- Increasing proportion of demand for certified BREEAM rated logistics space as occupiers become more selective in terms of energy efficient, quality stock.

SUPPLY

- Void rates have marginally increased across most markets but remain low against the long term average.
- Development of new stock has remained low across standard, multi-let industrial markets maintaining a favourable demand/supply balance.
- Speculative development has increased in the logistics markets.

KEY RISKS

- Rental affordability has become stretched owing to high levels of rental growth
- Tenant’s businesses exposed to inflationary pressures and rising operational costs.
- Weaker outlook for the global economy and the impact on supply chains.

OUTLOOK

- Strong occupier fundamentals will support continued rental growth, although at a more modest level.
- All industrial segments are expected to outperform the All Property average.
- Investment performance will be driven by continued rental growth and capital appreciation from 2024.

Source: PMA, Gerald Eve DTZ Investors

ESG IN REAL ESTATE

Occupier demand for certified space is increasing across the office and industrial sectors. The increased focus on prime space has widened the performance differential between the 'best in-class' stock and the rest.

Office

- Minimum EPC standards will rise to a C rating in 2027
- According to Savills, more than 70% of the office stock in London and the regions has a EPC rating of C or below.
- The cost to upgrade an office asset from today's standards to 2027's requirements is estimated to be £40psft+ on top of standard refurbishment costs.
- This cost can is more easily absorbed by a London asset, which attract higher rents and has a greater impact on the viability of regional offices where rents are lower.
- A two-tiered market is emerging owing to the impact of ESG performance and MEES compliance
- Since the end of 2020 capital value falls have been more severe on poorer quality, higher yielding office assets owing to the impact of elevated capital expenditure requirements.

Logistics

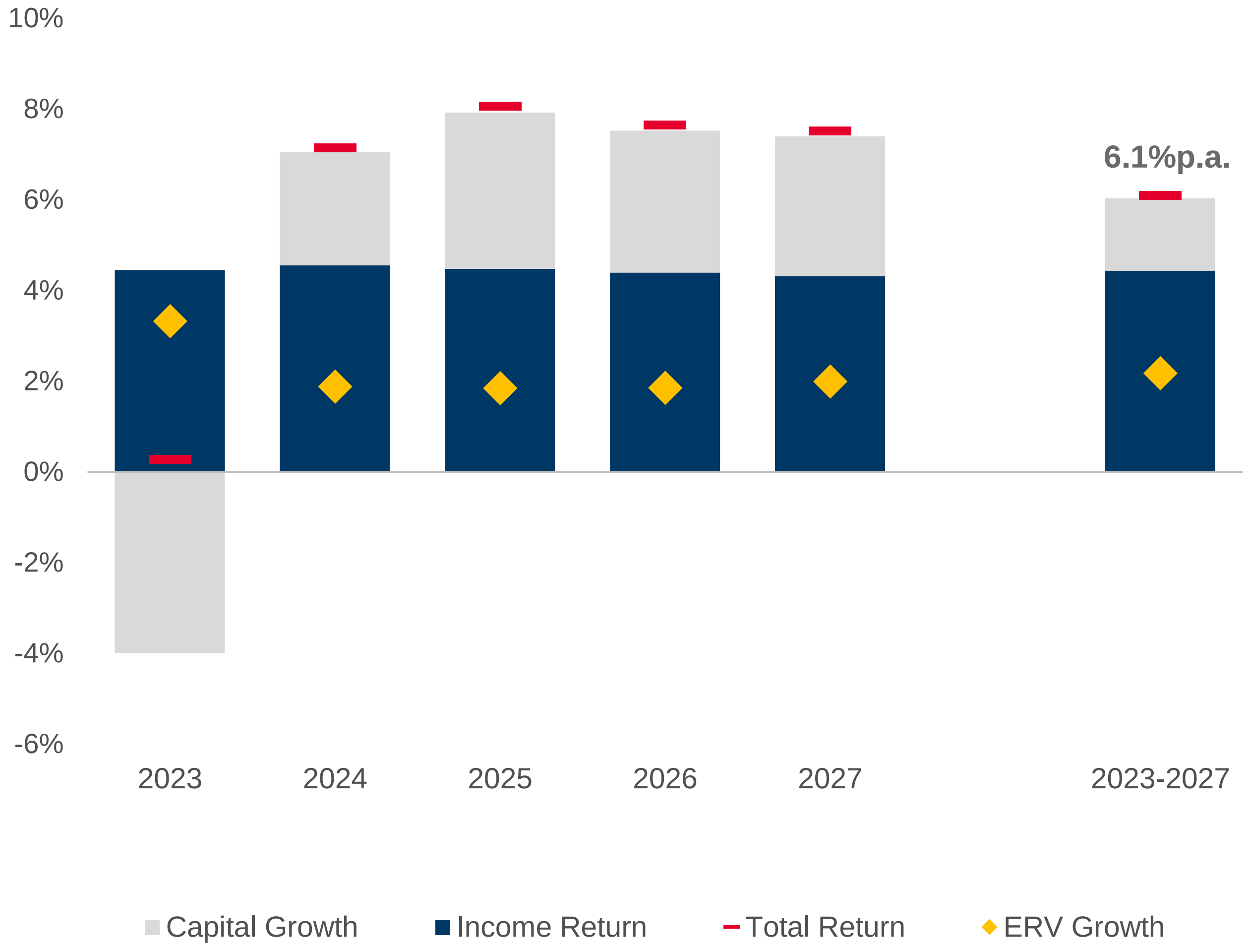
- The quantum of logistics stock with BREEAM credentials has increased from c.5% of all deals in 2010, to just under 60% of all deals in 2023.
- For Logistics units, occupiers have become more selective, opting for more efficient, prime stock over lower quality assets; in part to mitigate rising operational costs.
- According to PMA, half of all logistics take up was at the primer end of the market between 2010-2014, whereas the proportion of prime stock taken up between 2022-23 was 80%.
- The quality of stock is driving a differential in rental growth prospects; in 2020 rental values in the MSCI Quarterly Index increased by 12% and 25% for high and low yielding asset respectively.
- We expect this emphasis for higher quality stock and stronger performance on prime stock will continue, especially as legislative restrictions tighten and more occupiers look to their distribution networks as a way to offset the carbon footprint.

Source: Savills, MSCI, PMA, DTZ Investors

SEGMENT FORECASTS (2023-2027)

Segment performance will polarise over the next 5 years with industrials and retail parks performing best.

DTZ INVESTORS ALL PROPERTY FORECASTS %PA. (2023-2027)



INVESTMENTS THAT WILL PERFORM BEST OVER 2023-2027

SECTORS:

- Multi-let industrials and Logistics
- Retail warehousing, particularly those focused on convenience retail
- Supermarkets
- High Yielding retail segments (e.g. retail units in major towns)

FACTORS:

- BREEAM Excellence
- Prime, high quality assets
- Inflation protection
- Affordability

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Source: DTZI

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LGPS CENTRAL SUB FUND STRATEGY

LGPS CENTRAL SUB FUND REQUIREMENTS

The Sub Fund investment strategy has been developed based on clear objectives and key considerations

	1. ALLOCATION	2. INVESTMENT PERFORMANCE	3. ESG PERFORMANCE
Client's objective	**Phase 1:** Build and manage a £150m diversified commercial real estate portfolio. **Phase 2:** Medium term objective to grow to £500m through further acquisition.	Benchmark: MSCI Quarterly UK Property Total Return Index Target 0.5% above the Benchmark on a rolling 3-year period, net of all fees and expenses.	Implement policies to manage ESG risks, capture opportunities, plan for Net Zero target of 2040 and comply with all environmental legislation.
Considerations	• Diversification at asset and portfolio level • Right-size for future growth • Compliance with investment restrictions • Economic and real estate market outlook	• Attitude to risk – risk adjusted approach • Driver of returns – income vs capital • Investment time horizon	• Acquisition criteria and due diligence including environmental resilience • Asset quality, EPC rating and attitude to capital expenditure • Business planning and asset improvement plans for all assets

LGPS CENTRAL SUB FUND STRATEGY

1) Allocate capital across **lower risk investment styles** with more than 75% of the Fund invested **Core Income, Market Growth and Active Income** investment styles;

2) Concentrate capital in **sustainable locations** in dynamic urban centres with at least 50% of the Fund invested in London and the southeast and the balance in major regional centres;

3) Mitigate credit risk through a **high level of tenant diversification** with an average tenant income exposure of less than 5%;

4) Adopt an **active approach to asset management** to enhance portfolio income while targeting **low risk lease arrangements** with an average unexpired portfolio lease term of 6-10 years and a void rate that is in line with the Benchmark of 7-8%; and

5) Invest in flexible assets that are capable of adaption for future alternative uses and plan for asset improvement and enhancement to meet future ESG requirements and **transition to net zero**.

INVESTMENT TARGETS

The Fund is currently targeting the following asset types during the initial stages of the portfolio build.

	Sector	Location	Investment style	Asset style	Sector prospects relative to All Property
	Industrials	• Well connected markets with critical mass • Satellite markets serving London and other Major Regional Centres and Dominant Economic Centres	Market Growth / Active Income	Multi-let Industrials in / close to Major Urban Locations	**OUTPERFORM** The sector's strong fundamentals will drive rental and capital growth across the segments.
	Retail warehousing	• South East preference • "Big Six" regional economies • Dominant economic supply constrained Centres	Core Income / High Income / Active Income	Open A1 Retail Warehousing Bulky Goods Retail Warehousing Alternative Property Sectors	**OUTPERFORM** Performance underpinned by a high income return and relative better supply conditions than other retail segments
	Supermarkets	• South East & London suburbs – focus on affluent and growth locations • "Big Six" regional economies • Dominant economic supply constrained Centres	Core Income / Active Income	Assets with inflation linked income streams, close distance of major affluent populations	**OUTPERFORM** Performance underpinned by a high income return, inflation linked income and relative better supply conditions than other retail segments

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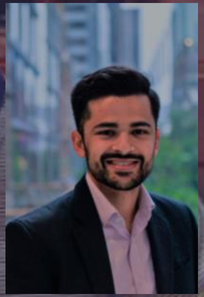

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