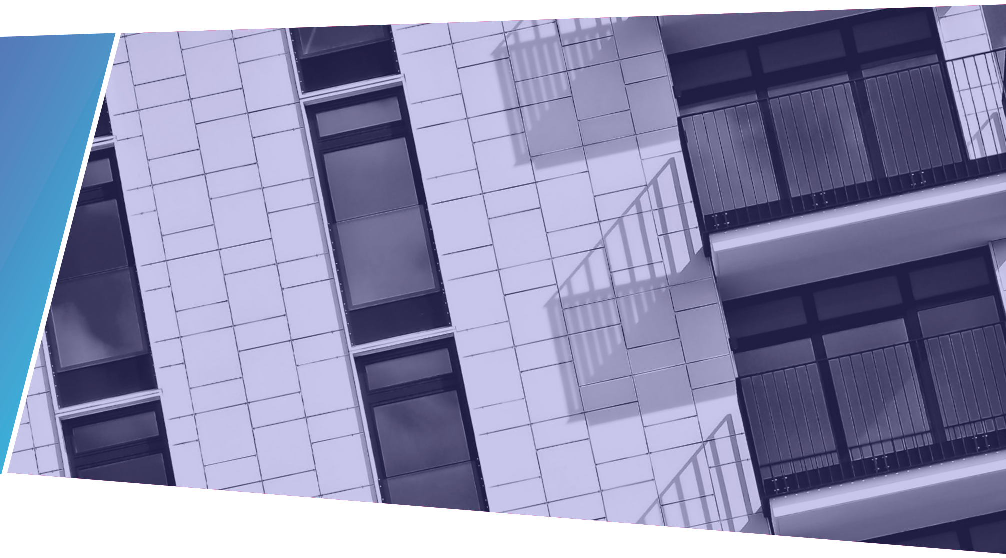
Quarterly Report Q2 2023 Irish Property Fund



MARKET REVIEW

Introduction

Two rate hikes were implemented in Q2 2023 by the European Central Bank (ECB), moving the main financing rate (the interest rate for commercial banks borrowing money from the ECB in the medium term), to 4%. The trend of interest rate increases was expected to curtail inflation. However, inflation is continuing to be an issue in the eurozone (particularly in Germany) and this may require interest rates to remain higher for an extended period.

Headline inflation across the eurozone in June was at 5.4%, a reduction from 5.7% at the end of Q1 2023, and this likely strengthened the possibility of a continued rise in rates at the next two ECB monetary policy meetings (in July and September), which would increase the main refinancing rate to 4.5%.

In Ireland, the economy continues to perform reasonably well, with employment remaining strong. However, exports from multi-national businesses started to contract in Q2. This contraction was reflected in the headline GDP number, which showed a fall in GDP of 4.6%, driven by the multi-national corporations (in sectors such as technology, pharmaceutical and aircraft leasing). This contrasts with the Modified Domestic Demand (that tends to reflect domestic consumption) increase of 2.7% in Q2 2023.

Continuing on from Q1, the property market continues to experience challenging times. Increased interest rates and deteriorating economic conditions have been reflected in the reduction of property valuations into Q2. Again, a principal driver of valuation falls has been the increased cost of debt financing (via increased interest rates), which has produced higher yields in most property sectors. Continuing high inflation and the resulting interest rate rises tend to produce deteriorating economic conditions. Furthermore, political events have also contributed to bringing uncertainty to the economy. These factors are impacting the property asset class across many economies – including the US, EU and UK, as well as Ireland.

Investment

The interest rates rises have dampened investment activity in the property market.

A total investment turnover of €333m across 26 transactions was recorded in Ireland for Q2, which brought the H1 2023 total to €964m. This total for the half year is approximately 50% under the 10-year average (of just over €2bn).

Institutional investors have adopted a cautious approach to exposure to real estate in light of the continued interest rate hikes, uncertainty in the occupational market for office property (as hybrid working continues to evolve), and future capital expenditure requirements to upgrade the environmental specifications of buildings in line with EU regulation standards.

The residential sector attracted the largest portion of the invested capital, at 44%, followed by the retail sector at 21%. Over 60% of the retail investment was in retail parks, which tend to perform well in a strong housing market. Occupancy and rental growth have been steady in this sub-sector.

Some of the market trading in retail assets was in secondary stock, where the high yields make the returns attractive and somewhat dilute the impact of the increased cost of debt financing.

A new development in the investment market has been the increased activity of French retail investor funds. These funds have continued to experience increased investor inflows which have positioned them to become more active in international investment markets. A combination of these inflows, the relative performance of equities and bonds, and the repricing across real estate has led a number of these funds to source investments outside of their domestic and core European markets.

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MARKET REVIEW (CONTINUED)

French retail investor funds accounted for 26% of activity in Q2 2023 (in terms of capital deployed) according to CBRE. The investment was across six transactions. The funds tend to target smaller deals (in the €5m to €40m lot size) in line with the liquidity requirements typically associated with retail investor funds. (Retail investors tend to have shorter investment commitments and so the funds tend to invest in lower deal sizes to permit the funds to honour investor redemptions. Institutional investor funds tend to have longer investor commitments – up to three years at times – which permit these funds to invest in larger assets that can take significantly longer to sell in the event of investor redemptions).

Regarding the transaction activity in Q2 2023, two of the larger lot sizes (for €55m and €24.5m) were in the residential sector, and the details of the deal remain confidential. Realty Income Corporation made its first transaction in Ireland, acquiring Blackwater and City East Retail Parks in Meath and Limerick respectively for a combined price of €45.9m.

It emerged during Q2 that Oaktree, which holds a retail portfolio across Ireland valued at approximately €400m, is considering disposals, including that of a majority interest in The Square Shopping Centre, Tallaght.

Inter Gestion REIM (a French retail investor fund) acquired the B&Q unit in Liffey Valley Retail Park for €26.6m, which reflects an income return (the relationship between contractual rent and the property value) of 7%. Another French retail investor fund (Remake AM) acquired the office building 87-88 Harcourt Street, which is occupied by Byrne Wallace Solicitors, for €34m, which reflects an income return of close to 6.7%, with 10 years remaining on the occupational lease.

Aside from this office deal, investment activity in the office market remains subdued, and appetite for secondary locations, or offices with older specification, is low. The hybrid working model seems to have reduced appetite for suburban and secondary locations, and the older office buildings can require quite significant capital investment to improve their environmental credentials.

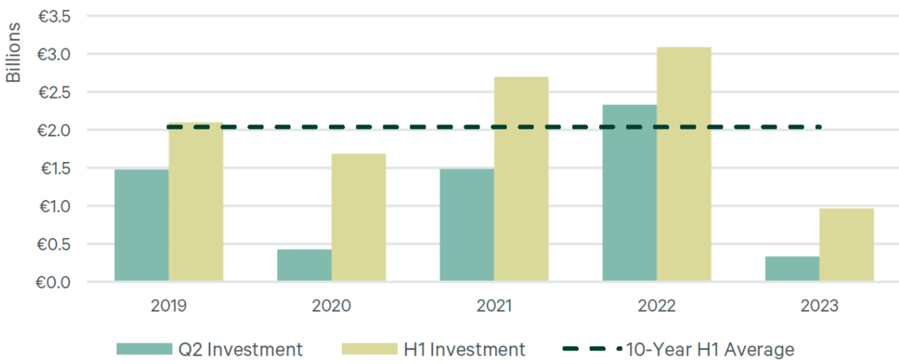
The relatively low level of activity in Q2 meant that no significant market evidence was created to guide valuations. However, a continued higher yields in the residential, office, and industrial sectors has reflected the reduced appetite from investors.

B&Q Unit, Liffey Valley Retail Park: acquired by French fund Inter Gestion REIM in Q2 2023

87-88 Harcourt Street: acquired by Remake AM in Q2 2023

Ireland Investment Volumes 2019 - 2023

Source: CBRE Research



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Office

The private equity firm KKR accepted a lease assignment of three floors (approx. 42,000 square feet) in Candeza, a newly built Irish Life held office building in Earlsfort Terrace, during Q2 2023. The passing rent (€60.00 per square foot) is a good reflection of occupational demand for high specification, well located assets. This building was developed by Irish Life in 2022 and has strong sustainability and environmental specifications, with A3, LEED Platinum, and Well Gold credentials. While challenges remain in the office occupational market, the well-located, high specification buildings will continue to attract strong tenants at strong rental levels.

A total of 389,000 square feet of office space was taken up in Q2 2023, which is lower than the 10-year quarterly average of 558,000 square feet. The Q2 2023 take-up contributed to bring the total take-up for H1 to 674,000 square feet. Again, this is a reduction of 30% on H1 2022 and a significant reduction on the average H1 take-up of 1.16m square feet since 2013.

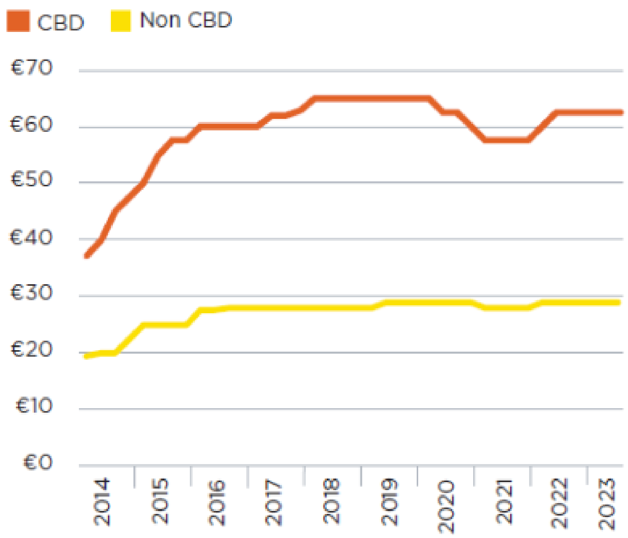
The largest letting of the quarter was of 79,600 square feet in the newly built Haymarket House, Smithfield to the National Transport Authority.

A trend is developing that occupational demand appears to be shifting towards smaller leased premises and away from the very large floor plates that have been produced in more recent developments. Again, this is likely a result of the growth in hybrid working arrangements that has more recently reduced aggregate demand for office space. The smaller office leased premises tend to be present in older buildings, although good design in an office building will permit sub-division of floors to meet with changing demands in the occupational market. While some of the smaller buildings will likely require capital expenditure to upgrade the environmental credentials, it is notable that this trend of increased demand for these premises is emerging. Savills reports that 32 lettings of spaces lower than 5,000 square feet occurred in Q2 2023, which is the largest quarterly number in this category since the start of 2017.

Another trend that continues is the development of demand in the grey market' for office leased premises. (The 'grey market' is the market for space that is contractually leased, but that is deemed surplus to requirements of the occupational tenant. This tenant sub-contracts out the space to a sub-tenant, either for the entire remaining duration of the lease or for a shorter period of time, to re-coop the rent payable to the owner of the building). This grey market is a direct result of the changing occupational market that has resulted from increased hybrid working. Much of this space that is surplus to requirements was leased before the pandemic, prior to the emergence of alternative working arrangements with office occupiers. The amount of grey space available on the market, currently stands at 1.9m square feet.

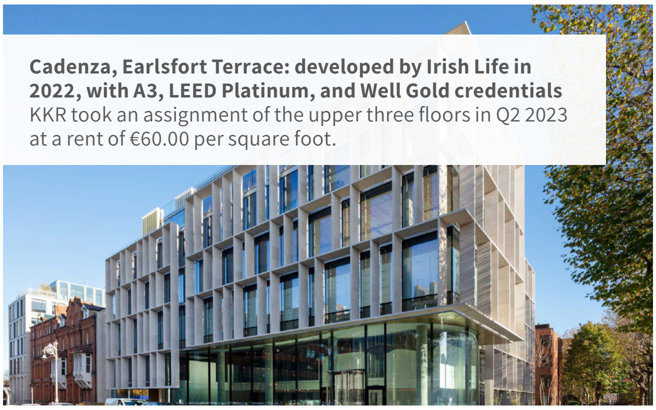
Total vacancy in Dublin now stands at 14.9%, up from 13.8% in Q1 2023. The greatest driver of this increase is the additional grey space leased premises that have been put on the market (which accounted for 80% of the increase). However, JLL notes that 16 active requirements for premises in excess 50,000 square feet are present in the market, including EY's recently announced requirement for approx. 200,000 square feet. EY has plans to create a campus-style office in the Dublin 2 area in the near-to-medium term. Prime rents remain at just over €60 per square foot (higher for smaller premises in modern well-located buildings). This number has remained relatively steady for several years, as evidenced by the graph below.

Headline rents in rates per square foot since 2014



Source: Savills Research

Cadenza, Earlsfort Terrace: developed by Irish Life in 2022, with A3, LEED Platinum, and Well Gold credentials
KKR took an assignment of the upper three floors in Q2 2023 at a rent of €60.00 per square foot.



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MARKET REVIEW (CONTINUED)

Retail

With respect to investment volumes, approximately €128m of retail property transacted in Q2 2023, equating to 39% of the total transaction market volume in the period. The significance of this is that the retail sector experienced a significant re-pricing during the pandemic (where values dropped due to the operational problems caused by the government lockdown and associated restrictions). The lockdowns disproportionately impacted this sector relative to other sectors. In recent quarters, since midway through Q4 2022, occupational demand has improved considerably, resulting in a good number of lettings, and a resulting drop in vacancy in the prominent high streets. It should be noted that most of the problems in the retail sector were restricted to high street and city centre shopping centres, which experienced significant drops in footfall. Suburban centres (often grocery anchored) and retail parks were not as adversely impacted by the pandemic. The falls in values in the high street sub-sector improved the income yields (the relationship between rents and capital values) and this combined with the recent pickup in occupational demand has created positive interest for investors, which has resulted in increased investment activity in recent months. So, the improving occupational market in the retail sector has strongly contributed to increased investment volumes.

Vacancy across the main retail districts and schemes nationwide has reduced significantly since the pandemic. Currently, 12 units are available on Grafton Street and five units are available on Henry Street, which is an improvement on the position 18 months ago. HMV entered into a new lease in 18 Henry Street, a property managed by ILIM, in Q2 2023. In addition, clothing retailer Castore contracted to occupy 34 Grafton Street, and Carroll's Irish Gifts took occupancy of 6-8 College Green (in Dublin city centre). Rental levels have shown signs of growth in 2023, but still reflect a discount on pre-pandemic levels, and lease terms average five years to a first break option or expiry.

18 Henry Street (managed by ILIM): leased to HMV in Q2 2023

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MARKET REVIEW (CONTINUED)

Industrial

Over 650,000 square feet of industrial space was leased or acquired (by owner occupiers) for occupation during Q2 2023 in 26 transactions. This Q2 2023 activity brings the year-to-date total to 1.57m square feet.

The size of the letting deals and the profile of the tenants entering into deals in the Dublin industrial letting market are notable. The American company Westrock (with a market capitalisation of $7.6bn) signed a lease to occupy a logistics facility of over 112,000 square feet for a 20-year term. It will terminate leases on several older buildings and consolidate its operation in this new facility. This deal is structured to commence in 2025 upon completion of the construction of the new facility. Otherwise, the French company Rexel Group (with a market capitalisation of €7bn) agreed a pre-let (like the Westrock deal, an agreement to occupy a 95,000 square foot facility upon construction completion). These are examples of strong operators committing to long-term occupation of modern high-specification facilities.

The occupational market is continuing to expand to harness the strong demand for modern industrial facilities. Almost 450,000 square feet of new stock was delivered in Q2 2023 and over 80% of this newly delivered space was pre-leased (leased in advance of construction completion). A further 1.3m square feet is scheduled for completion by end H1 2024, and reportedly 50% of this is already pre-leased. The average size of the newly built facilities is at over 75,000 square feet, able to accommodate the changing requirements of the logistics sector.

The demand of units at the end of Q2 2023 was estimated to be approximately 1.25m square feet, and it is estimated that the projected demand in the market is close to 5m square feet. At the end of Q2 2023, market vacancy was recorded at 1.4% in the top 35 industrial and logistics parks.

Prime rents are now at €12.50 per square foot for the best stock while secondary stock is available at levels from €9.50 to €11 per square foot.

Unit G, Mountpark, Baldonnell:
97,000 sq ft pre-let to Rexel Group in Q2 2023

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FUND STATISTICS

Total returns	
Q2 2023	-1.04%
1 Year	-2.93%
3 Years (annualised)	+1.52%
5 Years (annualised)	+0.80%
10 Years (annualised)	+9.64%

Property income yields	
Office	5.8%
Retail	6.8%
Industrial	4.8%
Portfolio	6.0%

Source: Irish Life Investment Managers. Data is accurate as at end of quarter two (30 June 2023).
The pricing basis of the fund changed in January 2020 from acquisition to disposal basis.

THE PORTFOLIO >

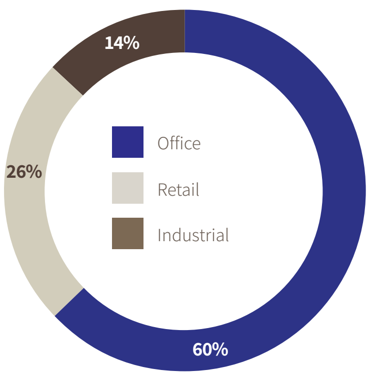
42 BUILDINGS

250 TENANCIES

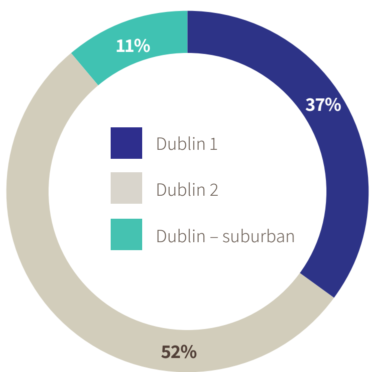
-1.04% TOTAL Q2 RETURNS (GROSS)

Source: Irish Life Investment Managers. Data is accurate as at end of quarter two (30 June 2023).

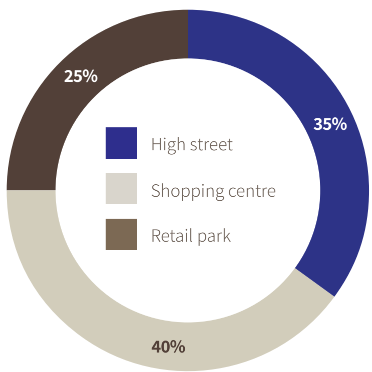
Sector Weightings:



Office Sub-Sector Weightings:



Retail Sub-Sector Weightings:



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FUND ACTIVITY

The Fund imposed a six-month deferral (notice period) to all withdrawal and switch requests on 3 March 2023, as communicated to customers at that time. The decision was made in response to investor flows, and is not a reflection of our view of the long-term suitability of property as an asset class, nor the quality of the portfolio of properties within the fund.

The fund has no leverage (debt financing) and so the negative returns generated (set out in the fund returns section) are a result of market driven capital falls (as opposed to being driven by property specific events such as lease terminations and resulting vacancies in buildings). The independent valuers assess the market value based on its view of a potential buyer in the market, from an analysis of comparable market transactions. Since the greater part of market investment transactions involves debt financing, the increased cost of debt has tended to mean that the price an investor would pay for a building has reduced relative to when debt financing was less expensive.

The weighted average unexpired lease term across the fund is 4.6 years across over approximately 250 tenancies in the fund.

> Rent collection rates in the fund are at virtually 100% (over 99.5%) for Q2, which is a strong attestation of the income profile of the fund.

> Two letting deals in particular, in 39 Mary Street (lease to Dubray Books) and 18 Henry Street (leased to HMV), were strong lettings, and they benefited from the recent increase in tenant demand in the high street sector for good-quality, well-located units.

> A lease re-negotiation to a strong fund management administrator also created capital value in the office portfolio.

These are an important part of portfolio management as they continue to strengthen the income profile of the fund.

> The fund vacancy rate at the end of Q2 2023 was at approximately 6.4%.

> The fund is continually looking to optimise the portfolio and continues to review sales opportunities and recycling of capital into investment opportunities within the existing portfolio.

> The fund has a well-constructed portfolio of assets, with a strong income profile and low vacancy.

> The strategy is to continue to improve the assets within the portfolio to create value-enhancing opportunities and to further improve the portfolio structure, the income profile and returns of the fund.

OUTLOOK

Limited stock is being prepared for the traditionally busy post-summer marketing period, and we do not expect institutional demand to re-emerge in scale in 2023. Investment into the property sector in the short term is expected to continue to be limited to yield seeking international funds (mainly French) or private, domestic investors.

Low levels of transactional activity and international pricing trends are expected to continue to negatively impact capital values. So, while a significant adjustment has already been factored into values to Q2 2023, it is likely that further valuation adjustment is expected as transactional price discovery evolves.

Occupational markets, particularly in the retail and industrial sectors, continue to benefit from a strong local economy and low unemployment. We see opportunities for further rental growth in certain sub-markets and sub-sectors during H2 2023.

Demand for office space is evolving to reflect hybrid working models and sustainability attributes. Aggregate demand will therefore continue to lag that of previous years. Office occupiers will continue to focus on modern, strategically located, and high specification space, while those seeking greater flexibility or transitionary offices will focus on smaller floor areas at lower cost. We believe this will maintain prime rents for best-in-class offices but continue to put pressure on rents for secondary buildings. The well-located older buildings will require capital investment to modernise to meet with the occupational requirements of the strongest tenants.

This document is intended as a general review of investment market conditions. It does not constitute investment advice and has not been prepared based on the financial needs or objectives of any particular person, and does not take account of the specific needs or circumstances of any person.