Quarterly Review

Q3 2013

Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

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Macro Overview

- The prospect of the US Federal Reserve tapering its quantitative easing programme dominated events over the 3rd quarter. With the US economy showing a continued improvement, the Fed had given strong indications that if unemployment continued to fall, it would think about decreasing the rate of asset purchases (known as QE3). Expectations that this would occur In September, led to a sharp decrease in risk appetite and an increase in market volatility.

- Contrary to investor concerns, the Fed's monetary policy committee postponed any reduction in its $85 billion monthly bond purchases leading to a quarter end market rally. This unexpected turnaround indicated that the Fed was still concerned about the overall health of the economy and the threat from higher mortgage rates. They may also have been swayed by the lack of progress in negotiations over the US debt ceiling and budget and the fallout from the possible partial government shutdown if Congress failed to reach an agreement.

- The Eurozone economy broke out of its longest ever recession after six quarters of negative growth, growing 0.3% in Q2. Even though the risk of a complete collapse of the Eurozone has greatly diminished, there remains a degree of political instability within the periphery. Going forward growth will remain weak and the recovery will be severely tested if and when the US tapers its asset purchase programme.

- The new Governor of the BOE, Mark Carney, gave his first news conference since taking over, setting out his new regime of forward guidance. Under this system, the MPC will not consider raising interest rates until the unemployment rate falls below 7%, which he predicted would take about three years and the creation of 750,000 jobs.

- The UK economy is showing the most positive signs of momentum since the financial crisis, expanding at the fastest rate since the second quarter of 2010. All four sectors (manufacturing, services, agriculture and construction) grew for a second consecutive quarter, in what is developing into a broad-based, sustainable-looking recovery.

- In 2012 GDP growth was barely positive, due to a weak outlook for the world economy and the effect of the continuing crisis in the euro area, this year however it has risen by 1% already. Employment levels have risen steadily and the UK housing market has shown notable strength since the beginning of this year.

- Rising equity markets have boosted consumer wealth. Comparing consumer debt with financial assets shows that balance sheets are in better shape than at any time in the last 10 years. Falling levels of mortgage arrears and write-offs of consumer credit fit with a picture of a healthier consumer sector.

- The Bank of England Credit Conditions Survey released in October provided encouraging signs. Whilst there was evidence that lenders were still reluctant to increase their commercial lending activities, 23% of lenders reported a rise in borrower demand in Q3. This was up sharply from Q2 and the highest number in the seven year history of the survey.

- Easier credit conditions are also supporting house prices and housing activity. Most measures of house prices have shown some increase in recent months, and the government's independent forecaster, the Office of Budget Responsibility, is forecasting strong growth in housing transactions.

- Government schemes such as 'Help to buy' have led to a sharp increase in lending. According to data released by the Bank of England, September saw British lenders approve the highest number of mortgages in over five years as borrowing costs sank to their lowest in a decade. Whilst this is significantly less than the pre-crisis average of around 90,000, 2013 will see the highest number of mortgage approvals since 2008. Further, with housing starts and loan approvals also up, it does seem apparent that market activity is picking up.

UK Property Outlook: Growth Returns to the Regions

- UK commercial property has been one of the strongest performers across Europe in 2013, benefiting from an improving UK economy and the continued attraction of the UK as a safe haven. The year so far has seen an improvement in both rental yields and vacancy rates as occupier demand has increased. This has fed through to commercial property returns, with All Property Total Returns up 2.8% in Q3. A rise in capital values (+1.3%) was a significant driver.

- The total return for London measured 3.5%, while returns for the rest of the UK rose to 2.4%, their highest in over three years. This compares favourably to UK Treasuries (+0.5%) and UK equities (+4.9%).

- The most welcome news from the IPD UK Quarterly Property report (3rd qtr. 2013) showed that, after having fallen by 7.3% over the last two years, we finally saw growth in the regions with offices, shops and warehouses outside of London rising by 0.8% over the quarter.

- Capital growth continued to strengthen across all three sectors in Q3. Overall, offices, Industrials and retail delivered a total return of 3.5%, 3.4% and 2.2% respectively.

- With returns in retail struggling to keep up with other sectors, the challenges facing the sector were further highlighted by removing London out of the equation. In doing this growth was marginally positive (+0.6%) and rents were down 0.3%.

- The logistics sector saw significant yield compression over the last three months. The popularity of this sector among investors caused prime yields to harden.

Quarterly Performance	Q2 2013			Q3 2013		
	All Property	Offices	Inner London offices	All Property	Offices	Inner London offices
Rental Value growth	0.2	0.8	1.4	0.1	0.6	1.2
Capital growth	0.4	1.0	1.9	1.3	2.2	3.0
Income return	1.5	1.3	1.1	1.4	1.3	1.2
Equivalent yield	7.1	7.3	7.2	7.0	7.2	7.5
TOTAL RETURN	1.9	2.3	3.1	2.8	3.5	4.2

Source: IPD UK Quarterly Q2 2013

- Commercial property supply remains tight due to the lack of new developments and rising tenant demand. The RICS Property Rental Expectations Index reported the first UK-wide decline in commercial property vacancy rates since 2007.

- The improving UK economic picture was reflected in a positive set of quarterly figures for the London office market. Take-up saw the highest quarterly level since the onset of the ‘credit crunch’. According to property agent Cushman & Wakefield, over the first 3 quarters of this year more than 7.4million sq. ft. of office space has been leased which is 44% ahead of the same period last year and 165,000 sq. ft. more than the total for 2012.

- Grade A take-up in the City of London reached its highest quarterly level for three and a half years this quarter at 470,640 sq. ft., despite the majority of transactions being for second-hand grade A space.

- Once again, the busiest business sector was TMT, accounting for 37% of take-up, with Finance and Banking accounting for 10%, and the Legal sector a further 9%.

- Investment volume was on the increase for Q3 2013 at £14.77bn, higher than for the same period last year and the highest since Q2 2007 according to The Property Archive.

Quarterly Review

Q3 2013

- The total inflow of £35.07bn represents over 90% of 2012's annual tally – which, in itself, was the largest annual total in four years.

- The largest net investors were (once again) overseas at £1.95bn. Overseas investors have been consistent net investors since Q1 2007 (except for one quarter - Q4 2008) and, along with UK institutions, continue to dominate the market throughout 2013 and as they did in 2012.

- The figures were driven by investment into London, where £8bn was transacted, the highest spent in Central London since Q4 2006. This was driven by several large high-profile transactions that completed during the period.

- Buoyed by a greater confidence in the UK economy and a longer-term outlook, UK institutions were net investors across the UK.

- Significant inflows continue to place downward pressure, with compression recorded across all three main sectors. The average all property yields contracted to 7.9%, returning to the level recorded at the end of 2012.

- Yields are still significantly higher than they were in 2010/11, however, we would expect further compression as the UK economic recovery gathers pace.

- The German private investor, Sirosa, made two leading market deals in Q3, which included the completion of the largest asset acquisition ever recorded in the West End. Sirosa purchased 99-121 Kensington High Street for £225 m and 80 Strand for £610 m.

- Investment outside of central London reached a six-year high in the third-quarter. As London continues to see a high level of capital inflows across all markets, not only has this had the effect of pushing up prices and forcing down yields, it has forced a number of smaller investors out into the regional markets.

- Phil Tily, IPD executive director & head of UK and Ireland, said: "The divide between London and the rest of the UK has reached unprecedented levels over the last six years, but with economic improvement spreading out of London, investors in the regions are starting to benefit from improved rates of return."

- Second tier cities remain heavily discounted. Values are over 35% below their pre-recession peaks in the majority of the cities measured, while rental declines for many over the period remain in double digits. Income yields are generally in excess of 6.5%.

Yield Gap between Primary and Secondary Property

Source: IPD UK Quarterly Q2 2013

- Regional markets (non-prime properties) are starting to look increasingly more attractive. The upturn in the economy and indications by the BOE that interest rates are set to stay low for some time, has meant that the high yields offered by these properties are becoming more secure.

- As the search for yield continues, investors are being supported in their move up the risk curve by the greater availability of senior debt and more competitive terms on offer.

- Overall UK property rents were up 0.1% in Q3, driven by the rise in London rents (+0.6%). Regional rents continued to fall, however the decline was just -0.1%, the lowest level since 2008 and a further indication that the economic improvements are more widespread.

- Prime rents in the last six months have seen sharp increases in areas where demand is far in excess of top quality supply such as north of Oxford Street and Fitzrovia.

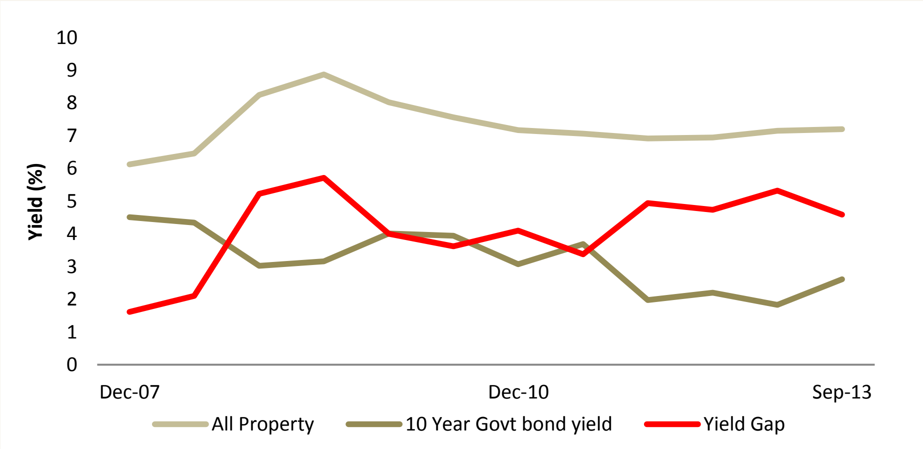
- While yields are relatively low, investors are increasingly buying in anticipation of rental uplift which will drive further value growth. This has resulted in a narrowing margin between yields in core and fringe sub-markets.

- Prime yields across most submarkets this quarter remained stable.

PRIME YIELDS	2013		
	Q1	Q2	Q3
West End Offices	4.00%	3.75%	3.75%
City Offices	5.00%	4.75%	4.75%
Non London Offices	6.50%	6.50%	6.25%
High street retail	4.75%	4.75%	4.50%
Good secondary retail	7.00%	7.00%	7.00%

– Having peaked at the end of 2012, the yield on the benchmark 10-year UK Gilt has risen approximately 1.2% over 2013. Despite the rise in government bond yields, the risk premium (spread over treasuries) offered by commercial property yields remains well above average.

UK 10 Year Government Bond Yield vs. IPD All Property Equivalent Yield



Source: IPD UK Quarterly Q2 2013

– In a report issued by JP Morgan Asset Management in June, entitled The Realisation, it stated that the “sway” of equities and bonds was being challenged, and allocators were taking note. “Recent shifts in allocation have largely been tactical (i.e. cyclical) moves between the two or, more recently, a gradually increasing strategic (i.e. structural) tilt to alternatives, including real estate, ”

– Signs that UK Institutions were back in the investment market, along with bonds losing their lustre, may reflect the first sign of institutional cash rebalancing towards commercial property.

Riverside Capital Outlook

– Dare we say it, but there is little doubt that that UK economy has turned the corner. Little over 6 months ago we were a negative number away from a triple dip, and now various commentators expect the Q3 GDP number to outstrip the second quarter.

– The IMF has raised its forecasts for UK GDP growth to 1.4% for 2013 and to 1.9% for 2014 (up from 0.9% and 1.5% respectively in its July 2013 forecasts). At the same time, the IMF has made downward revisions to its forecasts for global GDP growth (to 2.9% in 2013 and 3.6% in 2014).

Quarterly Review

Q3 2013

- Rising GDP is reflecting growth across the whole economy and should, going forward, be well supported by accommodating monetary policy.

- Momentum in the economic recovery appears to be gaining ground and the latest data would support the conclusion that Investor confidence is improving. As lending conditions remain tight and demand continues to get stronger, this is likely to help push capital values upwards.

- As capital values in London head back towards pre-crisis peaks, a number of investors have either been priced out or are looking towards the better performing regions in order to find value.

- Following the financial crisis, London offices have accounted for the largest portion of investment activity. As a region/investment class this is likely to continue to be the case for the foreseeable future, given that Central London remains very attractive to foreign investors.

- The rental recovery, thus far, has been predominately confined to London. However with the outlook for the occupier market improving, due to the pick-up in economic activity, we are starting to see investors broadening their search away from prime, long lease assets into secondary, growth assets.

- We anticipate the momentum of inflows to continue as we approach the end of 2013. The enhanced economic picture has intensified the demand for UK property with international interest in particular chasing an ever shrinking pool of suitable assets.

- We expect London to continue to motor ahead. However, as the labour market strengthens and the improved confidence and economic growth translates itself to business expansion and a firmer occupational market, we also expect to see property market recovery extend beyond the capital.

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