GUILDFORD BC INVESTMENT PROPERTY FUND PORTFOLIO REPORT

2017/18

Annual Report

GBC INVESTMENT PROPERTY FUND PORTFOLIO REPORT

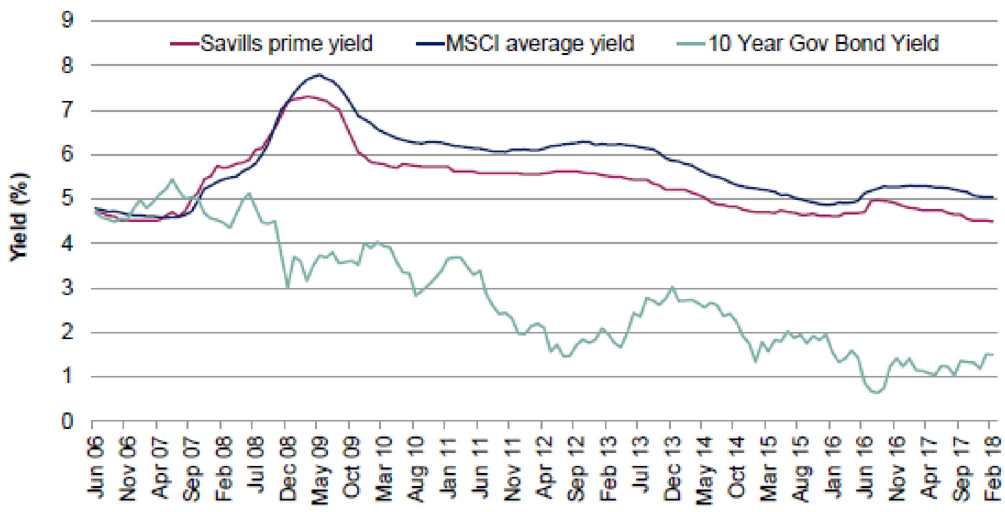
MARKET ANAYSIS

UK Real Estate Overview

Lingering uncertainty over the UK's future relationship with the EU continued to be a core theme of the last year, casting a shadow over economic growth. Negotiations may be underway, but as predicted, investors retain a cautious outlook across all sectors.

Although activity may be subdued, it does not mean investment has stopped. Instead, risk aversion has become the overriding theme. This translated into resilient demand for prime assets and secure income streams, throughout early 2018.

Gap between real estate and bonds remains wide



Graph source: Savills MSCI investing.com

Yields on many commercial property sectors, for example, are higher than those in much of Europe. Savills report that following three consecutive months of no movement in the Savills prime yield series, February saw a hardening of 2bps and the average yield reach 4.50%, this now stands just 19bps from the previous peak of 4.31% in 2007.

This was driven by an inward movement of prime yields for the Logistics sector, which now stand at 4.25%, the lowest level ever experienced. The Multi-let sector also has downward pressure. Savills now expect the average prime yield to see continued downward pressure into the rest of 2018 due to continued strong interest from investors in the M25 office sector.

Prime yields

	Feb 17	Jan 18	Feb 18
West End Offices	3.25%	3.25%	3.25%
City Offices	4.25%	4.00%	4.00%
Offices M25	5.25%↓	5.00%↓	5.00%↓
Provincial Offices	5.25%↓	4.75%	4.75%
High Street Retail	4.00%↑	4.00%	4.00%
Shopping Centres	4.50%	4.75%	4.75%
Retail Warehouse (open A1)	5.25%	5.00%	5.00%
Retail Warehouse (restricted)	5.75%	5.25%	5.25%
Foodstores	5.00%	4.50%	4.50%
Industrial Distribution	5.00%	4.50%↓	4.25%
Industrial Multi-lets	4.75%	4.25%	4.25%↓
Leisure Parks	5.00%	5.00%	5.00%
Regional Hotels	5.25%	4.50%	4.50%

Table source: Savills

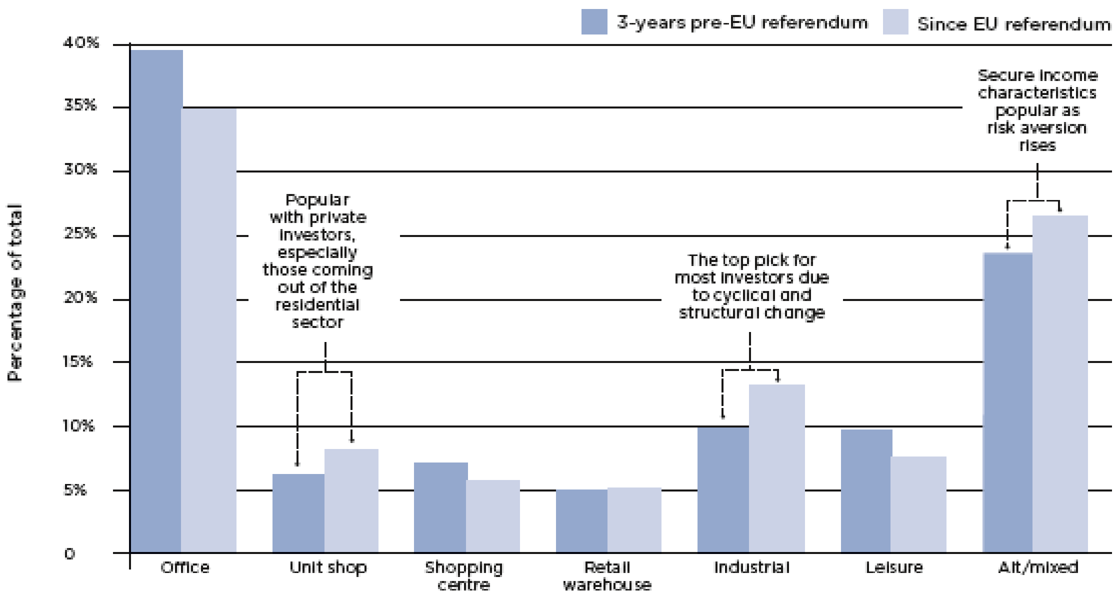
Property remains a safe haven for capital preservation, and demand for prime, secure investments has continued to be as keen as ever. This is expected to continue for the foreseeable future, with long-life income streams becoming ever more highly prized, especially as it is expected, the cost of capital will increase over the next five years.

The rise by a quarter of a point in interest rates by the US Federal Reserve in March (the sixth increase since 2015), appears to signal that the era of historically low interest rates that began during the Global Financial Crisis is to be coming to an end. With many believing a base rate increase by the Bank of England will occur in May.

However, the ONS announced on 18 April that, for the first time in around a year, average wages exceeded inflation in February 2018. This means the squeeze on people's wallets has started to ease with the cost of living taking a decent-sized step towards the Bank of England's target of 2%. The fact that inflation has already decreased may suggest the base rate will not need to change too dramatically if at all[i].

Although the pace of recovery will be dictated, largely, by Brexit, investors are exploring new opportunities. A shortage of prime stock is leading investors to seek secure income in alternative assets.

Investor appeal The change in popularity of commercial assets since the EU referendum



Source Savills Research from Property Data

Whilst domestic investors are likely to remain cautious in 2018 because of home bias, and as they tend to see local political issues as more important than others do, non-domestic investors will be attracted to the UK by comparative risk, and comparative returns. New opportunities are emerging for investors prepared to explore beyond the increasingly scarce pool of prime or secure assets.

Savills believe that the biggest beneficiary of the shortage of prime mainstream stock will be the plethora of income-producing assets classes that used to be lumped together as alternatives. Whether that asset is a pub or cinema, warehouse or student house, the attraction to investors will be the bond-type characteristics of the asset.

The other area of emerging opportunity will be development or asset management across all subsectors of the commercial market; namely, turning short, risky income into long, secure income will also be high on the agenda.

Moving forward, people will be waiting to see the impact of global macro-economic factors such as Global interest rate rises, Brexit negotiations, US trade tariffs and other geopolitical issues such as North Korea and Russia how they will impact the markets.

Commercial outlook: six trends for 2018

As demand for prime remains strong, alternative assets will grow in significance

Non-domestic demand
With the pound staying weak and UK commercial property yields now looking high in comparison to prime European and Asian markets, we expect non-domestic investor demand for UK commercial to remain strong in 2018.

Value beyond prime
With risk-averse domestic and global investors dominating the market in 2018, there will be less competition and even falling prices in secondary and tertiary markets. This will be a great opportunity for value-add and opportunistic investors as they turn short income into long.

Alternative appeal
The unifying theme among the plethora of alternative asset classes is their long-term secure income streams and popularity among risk-averse investors. So, 2018 will be the year that alternative becomes mainstream.

Retail therapy
In 2017, a perfect storm of negativity hit retail. For 2018, we will see better news about real earnings growth, and a less homogenous attitude to retail with investors. Some segments will be a good buy due to their defensive characteristics, while others just look cheap.

Brexit balance
With London's office market shrugging off the worst of the pre-Brexit negativity, 2018 will see more balance in the assessment of how much, where and when occupational risks will rise.

New-tech tools
While wellness and staff satisfaction will continue to increase in importance for many employers when choosing buildings and locations, some businesses will start to look at offsetting the costs of delivering wellness by using the margin-enhancing tools of artificial intelligence (AI).

Guildford Real Estate Overview

Despite the uncertainty, the Valuation Office Agency (VOA) report that Guildford remains in a strong position going forward, with solid economic and property fundamentals.

Guildford was placed 6 in Lambert Smith Hampton's 2018 UK Vitality Index with top ten placements in the sections for highly educated and fastest growing towns. Future prospects in Guildford may be led somewhat by the outcome of the proposed £2bn regeneration of the town centre.

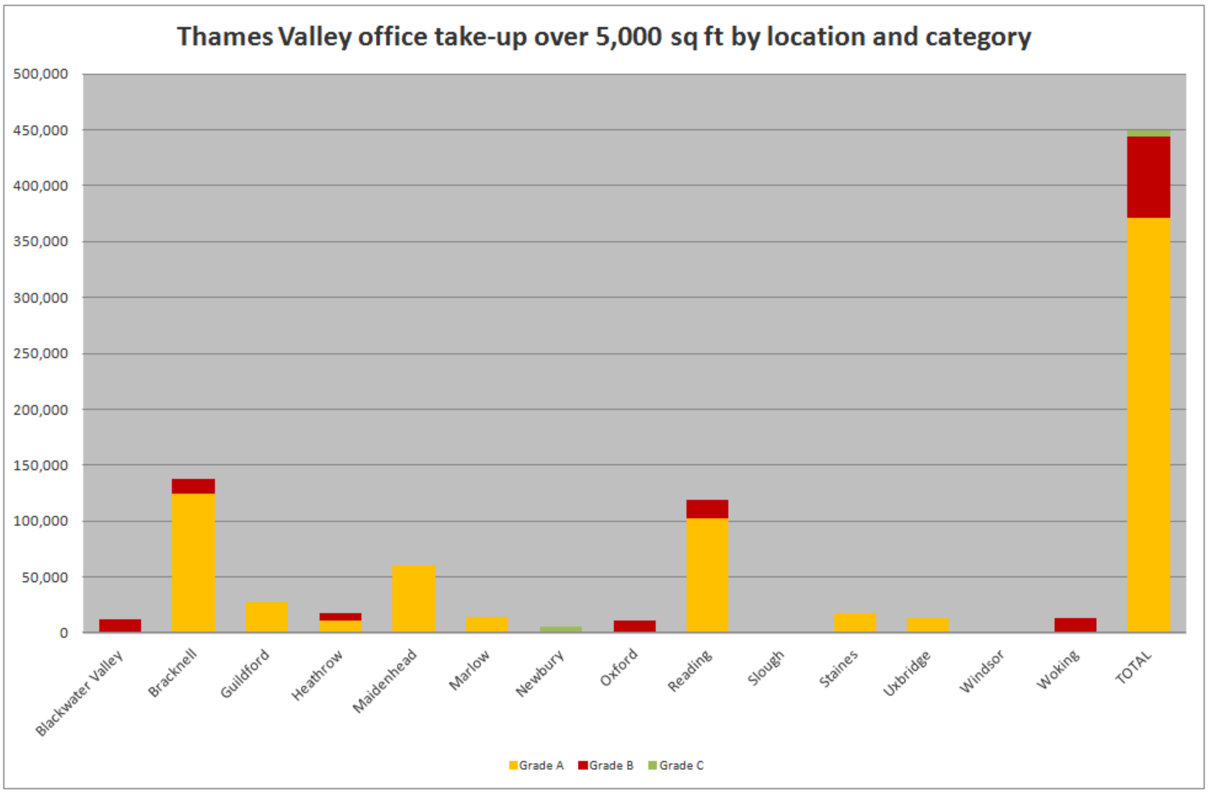
Commercial Office Market

The key themes for the Thames Valley Office market over the last year have been:

- the rise of the tech market;
- increase in co-working spaces;
- non-existent grade c stock; and
- average transaction sizes falling.

Lambert Smith Hampton (LSH) reported that the Thames Valley office market had its lowest enquiries for six years in Q4 with the 2017 total falling 21.7% against 2016. The main falls were in the 5/10,000 sq. ft. and 20/50,000 sq. ft. bands.

Take-up in 2017 was only a slight increase of 1% over the year but in Q4 2017 was increase of 49%.



The two most active business sectors in Q4 2017 were, Technology, Media and Telecommunications (33%) Finance Banking & Insurance (9%).

In terms of supply, the Thames Valley total has fallen by 1,615,065 (17.2%), compared to the 2016 year-end total of 9.4m.

In Guildford, most of the larger corporates are focused on working more efficiently and reducing the space they occupy. For example, EA Sports re-geared its lease at Onslow House, reducing its office space from 90,000 sq ft to 55,000 sq ft.. BOC is thought to be interested in reducing its occupational space from 90,000 sq ft to circa 30,000 sq ft.

A number of the corporates are also now leaving Guildford for numerous reasons. For example, Ericsson is moving its headquarters (vacating 50,000 sq.ft.) to Reading. It is assumed that those relocating within the Thames Valley are moving to areas where they can take advantage of the new Crossrail system.

This has led to a reduction in larger transactions. There were only two transactions of over 10,000 sq. ft. in Guildford in 2016. In 2017, there were only three and only three deals over 5,000 sq.ft. Overall take-up for 2017 was 84,000 sq ft, 19% below the 10-year average and the lowest seen since 2013. In Q1 2018 there has been just 5,000 sq.ft let in two deals.

Guildford office supply increased from 260,000 sq ft in 2010 to 337,000 sq ft in 2017. However, this is the third lowest availability rate in the Thames Valley at 10%.

New supply is generally being delivered by refurbishment of existing buildings, with the proportion of grade A space increasing from 0% in 2011 to 65% in 2017. According to LSH's most recent research, Q1 2018 availability is now at 432,000 sq ft (excluding BOC and Ericsson). Given that the ten year average annual take up in Guildford is just over 90,000 sq.ft it looks as though there will be 4-6 years' worth of supply.

There is now an increased reliance on the SME companies for new demand. Luckily, Guildford has a wide base of SME occupiers and an increasing tech sector. This mixed economic base provides stability and will maintain activity in the market, despite a lack of larger requirements. Demand will focus on high-spec interior refurbished and new buildings in the town centre.

As supply increases, LSH expect to see the speed of rental growth subside and rents to stabilise over the next two years. However, the Q1 2018 RICS UK Commercial Property Survey reported that the RICS expects prime office rents to show growth but with secondary flat.

Prime rents in Guildford increased steadily from £27.00 per sq. ft. for new grade stock in 2012 to £35 per sq. ft. in 2017.

Prime yields in the town remain unchanged at 5.00%. This is despite some downward pressure early on in the year, due to the Council's purchase of Wey House, reflecting 5.10%.

Commercial Retail Market

The VOA reported to GBC that Retail remained the worst performing sector in the investment market last year with transaction volumes falling for a 3rd consecutive year (10% year on year). Retail generally struggled and was characterised by negative sentiment increasing through 2017. Investors focused on prime secure asses widened the gap with secondary stock.

According to Knight Frank, next year is likely to be just as challenging for the UK retail sector as 2017 has been. Some pressures may have eased but there is no greater sense of certainty than there was 12 months ago. Almost without exception, retailers remain cautious

There is a common belief that the uncertainty over Brexit and the ceiling for on-line sales will mean that the market will continue the trend of flexible leases, with shorter terms, break clauses, and also increasingly trying to secure turnover rents.

Many retailers will also continue their operational rationalisations with a rolling programme of closures and downsizings, counterbalanced by selective re-locations and strategic new openings.

The downward pressure on retail rents is also expected to continue. The Q1 2018 RICS UK Commercial Property Survey noted weakness in retail was spreading to prime locations. That said, 2017 was the strongest year since 2010 for investment into high street shops outside central London. Savills believe 2018 will be much the same, with the UK funds focusing on the top 20 towns, and lot sizes of greater than £10m. The majority of investor demand will remain for 'safe' and 'secure'. Good shops on good pitches in good towns will continue to attract a premium (especially as demand will exceed supply).

Given the shortness of supply and the difference in yields between prime and secondary the VOA believes investors may take more interest in the right kind of secondary.

Due to the historic High Street and lack of out-of-town development, Guildford remains a resilient prime affluent retail market and retains its attraction for investors and occupiers alike with its quality of catchment.

Shopping centres

VOA and Savills both report that caution over Brexit and negative retail sentiment generally saw 2017 characterised by low transaction activity throughout the year. The focus from investors was concentrated on the most resilient centres with an outward shift in yields
.
Institutional investment reduced last year, whilst Councils gained a market share of circa 13%. In spite of some negative press, and barring any central government intervention, it is expected that Councils will continue to invest in shopping centres in 2018, doing so with a continued focus on assets within their jurisdiction.

Savills report that demand is particularly strong for convenience and community centres that trade well. Especially in London and South East. They also believe that redevelopment opportunities will be sought-after in 2018.

Commercial Industrial Market

According to LSH, in the space of a few years, industrial & logistics has gone from being the ‘Steady Eddy’ of UK property to the asset class of choice. Industrial investment was the strongest performer across the commercial sectors in 2017, with continued investor appetite for industrial assets and a rise in portfolio transactions. 2018 has also picked up where 2017 left off, with stock of varying size and quality changing hands across all parts of the market. LSH report that industrial is still widely expected to outperform the wider market once again, over the next five-years.

Occupiers appear to have been rather indifferent to the uncertainty posed by Brexit with take-up respectable across each of the size-bands. Appetite for quality also showed little sign of abating, with grade A space accounting for 30% of UK take-up.

During the first quarter of 2018, Savills prime yields for industrial properties reached the lowest level ever recorded at 4.25% for both multi-let estates and distribution warehouses. With yields at rock bottom, moving forward investors will be relying heavily on income and rental growth to determine asset performance.

As supply continues to be restricted, rental growth was maintained during 2017, LSH report that prime rents across the UK's 60 key markets increased by 4.9% on average, alongside secondary rental growth of 5.1%. In some locations, growth has been nothing short of extraordinary over the past two years, especially in London and the wider South East.

Currently, smaller occupiers are finding themselves displaced into more affordable locations, which is in turn driving growth in secondary markets. Secondary locations now have among the best prospects for growth, particularly those in close proximity to much more expensive locations.

The Q1 2018 RICS UK Commercial Property Survey noted that going forwards prime and secondary industrial are generally expected to see near term rent increases across the UK. This is certainly expected in Guildford, due to the low supply of existing stock across all size ranges. However, this may be dependent on the outcome of the Local Plan and the future availability of land for development.

The only real doubt is over the automotive industry. Better clarity over post-Brexit trading terms are now required, especially regarding prospective tariffs. Although, even if there are barriers to trade from Brexit, LSH believe this is arguably just as likely to encourage some occupiers to focus their footprint in the UK as it is to force others to take flight.

GUILDFORD BOROUGH COUCIL INVESTMENT FUND

Current Fund Overview – 2017/18

Current Properties

Sector	No. of assets	Sub-category	
Office	8		
Industrial	129		
Retail	10	Shops Shopping Centres Supermarkets	7 2 1
Leisure	6	Restaurants Nightclubs	5 1

Other Commercial	11	Educational Theatres Barns Petrol Stations Sui Generis Car Parks Water Treatment Works	3 2 2 1 1 1 1
Total Investment Properties	**164**		

Fund Statistics

Rental income

	Industrial	Office	All Retail	Other	All
2015/16	2,679,571	1,831,900	1,750,254	885,636	7,147,361
2016/17	3,057,302	1,858,638	1,447,672	1,062,137	7,425,749
2017/18	3,493,405	3,186,048	1,426,317	1,070,786	**9,176,556**

Capital value

	Industrial	Office	All Retail	Other	All
2015/16	39,077,755	19,227,500	34,270,000	11,233,500	103,808,755
2016/17	42,922,450	25,915,000	25,908,500	15,963,500	110,709,450
2017/18	51,509,000	49,574,000	26,065,000	17,471,500	**144,619,500**

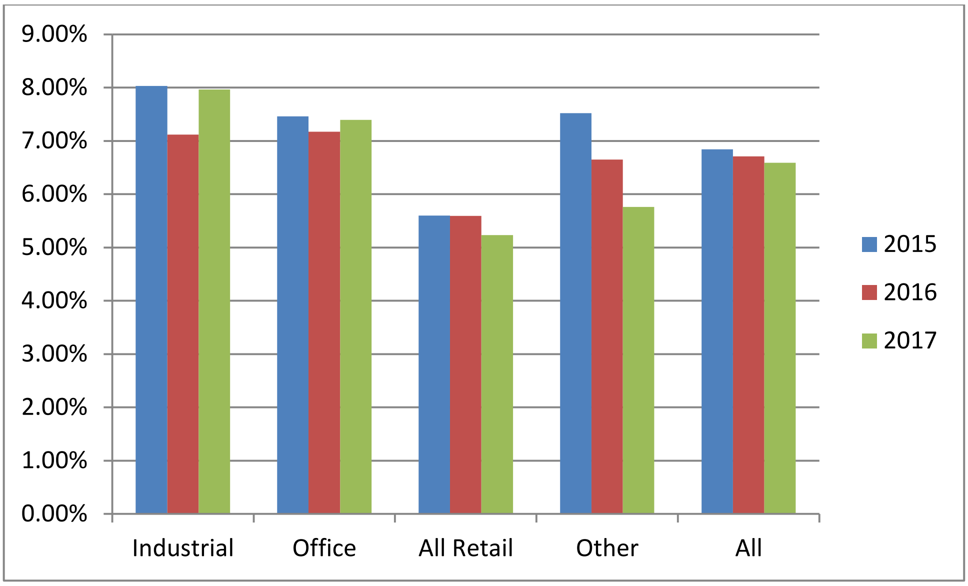
Income return

	Industrial	Office	All Retail	Other	All
2015/16	8.03%	7.46%	5.60%	7.52%	6.84%
2016/17	7.12%	7.17%	5.59%	6.65%	6.71%
2017/18	7.96%	7.39%	5.23%	5.76%	**6.59%**

Benchmark return

	Industrial	Office	All Retail	Other	All
2015/16	6.10%	4.70%	5.40%	4.70%	5.23%
2016/17	5.40%	4.10%	5.00%	5.50%	4.80%
2017/18	7.90%	3.90%	2.50%	2.50%	**4.20%**

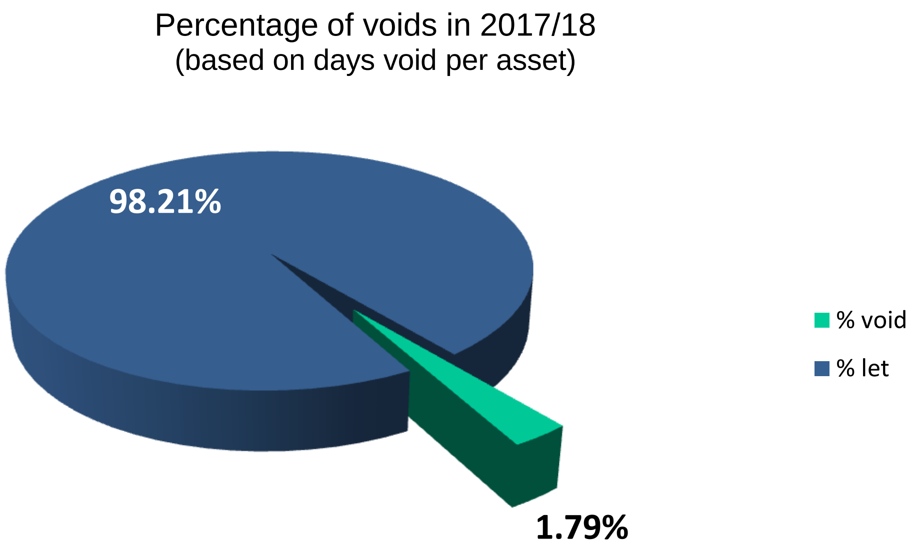
Fund Performance



Purchases and Sales

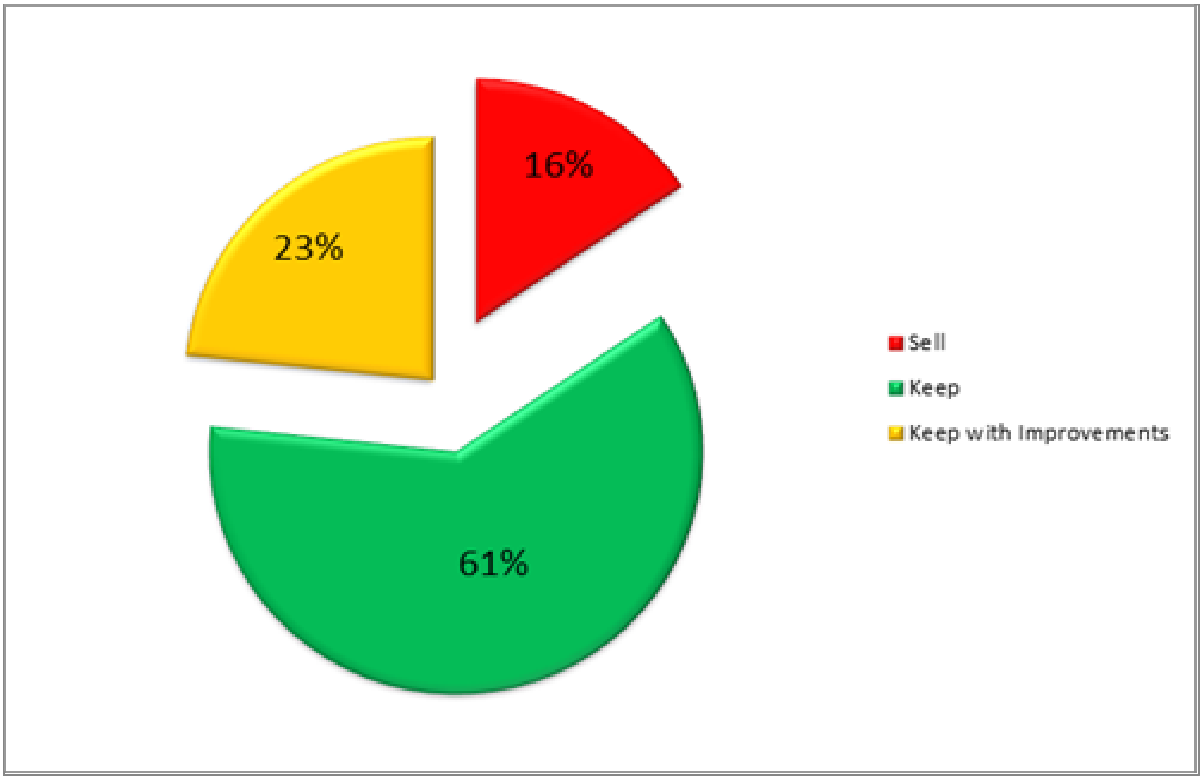
Property	Interest	Price paid	Date of completion	Tenant	Rental (pa)
9 Midleton Industrial Estate	Leasehold (to merge Freehold)	£500,000 excluding purchaser fees	24/03/2017	Now let to: Workshop - Sunbrella Hire Ltd (£28,000) Parking Spaces - Philips Electronical Ltd (£32,000)	Total Site Income – £60,000pa.

Void Properties



	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Year
Days void in 2017/18 based on number of units	1.22%	3.20%	1.56%	1.17%	1.79%

Property Review



1. [i] Economists at *Bank of America Merrill Lynch Global Research* even believe the *Bank of England* is unlikely to deliver two interest rate rises in 2018. The Bank's fundamental remit is to get inflation to a 2% target, so if as the data suggests that a fall towards target is already happening, then the more dovish analysts may prefer a policy of "wait and see".