Quarterly Review

Q1, 2015

Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

Economic Overview

It was a strong quarter for global equity markets supported by falling energy prices and the start of quantitative easing by the European Central Bank (ECB).

	Q4 2014	Q1 2015	% Change
FTSE 100	6566.	6773	3.15
DOW JONES	17823	17776	-0.26
DAX	9805	11966	22.03
CAC 40	4272	5033	17.80
NIKKEI 225	17450	19206	10.06
USD v GBP	$1.559	$1.484	5.49
GOLD $	$1186	$1187	0.08
OIL BRENT	$55.8	$54.5	-2.29

Source: Bloomberg, 2015

While world GDP growth in 2014 remained broadly stable at around 3.3%, current forecasts expect that growth this year and next year will be considerably higher across the majority of major markets.

Central Bank actions dominated the first quarter as we continued to see a divergence in economic policy. The ECB started its €60bn per month Asset Purchase Programme in early March, whilst investors looked to the U.S. Federal Open Market Committee (Fed) to try and ascertain the timing of the first interest rate rise in 9 years.

The Fed maintained near-zero interest rates, but removed its pledge for “patience” and endeavoured to remind observers that an eventual rate hike would be a data-dependent decision.

The ECB’s QE announcement came in response to below-target inflation figures. Annual inflation was -0.6% in January though this improved to -0.3% in February and again to -0.1% in March.

The Bank of England’s (BOE) Monetary Policy Committee decided, once again, to hold rates at a record low for the sixth full year. Rates were on hold at 0.5 per cent for the Coalition Government's entire time in power.

There have been questions as to whether the BOE would follow other central banks into the realms of negative rates. However, BOE Governor Mark Carney has made it clear that the next move in interest rates will be up, as he looks to quash talk that rates could hit zero if deflation in the UK takes hold.

Despite yet another breakdown in negotiations between Greece and its creditors - which heightened expectations that a Greek exit (‘Grexit’) from the Eurozone lies ahead - there was a welcome improvement in macro-economic data emanating out of Europe, as PMIs continued to rise and economic growth in Q4 2014 surprised on the upside.

Whilst there was no surprise in the announcement of ECB QE, the size of the overall programme was unexpected. The amount of bonds to be purchased (EUR60bn per month) as a percentage of outstanding debt is significantly higher than that seen in the US and Japan.

Yields in many Eurozone countries such as Germany, France, Ireland, Portugal, Italy and Spain fell to record lows over the quarter, as investors piled into the bond markets under concerns that the ECB would absorb the majority of supply.

Yields on sovereign bonds in Europe have edged so close towards negative territory this year that U.S. investment bank Goldman Sachs has called it the "new normal" in the region.

As much as €1.5 trillion ($1.7 trillion) of euro area debt maturing in more than a year now pays a negative yield, according to J.P. Morgan. This compares to none whatsoever a year ago.

UK Economy

Slower UK growth due to election uncetainty

Early in the quarter Mr Carney warned that Britain's economic recovery was neither 'balanced nor stable' enough to yet consider increasing interest rates, with a likely rise not expected to occur until next year.

This caution was backed up by evidence that Britain’s economy slowed more sharply than expected in the first three months of the year.

The last major economic release before the general election proved to be a disappointment for the government, as Gross Domestic Product (GDP) only grew by 0.3% in the first quarter, according to data by the Office for National Statistics (ONS). This was the slowest quarterly growth since the end of 2012 when there were fears Britain was heading into recession.

GDP growth was half that of the fourth quarter last year and below expectations of only a marginal slowdown to 0.5% in a poll of economists. However Joe Grice, the Chief Economist at the ONS, warned against reading too much into the data, given that the preliminary GDP number is an estimate and is often revised.

CPI inflation has moved to zero under the impact of lower food and fuel prices, this is generally thought to be a temporary situation rather than heralding prolonged deflation.

From a more positive perspective, Britain's economy was 2.4% bigger than it was in the first quarter of last year, the ONS said. It is now 4% larger than its peak before the financial crisis, and 8% bigger than when Cameron's Conservative-led coalition came to power in May 2010.

Employment growth has been strong with employment levels now at record highs and a recent rise in real wages supportive of domestic consumption.

Unemployment in the UK has continued to fall and the number of people in work has continued to rise, according to the latest ONS figures.

The number of people out of work in the January to March period fell to 1.83 million, down 35,000 from the previous quarter and the lowest for seven years. With employment levels now at record highs and a recent rise in real wages, this should be supportive of domestic consumption.

Whilst nothing in any of the polls suggested that the Tories could win an outright majority, the decisive majority outcome will be welcomed by the property industry. However, it won't be all plain-sailing from here, as we now face the promised referendum on Britain's place within the European Union.

The new government now faces a balancing act between keeping its promises on the UK's position within the EU, and not derailing the fragile economic recovery.

UK property market

Residential property

At the turn of the year we highlighted the easing of house prices. Despite prices increasing by 0.6% month on month in February, the annual pace of growth in property has continued to show signs of slowing across the majority of the UK, as evidenced by the ONS.

Year-on-year growth stood at 7.2pc in February, edging down from 8.4pc recorded in the year to January. This took the average UK house price to £268,000, meaning property values are now 0.8pc lower than the record levels seen last August.

The uncertainty of the election may also have had an impact on mortgage approvals, as the Council for Mortgage Lenders reported in February that the number of mortgages handed out to first-time buyers and home movers fell by 16pc year on year.

Housing analysts are predicting that house price increases across the UK will outperform those in London in 2015 for the first time in six years.

The Centre for Economics and Business Research (CEBR) says it expects UK house prices generally to rise by 1.5% this year and values in London to fall by 3.6% following “years of over-performance”. This would be the first time since 2009 that prices nationwide have risen faster than in the capital.

This will, however be a temporary phenomenon. By next year, property values are expected to rise by 2.7% in the capital and 2.3% across the UK.

Commercial property

Performance driven by “exceptionally low” bond yields and weight of money

The UK commercial property market is continuing to deliver good performance backed up by strong investor demand, positive rental growth and a growing economy.

Following a stellar year of returns in 2014, there was a sense of normality to performance numbers released by IPD in Q1, 2015 as total returns from UK commercial property fell from 4.1% to 2.9% between the final quarter of last year and Q1 this year. The 12 month total return is 18.3%.

All Property capital growth was 1.6%. Offices again led the way - up by 2.9% month on month - followed by industrial (2.1%) and retail (0.7%). Despite strong capital growth, property prices remain 25% below their peak at the All Property level.

Total returns from offices rose by 3.9%, the fastest of any sector, with industrial returns up by 3.4% and retail up by just 2%.

Income returns were up by 1.2% for All Property. Office incomes were up 1.1% whilst retail and industrial posted income growth of 1.3% & 1.4% respectively.

Quarterly Performance Q1 2015	All Property	Offices	Industrials	Retail
Capital growth	1.6%	2.9%	2.1%	0.7%
Income return	1.2%	1.1%	1.4%	1.3%
Initial yield	5.0%	4.4%	5.6%	5.2%
Total return	2.9%	3.9%	3.4%	2.0%

Source: IPD UK Quarterly Property Index

In comparison to other asset classes, equities saw the strongest return with the FTSE 100 up 3.15%. All Property returns outperformed gilts through the first quarter of 2015.

From a longer term perspective (5yrs annualised), UK property once again outperformed significantly.

Performance	5yr annualised (%)
All Property	10
Equities	7.3%
Property Equities	14.8%
Bonds (7-10 yrs)	7.0%
Inflation	3.1

Source: IPD UK Quarterly Property Index

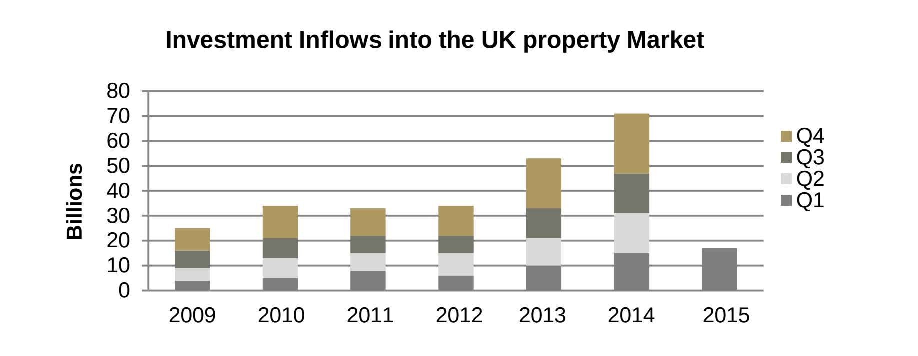
Property remains a compelling investment against other asset classes - especially when low levels of volatility are factored in - and continues to maintain a healthy yield margin over bonds & equities.

Investment volumes

Record volumes in UK commercial property in Q1, 2015

Data showed that there was a slight slowdown in momentum from (Q4) 2014, which saw investment inflows break the £50bn mark for the first time since 2007.

Last year saw the investment market get off to a slow start but this year we hit the ground running. Investment volumes of £17.4bn in Q1 represented the highest first quarter since 2006 and were over 20% higher than the same period last year, according to Property Archive.



Source: Property Archive

The UK market continues to be seen as a strong and stable place to invest, with Central London's appeal to overseas investors remaining as strong as ever. North American investors were once again the largest inward investors, taking advantage of a strong dollar.

Investment activityin London totalled £4.26bn in Q1 2015, which is one of the strongest investment starts to a year, only marginally behind record Q1 2014 activity of £4.31bn.

The largest deals over the quarter were the £1.1bn sale of the Liberty Living student housing portfolio to the Canadian Pension Plan Investment Board and Lone Star's purchase of the £1bn Project Laser portfolio from Moorfield.

With the wall of money showing no signs of abating we could be set to eclipse 2014's all-time high.

Yield compression set to continue due to weight of money

Demand for stock is not only highly competitive in London but has now firmly spread to the regions. This, along with rental growth, helped contribute to further yield compression over the quarter.

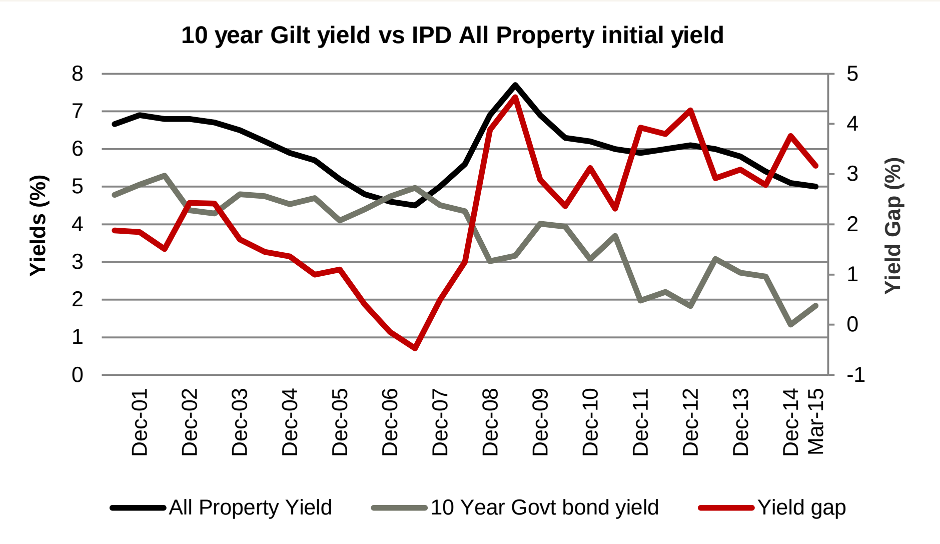
While yields at the prime end of the market were broadly stable in Q1, the yield gap between prime and secondary stock outside Central London narrowed further during the quarter.

As we move through 2015, the potential of further yield compression remains given the relative attractiveness of property investment and the weight of money entering the UK market. Overseas investors will continue to bid up the price of "trophy' assets.

Property yields vs government bonds

The BOE voted unanimously (the first time since July) to keep rates on hold, yet 10 year Government bond yields continued to fall in March due to the ripples from the European Central Bank's bond-buying program that commenced in the 1st quarter.

With little sign of rates rising in the UK until next year at the earliest, the yield gap between property and the risk free rate has remained attractive for investors.



Source: IPD UK Quarterly Property Index

Looking across to the continent, QE has resulted in a rapidly expanding universe of negative interest rates, which in turn, has turned investor attention to higher-yielding UK commercial property.

Occupational demand and rental growth

The ongoing recovery in the UK economy is picking up momentum and is perhaps best evidenced by unemployment falling to a seven year low. Employment is a key driver of occupational demand, particularly for the office sector, as employers look to increase or improve their office space.

As office market conditions continue to improve, demand is now outstripping supply. Currently there remains a severe shortage of Grade A availability as office take up increases. The problem is set to get more acute in 2015 due to the lack of speculative supply and the market will continue to struggle to meet occupier needs.

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There has been a positive knock-on effect for the best quality secondary stock, which is now letting at premium levels in locations where Grade A vacancy is at record lows.

Outside of the capital, there has been a marked improvement in office market conditions with regional office take-up 11% higher than the 5 year average in Q1, according to DTZ. This is the sixth consecutive quarter of above average take up and a very positive sign for regional markets.

Renewed economic optimism has also fuelled the meaningful return of speculative development outside London, with the amount of space under construction in the regional centres doubling since the end of 2013; Manchester, Edinburgh and Bristol are leading the way.

As highlighted in our end of year report, rental values have continued to grow, up 0.8% over the quarter, marginally down on the fourth quarter of 2014.
Offices showed the highest levels of rental growth over the quarter (+1.8%) which was ahead of industrial (+0.8%) and retail which was flat.

Quarterly Performance Q1 2015	All Property	Offices	Industrials	Retail
Rental Value Growth	0.8 %	1.8 %	0 8%	0.0%

The strongest rental growth is still concentrated around the capital, with quarterly growth running at 5% (for prime property) and year on year growth at 11.5%.

The low vacancy rate in the West End has continued to place upwards pressure on prices with the current prime rent now standing at £120 per sq. ft. A new record-high rent of £185/sq. ft. was achieved at 8 St James's Square, providing further evidence that tenants are prepared to pay a substantial premium to secure the best space.

Whilst speculative development has increased in the regions, a significant amount of office stock has been converted to other uses such as apartments and hotels since the introduction of Permitted Development Rights in May 2013. This will only put further pressure on rents and incentives going forward.

Outlook

- Whilst yields have come in significantly - due to the weight of money that is targeting larger office lots in the UK - London office yields are likely to compress further.

- Capital growth will be further supported by positive rental growth.

- The outlook for regional commercial property remains positive with demand increasing across the majority of key markets, representing a significant growth in take-up and a fall in supply. Regional office rents are also now returning to growth.
- Due to the continued high levels of demand, there is a severe shortage of available stock, particularly Grade A. This will lead to a pick up in demand for high quality secondary assets in good locations.
- There is still an exceptional spread between real estate yields and government bond yields. Substantial increases in rates may therefore be absorbed (when they start to rise) before upward pressure on real estate yields occurs.
- The spread between prime and secondary yields is still more than a percentage point higher than its long-term average. This gives scope for the spread to close further over the next 12 months.
- Greater availability of debt for investment in secondary property will be an important factor in the further closing of the prime-secondary yield gap.
- Industrial property will continue to perform strongly, due to a severe lack of supply and high levels of occupier demand.
- The general outlook for debt in the short/medium term remains positive. The De Montfort University's annual property lending survey paints a picture of a lending market in the sort of rude health not seen since the late 1990s and early 2000s.

For further information please contact:

Sarah White
Head of Marketing
Tel: +44 (0)20 7297 4480
Email: sw@rivercap.co.uk

Jaspal Phull
Head of Research
Tel: +44 (0)20 7297 4480
Email: jp@rivercap.co.uk

www.rivercap.co.uk