# Quarterly Review

Q1, 2014

Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

# Regional Recovery

## The Spread of Economic Growth

### Global Economic Review

Coming into 2014 Central banks around the world have made it clear that they will maintain highly accommodative monetary policies and will be sensitive to any threats to growth.  However, the continued recovery in the advanced economies means that interest rate rises are on the horizon, even if they take some time to come into effect.

Despite a difficult start to the year and an increase in geopolitical risk due to the political crisis in the Ukraine, the global economic recovery looks set to remain intact in 2014.

Hopes that the US economy would strengthen further over the 1st quarter took a back seat as macro factors such as business growth, manufacturing production, employment, consumer spending and housing activity generally disappointed, implying that growth will struggle to reach the predicted 2% annualised in Q1.

Europe is expected to do much better in 2014 than it has done over the previous 2 years as stable financial conditions are helping Europe recover from its “debt-crisis” recession.  While this recovery seems set to continue this year, deflation risks persist in some peripheral nations, suggesting a continued need for caution.

Data showed that economic growth picked up in the Eurozone at the end of 2013, with a GDP growth rate of 0.3% for the fourth quarter (2013) compared to 0.1% in the third quarter (2013).

The upturn in activity continued into 2014, with the purchasing managers’ indices (PMIs) still indicating expansion (the ninth consecutive month).

Fixed income markets defied end of 2013 predictions for a tough year ahead by broadly outperforming equity indices over the first quarter of 2014, despite mostly strong economic data from the UK and Eurozone.

The 10 year Treasury yield fell from 3.03% to 2.76% during the quarter. Gilts and (German) bunds saw similar moves; the 10 year gilt yield fell from 3.02% to 2.74%, and the equivalent bund fell from 1.93% to 1.57%.

At the last Federal Reserve (FED) meeting on March 19th 2014, the FED announced a further reduction of its monthly bond purchases from $65 billion to $55 billion and, despite rhetoric by the FED that it intends to keep interest rates low for an extended period after the end of the tapering cycle,  rate rises are now firmly on the agenda in the US and UK over the coming 12 months, with a rise in the UK expected to come first.

Whatever the timeframe, it has been made clear that any eventual rises will be gradual and unlikely to take rates back to their long term averages.

## UK Economic Review

The IMF has stated that it expects Britain's economy to grow at a faster pace than all the other leading industrial nations in 2014.

Britain's economy picked up pace in the first quarter of this year but not quite as fast as economists had been expecting.

The Office for National Statistics (ONS) stated that GDP expanded by 0.8% in the first quarter after 0.7% growth in the final three months of last year. That was below economists' forecast of 0.9%, according to the consensus in a Reuters poll.

The most recent Bank of England credit conditions survey (covering Q1 2014) showed conditions improving for both companies and households, yet there are still concerns over rates and fees being imposed on small and medium-sized firms.

Consumer spending followed by the housing market continues to drive the UK economy forward. This has led to concerns that households are saving less and spending more, a potentially unsustainable mix given already high household indebtedness.

The overall picture is nonetheless encouraging. Survey evidence suggests the investment surge will continue and real incomes may also soon start to rise, adding to the picture of improving economic fundamentals that should support ongoing, robust growth in 2014.

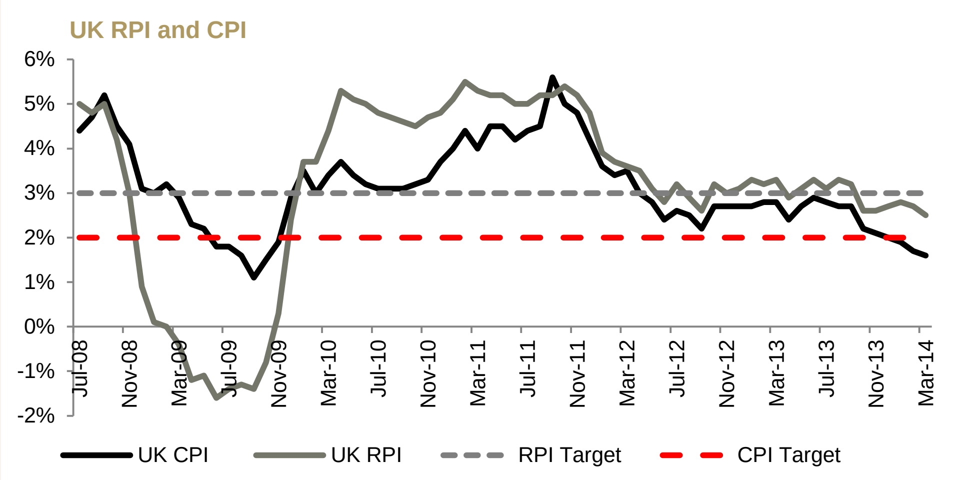
Expectations that interest rates will rise next year are now significantly higher. This is due, partly, to the strength of the pound and unemployment falling to 6.9%, which is below the 7% threshold set for considering a rate rise under Forward Guidance Mark 1.

With unemployment falling far more quickly than expected, the BOE dropped the 7% threshold and updated the guidance to indicate that it will use a more opaque measure of 'spare capacity' in the economy and that more of this so-called 'slack' must be taken up by the recovery before interest rates can be lifted.

# Regional Recovery

## The Spread of Economic Growth

There have been fears that cheap money would lead to higher inflation, but whilst the stock market is significantly higher – as are property prices – inflation hasn't fed through to the overall economy. According to CPI numbers, it has fallen below the 2% target for the first time since early 2010.




The latest labour market figures showed very strong growth in jobs in London over the last year. Data from the ONS published in April showed that workforce jobs in London increased by 2.0 per cent in the final quarter of 2013. Over the past year, this measure has increased by 6.1 per cent, the largest annual increase for London since the series began in 1996.

### UK Property Market Review

The recovery in the UK is well underway as an improvement in economic fundamentals offers stronger growth for real estate investors, in addition to stable income returns.

House prices have risen against a backdrop of low interest rates and government schemes put in place to encourage people to buy. Office of National Statistics figures showed that property values rose 9.1% in February compared to a year earlier, the highest annual increase in property values since June 2010.

Once again, London led the way as property values soared by 17.7% in February compared to the same month a year earlier. Taking London and the South East out of the data, average house prices nationally rose by, a still substantial, 5.8% annually.

The latest major reports from Halifax and Nationwide put annual house price inflation at 8.7% and 9.5% respectively; while the Royal Institution of Chartered Surveyors has said buyers chasing a short supply of decent homes for sale is driving up prices.

The RICS forecasts the average UK house price will rise by 6% a year for the next five years, pushing prices up 35% by 2020. There are fears, however, that house prices bouncing from a point where they were already high compared to wages will simply lock more buyers out.

Whilst a lack of supply has proved to be a big factor, cheap credit has been decisive in pushing prices higher over the last 12 months. The Help to buy scheme gave mortgage lenders an indemnity against losing money on riskier small deposit mortgages and the Funding for Lending scheme passed cheap money through banks and building societies to be lent out as mortgages.

New, tougher mortgage rules are already due to arrive later this month and whilst overall mortgage rates remain near record lows, some of the best rates on offer have been pulled and replaced with more expensive deals. Last year, a five-year fixed rate mortgage for those with a big deposit could be taken out at less than 2.5%. The best rates are now nearer 3%.

## UK Commercial Property Review - Strong returns continue

The recovery in UK commercial real estate was further confirmed during Q1 2014, as values rose by 2.2% for all property, contributing to a total return of 3.7% for the period, according to the IPD UK Quarterly Property Index.

Although this represented a slight deceleration since Q4 2013, a return to rental growth for all sectors provided further evidence of the solid foundations now underpinning the market.

Phil Tily, Executive Director & Head of UK and Ireland, IPD, said: “The broader UK commercial real estate market continues to show signs of recovery and growth, with March proving to be the strongest month of 2014 so far.”

# Regional Recovery

## The Spread of Economic Growth

| Quarterly Performance (%) | Q1 2014 | | | Q4 2013 | | |
|---|---|---|---|---|---|---|
| | All Property | Offices | Inner London offices | All Property | Offices | Inner London offices |
| Rental Value growth | 0.7 | 1.7 | 2.4 | 0.5 | 1.4 | 1.5 |
| Capital growth | 2.2 | 3.6 | 4.4 | 2.9 | 4.4 | 5.9 |
| Income return | 1.4 | 1.2 | 1.1 | 1.4 | 1.3 | 1.2 |
| Equivalent yield | 6.6 | 6.7 | 7.0 | 6.8 | 7.0 | 7.0 |
| **TOTAL RETURN** | **3.7** | **4.9** | **5.6** | **4.4** | **5.8** | **7.1** |

According to the IPD UK Monthly Property Index, values have now risen by 6.8% over the last 10 months of consecutive growth, although overall they still remain below their 2007 peak levels.

The office sector led performance with a total return of 4.9% for the quarter, based on the strongest capital value growth of 3.6%. Industrials lagged slightly, returning 4.8%, though this was due more to their higher level of income return at 1.6% for the quarter when combined with value growth of 3.1%.

Capital values continued to rise across almost all regions in Q1 2014, with the most notable regional improvements in the office sector. Offices in the South West, North West, Yorkshire and Wales all saw gains in their levels of capital growth compared to the previous quarter.

Offices in the rest of the South East are now challenging London's West End in performance terms, each returning equally strong returns at 5.3% for the quarter. These were however both surpassed by West End retails, which returned 6.4%. This continuing strength of Central London underlines its reputation as a safe haven for international capital.

### Strong Start to the Year Vs Bonds & Equities

The overall total return to UK real estate, at 3.7% for Q1 2014, exceeded the performance of both bonds and equities over the period, which stood at 2.5 per cent and -1.5 per cent respectively (JP Morgan 7-10 year/MSCI UK).

### Rental Growth Still Polarised

Central London prime rents grew by 2.5% during the quarter, with the West End, City and Docklands all seeing similar growth.  Prime rents across Central London are up 11.9% compared with the same time last year.

# Regional Recovery

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Rental values have continued to struggle in the retail sector, as lacklustre occupier demand and muted consumer confidence kept rents flat last month. Retail rents have been in decline for over 70 consecutive months since May 2008, leading to a cumulative decline of -12.6%. While expanding businesses are again demanding space in offices and logistical parks, demand remains far more muted for retail space, particularly outside of key urban centres.

**Fall in investment volumes only temporary, with regional investment doubling over the last 12 months**

Overall investment volumes into the UK commercial property market was down on Q4 2013, however, the Q1 total is still the third highest recorded since 2007.

This, in our opinion, does not represent a shift in investor sentiment towards the asset class. Rather, It represents temporary respite given the exceptional level of activity towards the end of 2013 and perhaps more significantly a lack of current supply.

Capital inflows into the London market remained strong as Cushman & Wakefield revealed there was £4.13 billion-worth of Central London commercial property transactions in Q1 2014, the highest level of Central London investment ever recorded in Q1.

Overseas investors accounted for more than three-quarters of spending. Investors from around the world have been rushing to snap up London property in recent months, motivated by a search for returns in the low-yield environment, and a perception that real estate assets in Britain are secure.

In particular, cash from Asia and the Middle East is being placed in London because of its perceived status as a safe haven.

- City & Docklands transactions amounted to £3.31bn in the first quarter of 2014, a record result.
- West End Q1 deals totalled £824m. Whilst this is nearly a 20% decrease compared to Q1 2013, it results from a shortage of stock as opposed to a lack of demand.
- Investor attention turned to quality assets further from the core, resulting in downward pressure on yields, and driving superior returns through above average capital value growth.

# Regional Recovery

## The Spread of Economic Growth

There was a new dynamic at work over the 1st quarter of 2014 with UK institutions the biggest net buyers of UK commercial property.

Due to the increasing positive sentiment towards property as an asset class, retail inflows have picked up significantly. This will ensure that UK institutions will have big influence over the next 12 months.

During the initial stages of the recovery, inward Investment was mainly focused towards core, income-producing, London-based property on long leases. However, we have now started to see this investment broaden out towards the regions.

Despite the increased appetite for regional investments, there was a fall in overall investment from Q4 2013 to Q1 2014. However, in comparison to 12 months ago, investment into the regions has actually doubled.

The support for regional investment is growing and the demand for higher yielding assets outside of London is getting stronger.

### Occupier Market Strengthens

The UK economy continues to improve and we are starting to see this translate into improvements in the occupier market. With companies more confident to commit to new leases, take up more space or move offices, demand has increased and supply of good quality space is starting to constrict.

This shortage is also particularly acute in multi-let industrials, where vacancy levels are falling sharply and putting upward pressure on rental values.

### Yields Continue to Move Inwards

The demand for London remains strong; this in turn has led to a number of investors looking to the regional markets for greater value. Whilst there is still a lot of value outside of the Capital, pricing has started to increase.

This demand has also been reflected in a downward move in yields.  Particularly in rest of UK offices, where the prime/tertiary yield gap narrowed by 1% over the first quarter.

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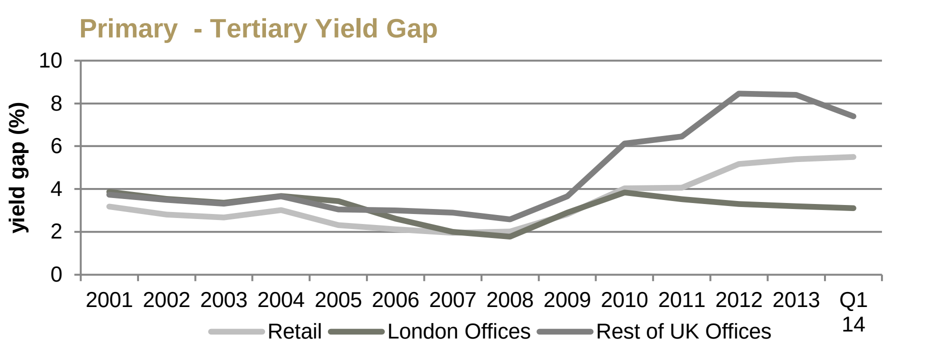


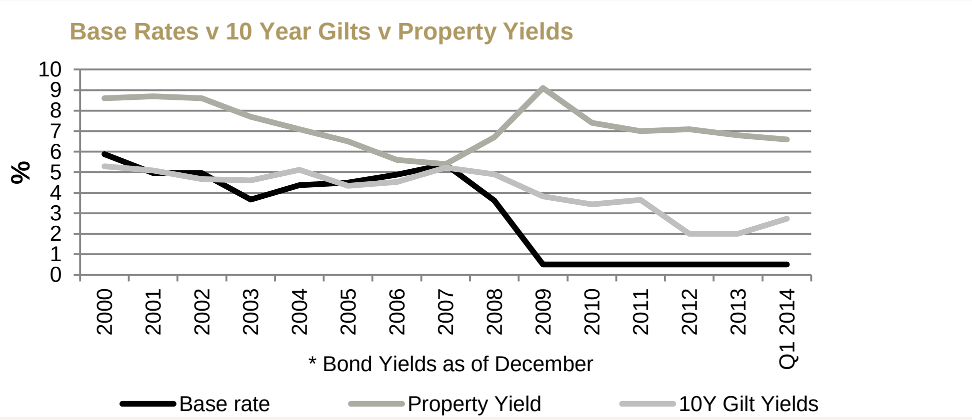

The wide yield gap and the constrained supply of prime and good quality secondary stock within the Central London market will encourage investors to keep investing in the regions; however, there will be a limit as to how far up the risk curve investors will be prepared to go and tertiary properties will continue to struggle.

Market yields continue to come down, with City Offices at around 4.5% and West End Offices transacting at around 3.5%, both well below the historical average.

**Risk premium offered by commercial property remains well above average**

Commercial property continues to offer an attractive risk premium over government bonds (the risk free rate), particularly when you compare this to the average spread over the last 25 years of 230bp.

The spread between gilt yields and average property yields as reported by IPD currently stands at approximately 380bp.



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### Headline Transactions, Q1 2014

| Address | Price (£m) | Yield (%) | Price (£/psf) |
|---|---|---|---|
| Moore London, SE1 | 1,700 | 4.6 | 810 |
| Sixty London, EC1 | 250 | 4.6 | 1,064 |
| 1 St Martins Le Grand | 163 | 5.76 | 592 |
| 7-10 Hanover Sq, W1 | 85.5 | n/a | - |
| 141-142 New Bond St, W1 | c. 75 | 2.64 | 6,471 |
| Waterstones, Piccadily, W1 | 67.5 | 2.73 | 1,003 |

### OUTLOOK

– A hike in interest rates before the General Election is seen as increasingly likely. With the economy growing at its fastest pace for nearly seven years, and with unemployment down from 7.9% to 6.9% in the past 12 months, pressure is mounting on the Bank to act.

– Despite a fall in transactional volumes from Q3 2013 to Q1 2014, economic indicators lead us to believe that investment transactions in 2014 will surpass the overall total of 2013.

– Demand for UK property remains as high and the weight of money flowing into the London market will continue to remain strong.

– Industrials and offices, outside Central London, are the areas of the market most sought after by investors and are likely to continue to see the strongest performance, at least in the short term.

– A sustained UK economic recovery is predicted to lead to a reduction in spare capacity, providing a foundation for improved tenant demand and an upturn in rental growth over time.

– The outlook for the UK economy remains positive and is now the fastest growing economy in the G7.

– The latest labour market figures showed very strong growth in jobs in London over the last year and a pick-up in occupational markets is now starting to reflect this.

# Regional Recovery

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- Given the strength of demand in the occupational and investment markets we expect to see further downward pressure on yields.

- London will continue to provide the strongest rental growth over the next 12-18 months due to the strength of the local economy. However, we do see this (economic strength) spreading out to the regions, and higher yielding assets look set for strong performance over the coming years.

- The debt market continues to evolve and remains an extremely attractive way to leverage returns. New 'non-traditional' lenders i.e. insurers and mezzanine funds, are entering the market and banks are also starting to lend more. As a result, margins have declined from the highs of four years ago.

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