Quarterly Review

Q1 2013

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Macro Overview

Q1 2013

The year started on a positive note as the continuation of loose monetary policy and a last minute resolution to the so called US "fiscal cliff" led to an increase in investor appetite, driving risk assets higher.

US economic data surprised to the upside, with bullish employment statistics and evidence that consumer spending was up in February. More importantly the US housing market showed signs of stabilising, with confidence surveys rebounding towards pre-crisis levels.

In response to a better outlook, US government bond yields started to move higher, whereas bond markets in the UK, Germany and Japan were broadly unchanged over the quarter owing to the on-going uncertainty over levels of economic growth. In Asia, the Yen continued to weaken throughout the quarter after the Japanese government unveiled a $109 billion spending package in January and the Chinese economy showed signs of improvement.

Whilst the fallout from the Eurozone sovereign debt crisis seems to be easing and the economic outlook appears considerably improved, headwinds remain after inconclusive election results in Italy were followed by a new crisis in Cyprus.

Despite the loss of the UK's triple A rating and George Osborne's rejection of calls for more short-term fiscal stimulus in the latest budget, recent news has been slightly more positive.

The UK economy grew by 0.3% in the first quarter of 2013, marginally avoiding a second consecutive quarter of contraction, which would have signalled a triple dip recession. GDP growth is forecast to improve to 0.9% (down from 1.2% in the autumn) in 2013 as the effect of austerity measures ease off and consumer confidence returns.

Whilst the rest of the UK struggles, London continues to show its resilience. Data released by the office for National Statistics in March showed that economic growth was higher, the number of jobs had risen faster and the experience of the recession had been less severe.

It has become increasingly evident that the Bank of England (BOE) is targeting a weaker Pound, but this will come at the cost of higher inflation. Inflation in March remained higher (CPI inflation increased to 2.8%, up from 2.7% in January) than anticipated as consumers continue to be squeezed, with incomes falling in real terms contributing to weaker demand.

UK Property Outlook

Q1 2013

	Q4 2012			Q1 2013		
	All Property	Offices	City Offices	All Property	Offices	City Offices
Rental Value Growth (% p.a)	0	1.3	0.6	0.1	1.7	1.7
Capital Growth (% p.a)	-0.7	-0.1	0.8	-0.4	0	0.5
Income Return	1.5	1.4	1.3	1.5	1.4	1.2
Equivalent Yield (%)	7.1	7.3	6.3	7.1	7.3	6.3
Total Return	0.8	1.3	2.1	1.1	1.4	1.7

Source: IPD Quarterly Digest, Q1 2013

On the face of it, UK commercial property had a strong start to the year with a total return of 1.1% in Q1 2013, according to the IPD Quarterly Index.

The trends in place over the last two years continued, with a rise in London prices once again off-setting a fall for the rest of the UK.

The market continues to show signs of increasing polarisation. A lack of suitable supply has seen prime asset valuations rise, whilst secondary asset valuations outside of Central London continue to fall.

Offices continue to be the best performing commercial sector with a total return of 1.4% according to IPD (5.57% annualised to March 2013).

London, and particularly the West End, continued to outperform other UK markets, benefiting from a combination of rental growth and yield compression.

Secondary market pricing continues to fall, thus widening the yield gap between prime, good quality secondary and tertiary (or poor secondary) asset classes.

Yield Gap Between Primary and Secondary Property

Source: IPD Quarterly Digest, Q1 2013

UK Property Outlook

Q1 2013

The trend of strong capital inflows into the UK over 2012 continued into 2013. According to data from the Property Archive there was £9.34bn of investment into UK commercial property during the first quarter of 2013, an increase of 1.8% over Q4 2012.

Overseas investors continued to dominate the UK market with close to a 50% share (£4.56bn) followed by UK institutions at 23% (£2.19bn).

Despite the high demand, transaction levels into central London offices were down on the quarter due, primarily, to the shortage of suitable stock.

Competition for prime assets is set to intensify, due to the Chinese government's deregulation of the insurance sector which allows life funds to invest in real estate outside of China for the first time. The current weakness in Sterling will also encourage overseas investors further.

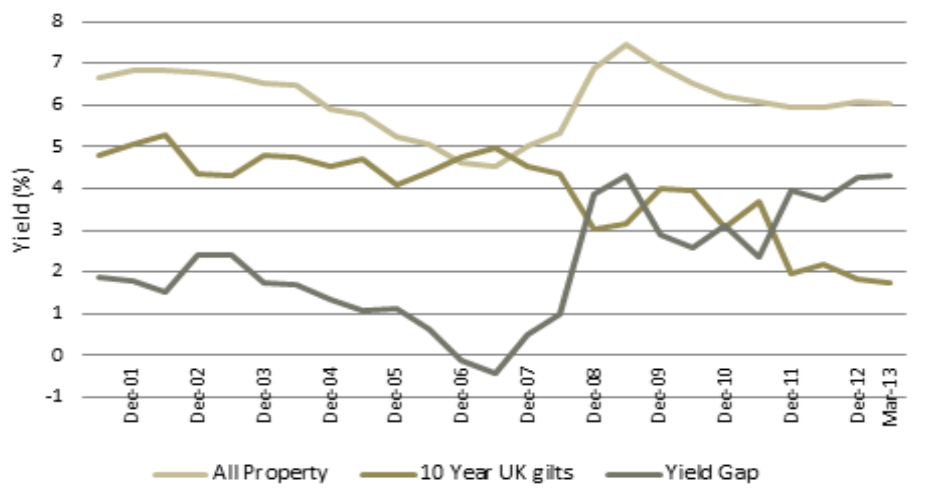
With demand for prime property in central London outstripping supply, investors may have to move up the risk curve over the coming year and look towards well located 'prime secondary' stock and asset management opportunities.

Strong overseas demand has put downward pressure on office yields with City prime yields contracting by 25 basis points to 4.75%. With the on-going issues in the Eurozone, London will continue to be the destination of choice. With no signs of a slowdown in overseas demand, there is potential for yields to compress further.

Prime Yields	2012		2013
	Q1	Q4	Q1
West End Offices	4.00%	4.00%	4.00%
City Offices	5.00%	5.00%	4.75%
Non London Offices	6.00%	6.25%	6.50%
High Street Retail	4.75%	4.75%	4.75%

With no significant change in government bond yields, property yields continued to maintain a substantial margin over UK gilts.

10 Year Government Yield vs All Property Yield



Source: IPD Quarterly Digest, Q1 2013, Bloomberg

UK Property Outlook

Q1 2013

Prime rents in the West End increased for the first time in seven quarters, from £95.00 per sq ft to £97.50 per sq ft. There was no change In City prime rents having risen to £57 after seven static quarters during the final three months of 2012.

Technology, Media & Telecom (TMT) was the most active sector in Q1, accounting for 27% of activity. Alongside on-going requirements for businesses such as Amazon, the Google transaction highlights the importance of the TMT sector going forward. After a fairly subdued period, we are also seeing an increase in demand from the financial services sector as sentiment picks up.

According to Jones Lang La Salle, 2.5m sq ft of office space was let during Q1 2013, the highest total since the end of 2010. This number was slightly skewed by the 725,000 sq ft letting to Google at Kings Cross; however we are still witnessing an upward trend.

The latest Credit Conditions Survey from the Bank of England suggests that the availability of credit for commercial real estate continues to improve in 2013.

With the majority of finance targeted at 'core' assets, secondary markets are held back. As the economic outlook improves investors would hope to see an easing in lending policies.

Conclusion

The overall economic outlook is considerably better than it was 12 months ago. Financial markets are buoyant and the US recovery remains on track. This has raised optimism that investors may be willing to increase their exposure to risk.

The London market has shown some encouraging signs over the first quarter, with both overseas investor demand and competition for sites remaining intense.

Downward yield movement alongside above inflation rental growth has continued to boost capital values. However, a shortage of prime investable stock could result in some investors moving higher up the risk curve and exploring opportunities outside of London.

Headline Transactions, Q1, 2013

Property	Sale Price	Yield (5)	Size (sq ft)	Purchaser
Ropemaker Place, EC1	£472m	5.00	575,00	Axa REIM
5 Canada Square	£383m	5.00	536,338	St. Martins Property
Woolgate Exchange, EC2	£265m	6.21	351,460	Ivanhoe Cambridge
1-19 Victoria Street, SW1	£180m	4.82	335,400	Mitsubishi Estate

Talking Points

Q1 2013

London Market Expertise Vital for Foreign Investors

Dominic Wright, Chief Executive

Overseas investors looking to buy into the UK commercial property market are entering an extremely popular market and without proper knowledge and guidance may find that their investments have not been best placed.

Considered a safe haven, the London property market in particular has seen massive levels of investment in 2012 - around £16bn. Compare that to less than £4bn going into the New York property market in the same time-frame and it provides a clear indication of just how attractive a location London is for overseas investors. This brings with it particular problems for investors who do not know the market, who should be wary of making a purchase without conducting proper due diligence on the property, the location, the current and future yield and the potential growth in the asset.

Location can be a major trap for the unwary investor. The huge demand for London property and lack of supply in the West End has seen many investors steer towards the City of London to invest. At face value there is logic to this, since the City is the hub of the financial district. But the City is a cyclical market where building supply is not constrained, so timing can be critical.

Simply entering the London property market and buying in the current boom may work in the short term, but there are inherent dangers, and a more tailored approach that assesses the ultimate objective of the investment - as well as risk management, should be used to determine the property purchase. Ongoing asset management is also essential to preserve and grow its value.

During the past 25 years, we estimate the supply of office space in the City of London has grown by around 60%. Compare that to London's West End, where there are tighter building regulations and planning laws and the supply has increased by an estimated 16%.

As a result, and combined with a more attractive physical landscape, rental levels from properties in the West End are higher and more stable than in the City, and as such, there is an argument to suggest there should be a wider gap in yields across the markets.

There are good opportunities in the City but stock selection is more crucial now than ever.

London's central geographical location and time zone between Asia and America, its doorway into Europe, its reputation as a leading financial centre as well as being a safe haven for overseas investment, are attracting increasing amounts of cash into the property market. Notably, in 2012 this trend was largely fuelled by equity over debt-backed buyers, which has been driving up values.

We remain bullish on the London market as a result, however, once you start to analyse the fundamentals, there are some areas where there is potential overheating and investors need to take considered advice to ensure they do not get caught out by their purchases a few years down the line.

Talking Points

Q1 2013

Channel Islands Property Fund Satisfies The Hunt For Yeild

Andy Taylor, Chairman and Investment Advisor to the Channel Islands Property Fund

In today's market, investors are finding it increasingly difficult to secure attractive, stable income yields backed by commercial real estate, and could be well advised to consider the commercial office markets in the offshore centres of Guernsey and Jersey.

Both Islands are home to a large number of high quality corporate occupiers, the list of which would not look out of place in the City or West End. In contrast with much of the UK outside London, the Islands have seen sustained demand for Grade A commercial offices as a result of both consolidation and inward investment. Limited land supply and the absence of speculative development has resulted in steady year on year rental growth.

Prime office rents in Guernsey now stand around £40.00 psf, higher than anywhere in the UK outside the capital. Jersey, with a slightly larger commercial centre tops out around £34.00 psf.

With new lettings averaging 24 years in Guernsey and 15 years in Jersey - break options are not a common feature of the market – incorporating 3 year upward only rent reviews, achieving an annual 6% - 7% fully covered sustainable dividend yield backed by high grade long let quality real estate is attainable.

Prime office yields are currently in the region of 6.25% - 6.50% compared with 4.75% for the City of London and 4.00% for the West End. With all in borrowing costs remaining relatively static at 4.25% and debt at 50% loan to value, lenders are all too willing to provide finance for acquisitions in St Peter Port and St Helier.

Investors contemplating these jurisdictions will be comforted to know that leases, finance documents and land registry follows English Law precedents with the major exception being the absence of Landlord and Tenant legislation which means less protection for occupiers.

Niche markets such as these remain a good place to look in the hunt for yield backed by high quality assets.

For further information please contact: Jaspal Phull, Head of Research, T: +44 (0)20 7297 4480, E: jp@rivercap.co.uk