M&G Property Portfolio

Annual Short Report September 2018
For the year ended 30 September 2018

Please note, when this document was originally published, property expenses and operating charges were incorrectly reported across all share classes.

We would like to make you aware that these figures have been corrected in this version.

Fund information

The Authorised Corporate Director (ACD) of M&G Property Portfolio presents its Annual Short Report which contains a review of the fund's investment activities and investment performance during the period. The ACD's Annual Long Report and audited Financial Statements for M&G Property Portfolio, incorporating a Glossary of terms is available free of charge either from our website at www.mandg.co.uk/reports or by calling M&G Customer Relations on 0800 390 390.

ACD

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(Authorised and regulated by the Financial Conduct Authority. M&G Securities Limited is a member of the Investment Association and of the Tax Incentivised Savings Association.)

Important information

Please note, with effect from 1 April 2018, the distribution policy has been changed so that in determining the amount available for distribution to income shares, the annual management charge and administration charge are offset against capital, increasing the amount available for distribution whilst restraining capital performance to an equivalent extent.

On 28 September 2018, the Depositary changed from National Westminster Bank Plc to NatWest Trustee & Depositary Services Limited.

Investment objective

The investment objective of the fund is to carry on Property Investment Business and to manage cash raised from investors for investment in the Property Investment Business. In so doing, the fund aims to maximise long term total return (the combination of income and growth of capital) through investment mainly in commercial property.

Investment policy

The fund invests in a diversified portfolio of commercial property mainly in the UK, seeking to add value through strategic asset allocation, stock selection and asset management. The fund may also invest in other property related assets, including collective investment schemes, transferable securities, derivatives and debt instruments, as well as government debt, money market instruments and cash. Derivatives may be used for investment purposes as well as for efficient portfolio management.

Investment approach

The M&G Property Portfolio aims to maximise long-term total return through direct investment in commercial property. The fund is diversified across different property sectors (such as retail, offices and industrial). This is done by reviewing the structural and portfolio risk implications of holding various assets within the fund and when acquiring new assets for the fund. In researching properties and therefore the associated risk, the manager considers location, property type, rent review and lease expiry pattern, tenant, industry sector, tenure, lease covenants and physical and environmental factors.

Risk profile

The fund invests in a diversified portfolio of commercial property mainly in the UK. It is therefore subject to the price volatility of the UK commercial property markets as well as the performance of individual properties.

The fund is valued daily on both an ‘offer’ basis (how much its assets would cost to buy) and a ‘bid’ basis (how much the fund would receive if assets were sold). The difference between the two, known as the ‘spread’, is currently around 7.25%. The published dealing prices are based on either the offer or bid valuation, depending on whether investors are generally buying fund shares (the fund is in ‘net inflow’) or selling shares (the fund is in ‘net outflow’). Should fund flows move from net inflow to net outflow, the dealing prices may ‘swing’ from an offer basis to a bid basis and fall by the extent of the spread. On the other hand, the dealing prices may rise by the same extent should fund flows move from net outflow to net inflow.

For large deals, the dealing price investors receive may be different from the published price. If investors are buying shares, they may receive a price that is higher than the quoted offer price. If investors are selling shares, they may receive a price that is lower than the quoted bid price.

In difficult market conditions, or if significant numbers of investors withdraw their investments from the fund at the same time, the manager may be forced to dispose of property investments, and the value of certain property investments may therefore be less predictable than usual. Under these circumstances, it may be harder to sell assets at a fair price. Such conditions could result in unpredictable changes in the value of the fund’s holdings. In general, property investments are harder to buy and sell compared to investments in fixed income securities and company shares.

There is the possibility that a portion of the portfolio will be held in cash if the supply of new investment opportunities is limited which, if the situation persists, may restrict the performance of the fund.

In addition, there is a risk that an occupational tenant on a property held in the fund’s portfolio could default on its rental payments. Furthermore, the fund manager will place transactions, hold positions and place cash on deposit with a range of eligible persons or institutions, also known as counterparties. There is a risk that a counterparty may default on its obligations or become insolvent, which could have a negative impact on the value of the fund.

The fund invests in illiquid assets, but trades daily and hence portfolio diversification is key in managing liquidity and default risks as well as reducing market risk. The fund’s risks are measured and managed as an integral part of the investment process. However, in exceptional circumstances where assets cannot be fairly valued, or have to be sold at a large discount to raise cash to settle redemptions, we may temporarily suspend the fund in the best interest of all investors.

As at 1 October 2018, for the year ended 30 September 2018

Performance against objective

Between 2 October 2017 (the start of the review period) and 1 October 2018, the M&G Property Portfolio produced a positive total return (the combination of income and growth of capital) across all share classes.*

Over the longer term (since the fund became a Property Authorised Investment Fund in January 2013) to 1 October 2018, the fund has achieved its objective of delivering income and capital growth over the long term through direct investment in commercial property.

* For the performance of each share class, please refer to the 'Long-term performance by share class' table in the 'Fund performance' section of the Annual Long Report and audited Financial Statements for M&G Property Portfolio.

To give an indication of the performance of the fund, the following table shows the compound rate of return, per annum, over the period for Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares. Calculated on a bid to bid basis with income reinvested.

Long-term performance

	One year 02.10.17 % [a]	Three years 01.10.15 % p.a.	Five years 01.10.13 % p.a.	Since launch % p.a.
Sterling [b]				
Class 'A'	+5.7	+1.2	+5.2	+5.0 [c]
Class 'I'	+6.4	+1.8	+5.8	+5.7 [c]

[a] Absolute basis.

[b] Bid to bid with income reinvested.

[c] 18 January 2013, the launch date of the fund.

Please note past performance is not a guide to future performance and the value of investments, and the income from them, will fluctuate. This will cause the fund price to fall as well as rise and you may not get back the original amount you invested.

Market background

Over the 12-month review period, the UK commercial property market on the whole enjoyed solid growth in capital values and a steady increase in rental income, according to property consultant CBRE. Capital values grew by nearly 4%, which when combined with rental income (which grew by just over 1%) gave a total return of over 9%.

While the overall figures are positive, there was a wide divergence in performance between the three main sectors: Industrials, Offices and Retail. Capital growth was strongest in Industrials and values were up by 15%. Together with rental income, the sector delivered a total return of 21%. We believe valuations in the industrial sector are reasonably well underpinned due to the lack of supply of quality assets. The popularity of e-commerce has led to an increase in demand for well-located fulfilment centres and smaller distribution units.

The Office sector recorded capital growth of just under 4% and a total return of over 8%. Meanwhile, rental values increased, albeit at a much slower pace than for Industrials. Rental growth has been particularly weak in Central London.

Retail was the only sector where capital values fell over the year, with a decline of just over 2%. Rental values also declined marginally, however, including rental income, the sector managed to record a positive total return of more than 1%. Unlike the other two sectors, Retail has not recouped the capital losses suffered in the summer of 2016 after the 'Leave' vote in the UK referendum on European Union (EU) membership.

The volume of property transactions remains resilient, with interest from both domestic buyers and overseas investors, attracted in part by sterling's weakness. (Overseas buyers represent around 45% of the market.) In 2017, transactions totalled over £66 billion and are expected to reach £55 billion for 2018 as a whole.

Portfolio structure

The portfolio is predominantly invested in what we consider as either prime or good secondary property – the higher quality end of the spectrum. In terms of strategy, we aim to balance the elements of income and growth within the portfolio while, importantly, managing the fund's assets actively to optimise performance.

Over the review period, we maintained the fund's exposure towards prime, higher-quality properties. The value of, and crucially, the income from prime assets, tends to be more resilient in times of market stress. As at the end of September 2018, the split between prime and good secondary was 65%/35% respectively.

Furthermore, according to an independent report by IPD (a company that provides analysis of the UK real estate market), the fund is just outside the top quartile relative to its peer group, in terms of quality of income.

The fund is a well-diversified portfolio designed to generate rental income across the UK by region and sector with valuations guiding asset allocation decisions. Across all sectors, the strength of rental growth in the next 12 to 18 months may have a significant bearing on property valuations going forward. The somewhat muted supply response in recent years (with the exception of Central London offices) and low historical vacancies should be supportive of rents at current levels.

In terms of positioning, our largest underweight exposure is to offices in Central London – that is, the City, Mid Town and the West End. Central London pricing has been driven higher in recent years, principally from overseas investors, pushing yields well below their long-run average. Our forecast is for Central London offices to be the most vulnerable to declines in capital value in the near term, which would be supportive of the fund's relative performance.

Overall, the fund's weighting in Offices is slightly above that of the broader market (as measured by IPD) as the underweight in Central London is offset by overweight positions in South East Offices and Rest of UK Offices, where we forecast healthier returns.

Turning to the Retail sector, we have continued to observe an ongoing polarisation of rental growth between prime, dominant locations at the expense of fringe, secondary towns. As the internet continues to alter the way consumers spend, those towns and centres that draw the greatest level of footfall and dwell time consistently attract retailers prepared to pay a premium rent. We therefore retain our material underweight position in the High Street and overweight exposure to dominant regional sites, including Shopping Centres. We also favour out-of-town retail parks, which benefit from the steady rise in online shopping, particularly the increasing demand for 'click & collect' shopping.

The fund's position to supermarkets is in line with the broader market. Supermarkets provide a steady income stream that is generally linked to movements in the Retail Prices Index or is subject to predefined increases. This should help protect, to a degree, the real income generated by the portfolio if inflation rises further.

In the Industrial sector, the fund is underweight in London and the South East and marginally overweight in the Rest of the UK. The fund has been underweight in London and the South East for some time as pricing has remained firm, making it challenging for us to find value in the sector. However, we bought three properties in the South East during the review period, thus reducing the fund's underweight position.

Within the sector, demand is strong from retailers for smaller warehouses close to towns, as online shoppers demand tighter delivery windows, while larger sheds are still required for regional and national distribution. Over the next three years, we forecast the total return for the sector will exceed the market as a whole, and will continue to look to add to our allocation there as attractive opportunities materialise.

Outside the three core property sectors, we hold a position in the growing direct student accommodation market. Student accommodation proved resilient in the last downturn and investment in this sector provides exposure to a market which is structurally undersupplied, as well as being accretive to the overall yield of the portfolio.

The vacancy rate (including developments) of the fund was 7.5% at the end of September, which compares to 8.7% at the start of the review period. Three offices – Bedfont Lakes, Heathrow, 5, The Square, Uxbridge and R+, Reading – and the Gracechurch Shopping Centre, Sutton Coldfield, account for around half of the fund's voids. The offices are best-in-class, prime assets, located in dense occupier markets and continue to generate interest from prospective occupiers who, on becoming tenants, should underpin the assets' value and income generated by the fund.

In normal commercial property market conditions, we aim to keep the amount of cash held in the portfolio between 7.5% and 12.5% of the value of the fund. However, in the short to medium term, the cash holding on the fund is likely to remain around 15%, above our normal stated desired range, as a precautionary measure given the uncertain economic climate at present. The fund's cash position declined from 18.3% at the start of the review period to 15.5% at the end of September 2018.

Investment activities**

Investment activity during the 12-month period was guided with portfolio positioning in mind, and with the aim of ensuring that going forward, the fund was aligned with those sectors forecast to outperform.

Consequently, we took the decision to increase the fund's allocation to South East Industrials, where the demand/supply imbalance is most acute and, correspondingly, rental growth forecasts are the most positive. We made three purchases: Orbital One Trading Estate, Dartford; Industrial units 2 and 7 at Millington Road, West London and Leatherhead Trade Park, London.

Orbital One Trading Estate, Dartford was bought for £12.8 million and is situated in an established industrial location within the M25 which benefits from excellent road and public transport links to surrounding areas and beyond. Rents across Greater London have continued to be pushed upwards over the past year and we think this will continue for the foreseeable future. The individual units are detached and benefit from self-contained yards, a feature which is becoming increasingly rare in Greater London.

Industrial units 2 and 7 at Millington Road, West London (value £38.3 million) were acquired via an asset exchange of the Premier Inn, Stansted (value £42.5 million). Meanwhile, the investment in Leatherhead Trade Park, purchased for £10.6 million, represented a great opportunity to acquire a multi-let industrial estate. Situated in a prominent South East location, the trade park benefits from being in a supply-constrained location facing strong levels of occupier demand, which translates into upward pressure on rents. Bought with a vacant unit, there is scope for some asset management to boost the value in the near term.

We also bought 78-92, Great Portland Street, an office building in the West End of London for £49.5 million. With strong demand from overseas investors supporting pricing at the prime end of the market, the investment rationale behind the purchase is multi-faceted: it provides the opportunity to acquire a highly liquid, newly built, mixed-use building (office, residential apartments and retail), where no medium-term capex will be required. The investment increases the fund's weighting in the sector (although the fund remains underweight in West End Offices) and reduces its tracking error.

** The prices of these transactions excludes related costs.

As well as the sale of Premier Inn, Stansted, we sold several other properties, the largest of which were: 3, Hardman Square, an office building in Manchester; Acergy UK Regional Campus, an out-of-town office park near Aberdeen; and Springfield Retail Park, in Haverfordwest.

3, Hardman Square, a Grade A office building in Manchester city centre, was sold for £107.3 million, representing a substantial premium to its carrying value. This gives an indication of the latent value within the portfolio and confirms wider data which shows that prime property prices have maintained their appeal to domestic and overseas investors alike. It also supports our decision to focus on selling good secondary assets over the past 18 months, where prices have been slow to stabilise. As the property had part empty floors, equal to 0.8% of the fund's total estimated rental value, the sale has therefore had the added benefit of reducing the overall vacancy rate on the fund as well as providing a substantial profit on the acquisition price of £87.5 million in 2015.

Acergy UK Regional Campus, an out-of-town office park near Aberdeen, was sold for £39.1 million. The decision to sell Acergy was driven by the desire to reduce the fund's exposure to Aberdeen, where the long-term prospect of the oil & gas sector is of concern. The fund has two other office buildings in Aberdeen, both of which are fully let. One of these is The Capitol, an award-winning Grade A building developed by the fund and located in the city centre.

Following strong capital growth in 2017, Springfield Retail Park, a retail park in Haverfordwest, was sold for £17.8 million – a 10% premium to its carrying value. The decision to sell the property was partly due to positive asset management activity over the past year – two units that had been vacant for some time were let to DFS and Currys in 2017 – and over concerns that the WAULT (weighted average unexpired lease term) on the park was declining. In addition, we feel the town has an oversupply of retail units.

Other sales during the review period included Mill Court, an office building in St Peter Port, Guernsey for £12.3 million and a shop in Hounslow for £5.3 million. We also sold two properties in Scotland: a shop in Glasgow at 70/76 Argyle Street for £9.1 million and Souterhead Industrial Estate in Aberdeen for £4.2 million.

Asset management

Active asset management continued during the review period so as to enhance the performance of the portfolio by maintaining values through securing and strengthening rental income.

Retail

At Parc Trostre Retail Park, Llanelli, we completed three initiatives. The first involved the surrender of Monsoon's lease on a unit, while exchanging an 'agreement for lease' with Superdrug. (An 'agreement for lease' is a binding agreement between a landlord and prospective tenant to grant and/or to accept a lease in the future.) At the same time, we agreed to carry out minor works on the unit. Superdrug took a 10-year protected lease from March 2018, with a 12-month rent-free period and a tenant break in year 5 with a six-month notice period. (A protected lease gives the tenant a statutory right to request a new lease from their landlord on similar terms to their existing lease when it expires.) This activity improved the WAULT on the unit by 10 years and increased its rental value.

We also completed a rent review with Carphone Warehouse, which led to an uplift in rental value and completed a reversionary lease (a lease that takes effect when an existing lease has expired) for five years with Sportswift (trading as Card Factory). The new lease now expires in June 2024.

At 3 Royal Baths, Harrogate we agreed a lease with a regional pub operator, which provides casual dining as part of its business model. The operation will be run under the Potting Shed Bar brand and comprises around 8,100 sq ft of space with additional external seating. The lease is for 20 years, starting in March 2018 and is subject to five-yearly upward-only rent reviews.

At Lisnagelvin Retail Park, Londonderry, an existing lease to TK Maxx was surrendered. The lease had two years to expiry. A new 15-year lease with an increased rent of just over 10% has been put in place and is subject to five-yearly upward-only rent reviews. In exchange, the tenant receives a three-month rent-free period and there is a tenant-only break option in year 10.

At Fremlin Walk Shopping Centre, Maidstone, we surrendered a lease with New Look and signed an Agreement for Lease with Roman Originals, a women's fashion retailer. The five-year lease includes a rent-free period of three months and Roman will take occupation in October 2018. The unit is approximately 3,400 sq ft in size and is arranged over two floors.

We also agreed terms with SportsDirect on behalf of House of Fraser. (SportsDirect has recently acquired House of Fraser.) The new lease is for 24 months and has a landlord break option after six months on three months' notice, and a tenant break option after 12 months on three months' notice.

Offices

At 3 Temple Quay, Bristol we completed two new lettings: one to Bluefield for 4,000 sq ft and the other to Quilter Cheviot for 7,100 sq ft. We also agreed a re-gear of a lease with Womble Bond Dickinson. This included the surrender of the second, third and fourth floor leases, where we inherited existing sub-tenants and some vacant space. In addition, on the fifth to eighth floors (which represent over 50,000 sq ft), there was a variation in the lease to allow for a 15-year term. The activity at 3 Temple Quay produced an uplift in valuation of £1.4 million.

At 120 Edmund Street, Birmingham, we completed a re-gear of the lease which removed the 2019 break clause and increased the rent. In return, we granted a 36-month half-rent incentive period to the tenant. The re-gear led to an uplift in valuation of over £5 million.

Asset management activity also took place at offices at R+, Reading, 5, The Square, Stockley Park, Uxbridge and Alder Castle in the City of London. At R+, contracts were exchanged on a new lease with Northgate Plc. Northgate has taken c10,000 sq ft of space on the fourth floor for its head office, which has been relocated from the north of England. We also completed a new letting of the whole of the ground floor (c16,100 sq ft) to Central Working, on a 15-year lease. Central Working is a serviced office/co-working business that will create a new hub at R+.

We completed two new lettings at 5, The Square, Stockley Park an out-of-town office park. Contracts were exchanged on a new lease with Mitsubishi, who has taken 7,000 sq ft on the ground floor and a new 10-year lease was agreed with Canon Europe Ltd, who has taken 8,480 sq ft of space. This activity helps to underpin the value of the asset where we have undertaken significant development, a decision which resulted in a vacancy during a challenging period after the EU referendum. Encouragingly, businesses continue to take space at 5, The Square, Stockley Park, as the asset is best in class.

At Alder Castle, an office building in the City, Drax Group plc has taken the third floor of the building, representing 13,000 sq ft of space.

Industrial

In the industrial and logistics sector we were active at two sites. At Hartlebury Trading Estate, we completed a 20-year reversionary lease on a unit with Weinberger to commence in September 2023. Rent reviews are every five years with the first at the start of the lease. The new terms have resulted in an uplift to the valuation.

At Brackmills Trade Park, we let the final three units at the site. The new tenants are National Windscreens, Cubico (UK), a bathroom stockist/showroom, and Dulux. This speculative development was practically completed in February 2017 and consists of 14 warehouse/trade/retail units totalling 65,200 sq ft of space. Other tenants include Screwfix, Howdens, Topps Tiles, Costa and Subway.

Outlook

Two years on from the result of the UK referendum on EU membership, commercial property continues to deliver attractive returns. Despite the negative sentiment following the vote, the decision to leave the EU made hardly a dent in the medium-term performance of commercial property. By the end of 2016, capital values had all but recovered their summer losses. This was down to an asset class financed by relatively low levels of debt and supported by healthy investor and occupier demand.

The same property fundamentals that provided that resilience remain largely in place today. While the possibility of an acrimonious Brexit appears on the rise, transaction volumes – a gauge of investor appetite for risk – suggest a collectively more pragmatic outlook.

Arguably, the economic expansion since the financial crisis is long in the tooth, with market commentary increasingly focused on potential destabilising risks. This is true too of the property cycle; and yet, while interest rate risk, Brexit, investor confidence in UK property and occupier strength are tabled as worries, data and sentiment suggest that near term, these concerns are somewhat unfounded.

Taking each in turn, the unanimous vote to raise the UK's base rate in August 2018 was perhaps less a vote of confidence in an economy that continues to perform well in the face of a challenging political outlook, than a need for rates to 'normalise' after a decade of very accommodative monetary policy. While the US Federal Reserve began tightening in 2015, thus far there has been little impact on property yields, where the spread over US Treasuries remains considerably higher than its long-run average. This feature can also be found in the UK and provides a cushion in the face of rising interest rates, illustrating the relative attractiveness of property to other income-generating assets.

Some of the reaction to Brexit – for example, the exodus of investors from daily-dealt UK property retail funds in the summer of 2016, including our own – appears to be born more out of fear than fact, given the rise in capital values since the vote.

The office sector was expected to fare the worst, with estimates that over 100,000 city workers would be relocated to Europe in short order. However, recent estimates suggest that the figure is much smaller and the exodus will take place over several years.

It should be remembered that UK property fundamentals remain strong: transactions are expected to reach £55 billion in 2018; rental growth is positive in all but the retail sector; and this property cycle has been fuelled predominantly by equity, rather than debt. Collectively, these fundamental characteristics point to a more benign than bleak course for property values over the medium term, in our view.

We would argue that the challenges facing UK commercial property come more from a technology-led industrial revolution, rather than an overheating asset class exposed to political uncertainty.

New tenant behaviour, as a result of the 21st century influences, is affecting all sectors, but in different ways. In the office sector, serviced office buildings are becoming more popular and disrupting the way we work. Meanwhile, the view that a retailer needs an extensive, multi-faceted retail footprint is being challenged. Instead, will an online presence with new-age retail-distribution stores and third-party supply chains be sufficient?

There is no blueprint, however, and understanding your customer has never been more important – as recently demonstrated by IKEA. Formerly synonymous with big blue and yellow out-of-town boxes, IKEA is breaking with tradition with a move into shopping centres and the high street.

Looking ahead, we expect UK commercial property to generate low, mid-single-digit returns over the next five years, with some weakness in capital values moderating returns. In the near term, this weakness is expected to come predominantly from Retail and Central London Offices, with a softening in Industrials towards the latter part of the period.

Fiona Rowley and **Justin Upton**
Co-fund managers

Employees of M&G Limited which is an associate of M&G Securities Limited. At the start of the review period Fiona Rowley was the sole fund manager.

Please note that the views expressed in this Report should not be taken as a recommendation or advice on how the fund or any holding mentioned in the Report is likely to perform. If you wish to obtain financial advice as to whether an investment is suitable for your needs, you should consult a Financial Adviser.

Portfolio statement

as at 30 September Location		2018 £'000	2018 %	2017 [a] %
	Retail properties	**1,329,121**	**36.77**	**36.89**
	Values between £100 million and £150 million	**369,646**	**10.23**	**10.11**
Llanelli	Parc Trostre Retail Park			
Bridgend	Wales Designer Outlet, The Derwen			
Maidstone	19-21 Fremlin Walk			
	Values between £50 million and £100 million	**426,294**	**11.79**	**11.57**
Northampton	Riverside Retail Park			
Sutton Coldfield	The Gracechurch Centre			
London, N18	Ravenside Retail Park			
Lincoln	Lindis Retail Park, Tritton Road			
High Wycombe	Wycombe Retail Park			
Romford	The Brewery (25% of Trust for Land)			
	Values between £20 million and £50 million	**350,849**	**9.71**	**9.60**
Tyne And Wear	Newcastle Shopping Park, Fossway, Heaton, Byker			
High Wycombe	Tesco Supermarket, London Road, Loudwater			
London, E4	Corktree Retail Park, Hall Lane, Chingford			
Petersfield	1-20 Rams Walk & 11-13 The Square			
Ayr	Ayr Central Shopping			
Bolton	Bolton Shopping Park, Trinity Street			
Cannock	Orbital Retail Park, Voyager Drive			
Scarborough	Brunswick Shopping Centre			
Blandford St Mary	Tesco Supermarket, Stour Road			
Croydon	Trafalgar Way Retail Park, Purley Way			
Birmingham	The Fort Retail Park (12.5% of Trust for Land)			
	Values up to £20 million	**182,332**	**5.04**	**5.61**
Sheffield	Debenhams, The Mall and Charter Square			
Londonderry	Lisnagelvin Retail Park			
Harrogate	Royal Baths and Harrogate House			
York	3/7 Coney Street			
Cannock	Orbital Retail Park			
Northampton	Tungsten Business Park, Caswell Road			
Belfast	17-21 Donegall Place			
Newcastle	46/48 Northumberland Street & 1/5 Saville Row			

Portfolio statement (continued)

as at 30 September Location		2018 £'000	2018 %	2017 [a] %
	Retail properties (continued)			
	Values up to £20 million (continued)			
Harrow	Debenhams, 275 Station Road			
Southampton	57/61 Above Bar Street			
Worcester	48-50 High Street & 3-6 The Shambles			
London, N1	359 Upper Street, The Mall			
St Albans	Lockey House, St Peters Street			
Brighton	45 East Street & 10-12 Castle Square			
Chester	43 Eastgate Street			
Peterborough	Barclays Bank, 1/3 Church Street			
Winchester	71/73 St Georges Street & 126 High Street			
Leeds	27-28 Commercial Street			
Leeds	25-26 Commercial Street			
	Office properties	**900,901**	**24.92**	**24.81**
	Values between £150 million and £200 million	**178,178**	**4.93**	**4.67**
Heathrow	1-8 New Square Bedfont Lakes Office Park			
	Values between £100 million and £150 million	**106,548**	**2.95**	**0.00**
London, EC2	Alder Castle, 10 Noble Street			
	Values between £50 million and £100 million	**251,413**	**6.95**	**8.41**
Glasgow	Aurora Building, 120 Bothwell Street			
Uxbridge	Enterprises House, Bakers Road			
Reading	Aldwych House, Blagrave Street			
Birmingham	120 Edmund Street			
	Values between £20 million and £50 million	**315,751**	**8.73**	**10.66**
London, W1	Portland & Riding Estate			
Maidenhead	Quantum Business Park			
Bristol	3 Temple Quay			
Uxbridge	Stockley Park, 5 The Square			
Milton Keynes	Wavendon Business Park			
Aberdeen	The Capitol, 431 Union Street			
Staines	20 Kingston Road			
London, E14	8 Greenwich View Place			
Brighton	2 City Park			
London, W8	2 Kensington Square			

Portfolio statement (continued)

as at 30 September Location		2018 £'000	2018 %	2017 [a] %
	Office properties (continued)			
	Values up to £20 million	**49,011**	**1.36**	**1.07**
Aberdeen	City View, Craigshaw Drive			
Glasgow	23 Cadogan Street			
London, N1	Units 1-4 The Yard, 122 East Road			
	Industrial properties	**613,042**	**16.96**	**13.62**
	Values between £50 million and £100 million	**82,250**	**2.28**	**1.86**
Belvedere	Iron Mountain Distribution Warehouse, Isis Reach, Norman Road			
	Values between £20 million and £50 million	**388,134**	**10.73**	**7.36**
Hayes	Unit 2 & 7a/b/c Millington Road			
Birmingham	Units 2-12, 14 & 15, Junction 6 Industrial Estate, Electric Avenue			
Enfield	Heritage House, Southbury Road			
Bristol	Plot 4000, Western Approach Distribution Park			
Southampton	Tesco Distribution Unit, Main Site, Nursling Industrial Estate			
Didcot	Booker Unit, Foxhall Road			
Aberdeen	Sites A1, A7-A10, A12, A15-A25 & A29, Altens Industrial Estate			
Walsall	TK Maxx Distribution Centre, Green Lane			
Aberdeen	Sites WT1-WT5 & WT8-WT18 & WT20, West Tullos Industrial Estate			
Warrington	Royal Mail Distribution Centre, Orion Boulevard			
Rainham	Wincanton Distribution Unit			
Coalville	Canon Unit, 22 Beveridge Lane, Bardon Hill			
	Values up to £20 million	**142,658**	**3.95**	**4.40**
Tamworth	DSV, Kingsbury Link, Trinity Road			
Normanton	Royal Mail Distribution Centre, Tuscany Way, Wakefield Europort			
Thrapston	Units HP1 & HP2, Halden's Parkway			
Lutterworth	Plot 3320, Magna Park			
Leatherhead	Leatherhead Trade Park			
Southampton	Norbert Dentressangle Recycling Plant, Site 1b, Nursling Industrial Estate			
Hartlebury	Unit 100, Hartlebury Trading Estate			
Fareham	11 Barnes Wallis Road			

Portfolio statement (continued)

as at 30 September Location		2018 £'000	2018 %	2017 [a] %
	Industrial properties (continued)			
	Values up to £20 million (continued)			
Nottingham	Unit 10, Blenheim Park			
Tamworth	Inalfa Unit Kingsbury Link			
Aberdeen	Portfolio of 7 Ground Leases, Murcar Industrial Estate			
Normanton	Unit 1000, Normanton Industrial Estate			
Aberdeen	Units 1-4 Howe Moss Drive, Kirkhill Industrial Estate			
Liverpool	Britonwood			
	Leisure properties	**152,884**	**4.23**	**5.05**
	Values between £20 million and £50 million	**93,439**	**2.59**	**3.51**
Rochester	Medway Valley Leisure Park			
Telford	Southwater Square			
Blackburn	Peel Retail & Leisure Centre, Lower Audley Street			
	Values up to £20 million	**59,445**	**1.64**	**1.54**
Swansea	Premier Inn Hotel, The Waterfront Development			
Birmingham	Travelodge - 2225 Coventry Road			
Milton Keynes	Travelodge - Burchard Crescent			
Slough	Travelodge - 399 London Road, Langley			
Northampton	Travelodge - London Road			
Walton on Thames	Travelodge - Ashley Park Road			
Redhill	Travelodge - 2 Redstone Hill			
Woodford Green	Travelodge - 735 Chigwell Road			
Borehamwood	Travelodge - Studio Way			
London, E11	Travelodge - 73 Hollybush Hill, Snaresbrook			
Arundel	Travelodge - Fontwell Avenue			
Northolt	Travelodge - Mandeville Road			
Eastbourne	Travelodge - Highfield Park, Willingdon Drove			
London, N14	Travelodge - The Green, Southgate			
Portsmouth	Travelodge - 1 Whichers Gate Road, Rowland's Castle			
	Other properties	**34,800**	**0.96**	**0.77**
	Values between £20 million and £50 million	**34,800**	**0.96**	**0.77**
Birmingham	Selly Oak Student Quarter			
Total direct properties		**3,030,748**	**83.84**	**81.14**

Investment review

Portfolio statement (continued)

as at 30 September Location		2018 £'000	2018 %	2017 [a] %
	Indirect properties	**31,218**	**0.87**	**0.78**
	Kames Target Healthcare I LP	17,993	0.50	
	Octopus Healthcare Fund	13,225	0.37	
Portfolio of investments		**3,061,966**	**84.71**	**81.92**
	'AA' credit rated bonds [b]	**299,749**	**8.29**	**10.80**
£50,000,000	Treasury 0% 2018 (1 Oct 2018)	49,997	1.39	
£50,000,000	Treasury 0% 2018 (8 Oct 2018)	49,993	1.38	
£50,000,000	Treasury 0% 2018 (5 Nov 2018)	49,964	1.38	
£50,000,000	Treasury 0% 2018 (19 Nov 2018)	49,950	1.38	
£50,000,000	Treasury 0% 2018 (26 Nov 2018)	49,943	1.38	
£50,000,000	Treasury 0% 2018 (31 Dec 2018)	49,902	1.38	
Total portfolio		**3,361,715**	**93.00**	**92.72**
Net other assets		**253,071**	**7.00**	**7.28**
Net assets attributable to shareholders		**3,614,786**	**100.00**	**100.00**

[a] The comparatives reflect the properties in the bands based on the value and ownership at 30 September 2017.

[b] Cash equivalents.

Financial highlights

Fund performance

Please note past performance is not a guide to future performance and the value of investments, and the income from them, will fluctuate. This will cause the fund price to fall as well as rise and you may not get back the original amount you invested.

The following chart and tables show the performance for two of the fund's share classes – Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares.

We show performance for these two share classes because:

- The performance of the Sterling Class 'A' (Accumulation) share is what most individuals investing directly with M&G have received. It has the highest ongoing charge of all the share classes. Performance is shown after deduction of this charge. All investors in the fund therefore received this performance or better.
- The performance of the Sterling Class 'I' (Accumulation) share is the most appropriate to compare with the average performance of the fund's comparative sector. It is the share class used by the Investment Association in the calculation of the comparative sector's average performance. This share class is available for direct investment with M&G subject to minimum investment criteria, or via third parties who may charge additional fees. The performance shown takes the deduction of the ongoing charge for this share class into account but it does not take account of charges applied by any other party through which you may have invested.

The fund is available for investment in different share classes, each with varying levels of charges and minimum investments; please refer to the Prospectus for M&G Property Portfolio, which is available free of charge either from our website at www.mandg.co.uk/prospectuses or by calling M&G Customer Relations. For the specific performance tables of all share classes, please refer to the Annual Long Report and audited Financial Statements for M&G Property Portfolio, which is available free of charge either from our website at www.mandg.co.uk/reports or by calling M&G Customer Relations.

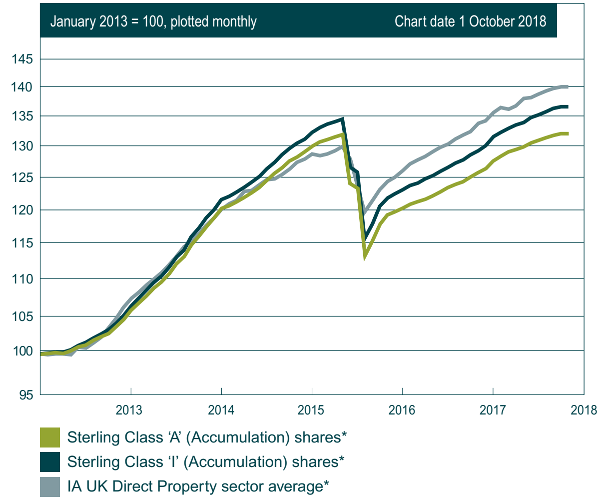
Fund level performance

Fund net asset value

as at 30 September	2018 £'000	2017 £'000	2016 £'000
Fund net asset value (NAV)	3,614,786	3,701,686	4,102,611

Performance since launch

To give an indication of how the fund has performed since launch, the chart below shows total return of Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares.



* Income reinvested

Source: Morningstar, Inc. and M&G

Interest distributions payable to holders of Sterling Income shares are shown gross, including any income tax. Retained interest distributions in respect of Sterling Accumulation shares are shown net of income tax, with the income tax payable shown as distributions.

To give an indication of how the fund has performed during the period the tables below show the performance of Sterling Class 'A' (Accumulation) shares and Sterling Class 'I' (Accumulation) shares.

All 'Performance and charges' percentages represent an annual rate except for the 'Return after operating charges' which is calculated as a percentage of the opening net asset value per share (NAV). 'Dilution adjustments' are only in respect of direct portfolio transaction costs.

Historic yields for the current year are calculated as at 12 October 2018.

Sterling Class 'A' Accumulation share performance

The share class was launched on 18 January 2013.

for the year to 30 September Change in NAV per share	2018 UK p	2017 UK p	2016 UK p
Opening NAV	131.74	124.77	127.32
Return before operating charges and after direct portfolio transaction costs	10.96*	10.53	0.87
Operating charges	(2.80)*	(3.02)	(2.67)
Return after operating charges	8.16	7.51	(1.80)
Distributions	(3.47)	(3.12)	(4.13)
Retained distributions	2.87	2.58	3.38
Closing NAV	139.30	131.74	124.77*
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	0.34	0.24	0.33
Dilution adjustments [a]	(0.12)	(0.17)	(0.22)
Total direct portfolio transaction costs	0.22	0.07	0.11
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.17	0.06	0.08
Operating charges excluding property expenses	1.69	1.70	1.67
Property expenses	0.37*	0.67	0.41
Operating charges	2.06*	2.37	2.08
Return after operating charges	+6.19	+6.02	-1.41
Historic yield	2.35	2.35	3.36
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	56,327	74,592	89,664
Closing NAV percentage of total fund NAV (%)	1.56	2.02	2.19
Number of shares	40,434,668	56,620,668	71,862,668
Highest share price (UK p)	146.44	139.66	146.05
Lowest share price (UK p)	138.32	131.07	132.85

* Restated.

Sterling Class 'I' Accumulation share performance

The share class was launched on 18 January 2013.

for the year to 30 September Change in NAV per share	2018 UK p	2017 UK p	2016 UK p
Opening NAV	1,354.88	1,275.54	1,293.93
Return before operating charges and after direct portfolio transaction costs	113.15*	108.11	9.47
Operating charges	(18.43)*	(21.30)	(18.27)
Return after operating charges	94.72	86.81	(8.80)
Distributions	(46.31)	(41.77)	(51.55)
Retained distributions	38.11	34.30	41.96
Closing NAV	1,441.40	1,354.88	1,275.54
Direct portfolio transaction costs	**UK p**	**UK p**	**UK p**
Costs before dilution adjustments	3.46	2.51	3.30
Dilution adjustments [a]	(1.19)	(1.76)	(2.26)
Total direct portfolio transaction costs	2.27	0.75	1.04
Performance and charges	**%**	**%**	**%**
Direct portfolio transaction costs [b]	0.17	0.06	0.08
Operating charges excluding property expenses	0.94	0.95	0.92
Property expenses	0.38*	0.68	0.48
Operating charges	1.32*	1.63	1.40
Return after operating charges	+6.99	+6.81	-0.68
Historic yield	3.07	3.07	4.10
Effect on yield of charges offset against capital	0.00	0.00	0.00
Other information			
Closing NAV (£'000)	250,575	234,627	269,877
Closing NAV percentage of total fund NAV (%)	6.93	6.34	6.58
Number of shares	17,384,104	17,317,204	21,157,904
Highest share price (UK p)	1,515.33	1,422.00	1,445.19
Lowest share price (UK p)	1,422.67	1,358.18	1,315.85

* Restated.

[a] In respect of direct portfolio transaction costs.

[b] As a percentage of average net asset value.

We explain below the payments made to meet the ongoing costs of investing and managing the fund, comprising operating charges and portfolio transaction costs.

Operating charges

Operating charges include payments made to M&G and to providers independent of M&G:

- **Investment management:** Charge paid to M&G for investment management of the fund (also known as Annual Management Charge).
- **Administration:** Charge paid to M&G for administration services in addition to investment management – any surplus from this charge will be retained by M&G.
- **Oversight and other independent services:** Charges paid to providers independent of M&G for services which include depositary, custody and audit.
- **Property expenses:** Costs associated with the management and operation of the property portfolio itself, including day-to-day property management and rent collection.

Operating charges do not include portfolio transaction costs or any entry and exit charges (also known as initial and redemption charges). The charging structures of share classes may differ, and therefore the operating charges may differ.

Operating charges are the same as the ongoing charges shown in the Key Investor Information Document, other than where an estimate has been used for the ongoing charge because a material change has made the operating charges unreliable as an estimate of future charges.

For this fund there is no difference between operating charges and ongoing charges figures, unless disclosed under the specific share class performance table.

Portfolio transaction costs

Portfolio transaction costs are incurred by funds when buying and selling investments. These costs vary depending on the types of investment, their market capitalisation, country of exchange and method of execution.

Investments are bought or sold by a fund when changes are made to the investment portfolio and in response to net flows of money into or out of the fund from investors buying and selling shares in the fund.

Financial highlights
Operating charges and portfolio transaction costs

Portfolio transaction costs include the costs of acquiring or disposing of, as the case may be, all the assets forming the scheme property, being agents' commissions, legal, fiscal and financial advisory fees and additionally in the case of acquisitions, surveyors' fees and taxes, including Stamp Duty Land Tax (SDLT).

To protect existing investors, portfolio transaction costs incurred as a result of investors buying and selling shares in the fund are recovered from those investors through a 'dilution adjustment' to the price they pay or receive. The table below shows direct portfolio transaction costs paid by the fund before and after that part of the dilution adjustment relating to direct portfolio transaction costs.

Further information on this process is in the Prospectus, which is available free of charge on request either from our website at www.mandg.co.uk/prospectuses or by calling M&G Customer Relations.

Portfolio transaction costs

for the year to 30 September Direct portfolio transaction costs [b]	2018 %	2017 %	2016 %	Average [a] %
Agents' fees	0.01	0.01	0.04	0.02
Legal fees	0.07	0.18	0.09	0.12
Stamp Duty Land Tax	0.16	0.00	0.12	0.09
Survey fees	0.01	0.00	0.00	0.00
Costs before dilution adjustments	0.25	0.19	0.25	0.23
Dilution adjustments [c]	(0.08)	(0.13)	(0.17)	(0.13)
Total direct portfolio transaction costs	0.17	0.06	0.08	0.10

[a] Average of first three columns.

[b] As a percentage of average net asset value.

[c] In respect of direct portfolio transaction costs. Please see the section above this table for an explanation of dilution adjustments.

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