Quarterly Review

Q2, 2014

Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

Introduction: Macro Perspectives

As we move into the second half of the year, with equity indices hitting new highs and property prices continuing to rise, there are growing concerns that investors are becoming increasingly complacent about the risk inherent in markets.

Over recent months the Volatility Index (VIX) - a measure of instability that is used to gauge market risk/fear - has hit record lows, despite the rising geopolitical risks due to the ISIS incursion in Iraq and escalating tensions between Russia and the Ukraine.

Global equities continued to make gains in the second quarter, supported by ongoing accommodative monetary policy from central banks. This was most evident in Europe where, despite news being dominated by deteriorating economic sentiment across most member states, European Central Bank (ECB) policy action helped support Eurozone equities.

With the Standard & Poor's 500 Composite Index notching its sixth consecutive quarterly rise, U.S. stocks touched multiple new highs – the longest streak of quarterly gains since 1998.

In a bid to encourage lending by banks the ECB cut the main refinancing rate from 0.25 per cent to 0.15 per cent and forced the deposit rate into negative territory, meaning that commercial banks must now pay to keep funds at the ECB. The International Monetary Fund also urged the ECB to launch a large-scale bond-buying initiative, similar to the Fed's quantitative easing program.

With the recovery in the Eurozone still somewhat fragile, the ECB has pledged to keep interest rates low for an extended period. The bank has also been vocal in its concern regarding persistently below target inflation and the need to avoid a deflationary outcome in Europe.

At the turn of the year it was widely expected that we would start to see the "bond bubble" burst. However, yields continued to fall over the quarter as bonds benefited from a flight-to-quality due to interest rates tumbling in developed markets and central banks reinforcing their commitment to accommodative monetary policy. Rising geopolitical risks also bolstered demand for the safe haven assets.

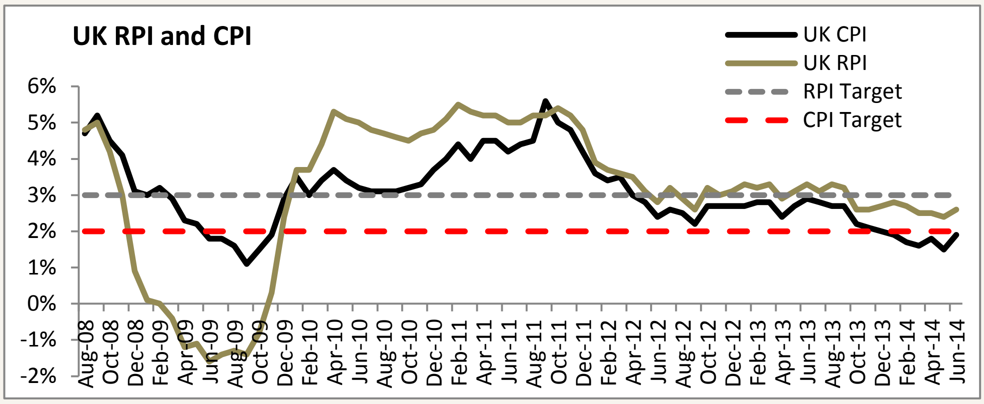
The 10-year treasury rate slipped from 2.72 per cent to 2.53 per cent, and the equivalent UK gilt moved from 2.74 per cent to 2.67 per cent. Weak European growth reinforced the view that the ECB might need to act again and pushed the

German 10-year rate to a 13 month low of 1.25 per cent, meaning that 10 year bund yields have almost halved this year.

As we move forward, recent action has highlighted the divergence in global central bank policy. Whilst it has been increasingly evident that the ECB need to take accommodative action in order to get Euro growth back on track, more questions are being asked about the timing of the first rate rise in the US and UK. Forward guidance is gradually being abandoned by both the Bank of England (BoE) and the US Federal Reserve (the Fed) and a more bullish tone on economic growth and employment conditions is starting to signal potential rate increases in 2015.

UK Economy

The UK economy continues to perform strongly, driven by growth in household spending and increased business investment. However, despite this strong economic growth and a falling unemployment rate, the Bank of England has been able to keep interest rates at extreme low levels due to ongoing benign inflation.



In terms of GDP levels, the UK economy has now fully recovered from the financial crisis. The National Institute of Economic and Social Research (NIESR) estimate that GDP grew by 0.9 per cent in the three months ending in May, meaning economic output has surpassed its pre-recession peak.

In June, national emploment figures for the three months ending April grew by 345,000, demonstrating the biggest increase in any three-month period since records began in 1971 and the highest level of employment in nearly six years.

There are now consensus expectations that we will see a rise in interest rates, although confusion still remains around the likely timing of a rise.

Back in July 2013 the Governor of the Bank of England, Mark Carney, introduced the concept of forward guidance. The intention was to provide the market with greater clarity on the likely future path of interest rates and the conditions that would necessitate the start of policy tightening. In the first of many U-turns, however, the BoE was soon forced to alter criteria as unemployment fell far faster than anticipated.

In June of this year the market was, once again, led to believe that the first hike in interest rates would come much sooner than previously expected. Carney stated "There's already great speculation about the exact timing of the first rate hike and this decision is becoming more balanced. It could happen sooner than markets currently expect" (Reuters).

However the BoE soon backtracked as Mark Carney stated that millions of workers were not getting the pay rises that the committee expected. Carney told MPs that there seems to be “more spare capacity in the labour market than we previously had thought” (Reuters).

The Governor declined to give any guidance on the date when the first interest rate rise might come, but told the committee he expects the base rate to remain "materially below” its historic average of five per cent for at least the next three years. He also indicated that he does not expect the Bank of England to start unwinding quantitative easing until after interest rates have risen above one per cent.

UK Property

Average house prices in the UK have surpassed their 2007 peak, rising nearly 12 per cent in the past year and stoking fears of a property bubble as the Bank of England acts to cool the mortgage market.

London saw the strongest gains, with average house prices soaring 26 per cent in the year to June 30, according to the latest data from Nationwide, the mortgage lender. This was the biggest annual increase in the capital since 1987, with the price of the average London home surpassing £400,000 for the first time.

"House prices in the capital are now around 30 per cent above their 2007 highs, and more than twice the level prevailing in the rest of the UK when London is excluded," said Robert Gardner, Nationwide's chief economist.

While rising house prices are indicative of a recovering economy, questions are being asked over its sustainability. As a result, the BoE have put in plans to cap riskier mortgages.

Under new proposals lenders will not be allowed to lend any more than 15 per cent of residential mortgages at more than 4.5 times a borrower's income.

Whilst this will have little short term impact, its influence may come in the future if house prices grow more than expected. At present, only about 10 per cent of overall mortgage lending is at this threshold, so the cap allows lending to become even more excessive before the limit is reached. Furthermore, there is no differentiation between regions. In London, some 20 per cent of lending exceeds the 4.5 times limit. But as the cap is national, not regional, there is no compulsion on the Capital's borrowers to start tightening.

Lenders are already using new affordability checks - known as the Mortgage Market Review (MMR), which test people's ability to repay should interest rates rise. This will be added to, under the BoE's plans, as lenders will need to assess if borrowers could still afford to repay their mortgage if interest rates were three percentage points higher - during the first five years of the term - than at the time the loan was approved.

In spite of these new measures put in place under the MMR, data released by the BoE showed 67,196 mortgages were approved in June, up 8 per cent on the previous month after four consecutive months of decline.

However, the number of mortgages granted remains low by historic standards; during the housing market boom in the mid-2000s lenders were routinely granting more than 100,000 mortgages a month.

UK Commercial Property Returns Remain on the Up

UK commercial property continued to perform strongly over the 1st half of 2014. Q2 performance was driven by strengthening demand across the country for all sectors of UK real estate and showed that the UK recovery is now firmly in place.

UK real estate returned 4.7 per cent over the 2nd quarter, according to IPD Quarterly Digest the highest quarterly total return for property since Q1 2011. The 12-month return for the year to the end of June (+16.4 per cent) was also significantly up on the return (+13.3 per cent) to March-end.

Strong Performance Over the Quarter for Property vs Bonds and Equities

Property returns exceeded the performance of both bonds and equities over the period, which were up 0.9 per cent and 3.4 per cent respectively (JP Morgan 7-10 year/MSCI UK).

Performance was driven by falling yields and rising rents, resulting in a large uplift in capital values across all sectors. Capital values for all property increased by 4.7 per cent over the quarter. Growth in value accelerated across the vast majority of regions in Q2 2014, a trend that showed a remarkable degree of consistency by sector.

The office and industrial sectors led the UK market in Q2 2014, returning 5.3 per cent and 5.4 per cent respectively, although all sectors saw a higher return than in the first quarter of the year. Offices delivered the strongest level of capital value growth, at 4.1 per cent. The industrial sector's advantage is still afforded by its higher income return of 1.5 per cent for the quarter as values grew by 3.9 per cent.

Retail returns showed the most dramatic return, rising from 2.6 per cent in Q1 to 4.3 per cent in Q2. Value growth more than doubled to 2.9 per cent as investors turned their attention to the sector.

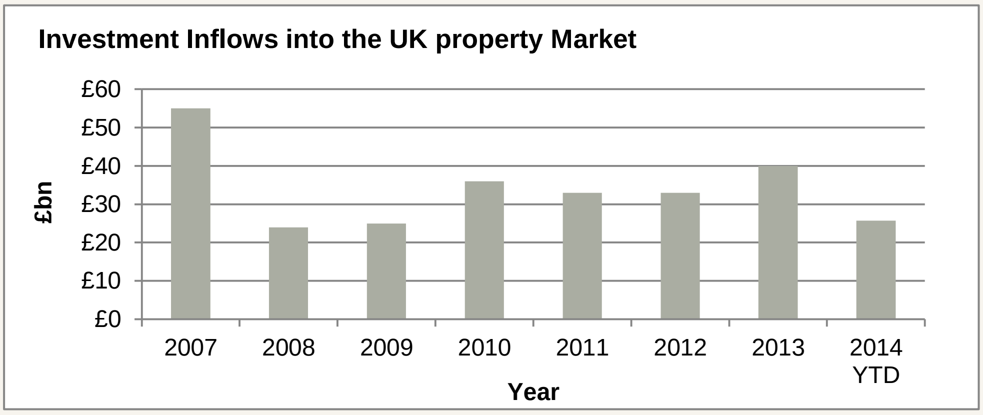
Quarterly Performance (%) Q2 2014	All Property	Offices	Industrials	Retail
Rental Value growth	0.7	1.7	0.5	0.1
Capital growth	3.3	4.1	3.9	2.9
Income return	1.4	1.2	1.5	1.4
Initial yield	5.4	4.9	6.1	5.5
TOTAL RETURN	**4.7**	**5.3**	**5.4**	**4.3**

Source: IPD UK Quarterly Property Index

London and the South East continued to lead in terms of the absolute level of growth, with West End retails, whose values rose by 5.8 per cent in the quarter, dominating.

For London offices, the West End and Midtown continued to outperform the City, as they have done in each of the last 12 quarters.

UK Investment – Volumes Up On Last Year



Source: Property Archive

Investment levels in the UK commercial property market are now firmly in the “pre financial crisis” territory. According to Property Archive, the first half of 2014 saw an investment of £25.68 billion; a 22 per cent increase from the same period last year.

Over the last year, investment into the UK hit £58 billion according to Cushman & Wakefield, indicating that appetite for commercial property is well and truly back.

UK institutions and overseas investors were once again highly active in the UK real estate market. Overseas investors continued to pour money into the UK market, investing £10.8 billion over the first half of the year. However due to sales from overseas investors, the highest net investors were UK institutions (as was the case in Q1). Driven by inflows from retail investors looking to diversify their portfolios, Q2 represented the highest level of new investment by UK institutions since 2006.

London

According to Cushman & Wakefield, £3.38 billion of Central London commercial property transactions took place in Q2 2014; this takes total London investment over the first half of the year to £7.6 billion.

The Q2 2014 figure is down on the £4.28 billion seen in the previous quarter, which was the highest level of Q1 Central London investment ever recorded – but this number was significantly inflated by the £1.7 billion St Martins acquisition of More London.

Regional

Regional investment remained on the up, due mainly to the increase in investment from UK institutions. Quarterly investment into the regions was £6.6 billion, representing the largest share of the quarterly investment total since Q1 2011.

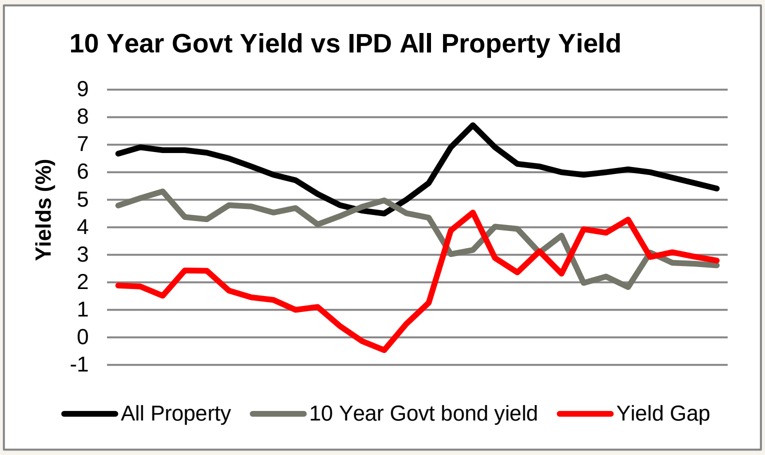
The success of the UK economy is highly reliant upon London, however the government is now trying to address this by outlining plans to create an alliance between Leeds, Liverpool, Manchester, Newcastle and Sheffield. The £15 billion transport plan linking ports, airports and the city centres will go a long way to driving more capital flows into the regions and will impact positively on the property markets.

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 230 basis points (bps).

The spread between gilt yields and average property yields as reported by IPD currently stands at approximately 280 bps.

With the average forecast of interest rates to reach 2 per cent over the next few years (150 bps higher from where we are now), the resultant yield spread between property and gilts is likely to ensure that property remains an attractive asset class going forward.



Source: IPD UK Quarterly Property Index, Bloomberg

The impact of rising government bond yields is likely to be felt the most in Prime markets such as Central London, which have historically been correlated with gilt yields.

The impact is expected to be lessened by the fact that the reasons behind the expected higher interest rate rises are positive. This means that occupier demand is likely to offset some of the negative effects of rising yields on pricing through real, or anticipated, future rental growth.

Yields Continue to Move Inwards

Competition for a limited number of investments continues to have an impact on yields. According to Savills, the UK average prime yield moved lower by seven basis points during July to 4.77 per cent, a level not seen since August 2007.

West End offices and prime Central London retail are now seeing initial yields at historic lows and as a result capital values are either on a par, or have exceeded the pre–recession peak.

As investors continue to pay above valuation for new stock due to high levels of competition for any assets coming up for sale in London, many markets outside Central London continue to see downward pressure on property yields as investors turn their attention to the regions.

	Jul-13	Jun-14	Jul-14
West End offices	3.50%	3.25%	3.25%
City Offices	4.75%	4.50%	4.50%
Regional Offices	6.00%	5.25%	5.25%
High street retail	4.75%	4.50%	4.50%
Shopping Centres	5.00%	4.50%	4.50%

Source: IPD UK Quarterly Property Index

Outside of London, Manchester has been the best performing city with yields of 5.5 per cent approaching the pre-recession peak of 4.75 per cent.

With the supply of prime and good quality secondary stock dwindling and the demand for well-located good-quality space remaining strong, yields are likely to continue to harden over the next 12 months.

Occupier Confidence the Key Driver of Continued Rental Growth

The outlook for rental growth is now extremely positive as the market recovers and demand from occupiers strengthens. UK businesses are currently more enthusiastic about their prospects than they have been in recent years and are now willing to put in place spending and expansion plans that had previously been put on the back burner.

The latest Grant Thornton Business Confidence Monitor confirms the increasing strength of the UK economic recovery. In the 12 months leading up to the next General Election, businesses expect to create almost half a million new jobs. Business expectations continue to improve across all regions and the economy is expected to grow by 1.2 per cent next quarter, finally reaching its pre-recession peak.

According to research carried out by Property Week, prime office rents have now equalled or exceeded pre-recession levels in five regions, whilst the West End and City are approaching 2008 levels.

City of London prime rents hit £60/sq. ft. in Q2 compared to £66/sq. ft. in 2008, and rents in Mayfair are now just below the £115/sq. ft. peak at £105/sq ft. The only major region where rents now remain below pre-recession levels is Birmingham; rents here are now £28.50/sq. ft. compared to £33/sq. ft. in 2008.

With supply set to remain short of demand, rental growth prospects remain compelling. Given that performance has been driven by inward yield shifts over the 12 months investors will be hoping to see rental growth in order to drive property performance over the next 12 months.

Riverside Capital Outlook

- Despite mixed messages from the BoE a hike in interest rates before the General Election remains increasingly likely. With the economy growing at its fastest pace for nearly seven years, and with unemployment down to a five year low of 6.6 per cent, pressure is mounting on the Bank to act.
- Investment activity has picked up significantly over the last 12 months. The Property Market is significantly ahead of where it was last year and could surpass record numbers seen in 2007 as demand for UK property remains high. Given the strengthening economy and increasing geopolitical risks globally, the weight of money flowing into the London market will continue to remain strong.
- The outlook for the UK economy remains positive and is now the fastest growing economy within the G7. 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.
- Given the strength of demand in the occupational and investment markets we expect to see further downward pressure on yields over the next 6–12 months.
- 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 next few years.
- Whilst the office sector continues to see the majority of investment flows, the alternative sector is starting to attract significant attention.
- Industrials space is one of the areas of the market most sought after by investors and is likely to continue to see the strongest performance. Supply of

grade A Logistics space remains limited whilst increased investor demand has caused a significant S&D imbalance. Given that internet shopping continues to gather pace, yields have been forced downwards as bidding has become increasingly competitive, and look set to contract further.

- 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.

- Concerns that a new credit bubble has started to develop have been allayed by the recent De Montfort annual lending report. This report showed that the quality of loans has improved significantly (pre crisis) and also, more importantly, that the market is not being driven by excessive levels of lending.

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