Annual Review

Of the Year 2014 and Outlook for 2015

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Global view

2014 was characterised by the return of geopolitical risk and a subsequent rise in volatility. Following a fairly sedate couple of years the US market volatility measurement tool (VIX)showed it had spiked to its highest level since June 2012 when the sovereign debt crisis in Europe hit its peek.

Geopolitics was at the top of everyone's agenda, starting with Russia's intervention in the Ukraine crisis and the annexing of Crimea. Following this, the advances made by Islamic militants in Iraq and Syria - and Israel's military strikes on Gaza - set investors nerves on edge over the summer. The second half of the year was dominated by concerns over the spread of Ebola and the plummet in oil prices, plunging Russia into crisis.

For the most part, investors enjoyed stellar returns over the year; the influence of the world's major central banks outweighed the lower than expected global GDP growth, geopolitical tensions and the deflation risk in Europe.

U.S equity markets led the way in 2014, with the Standard & Poors (S&P) 500 Index returning 13.7%. Whilst other developed markets were also positive, emerging market indices evidently struggled, with the Morgan Stanley Capital International (MSCI) World Excluding U.S Index falling -6.7%.

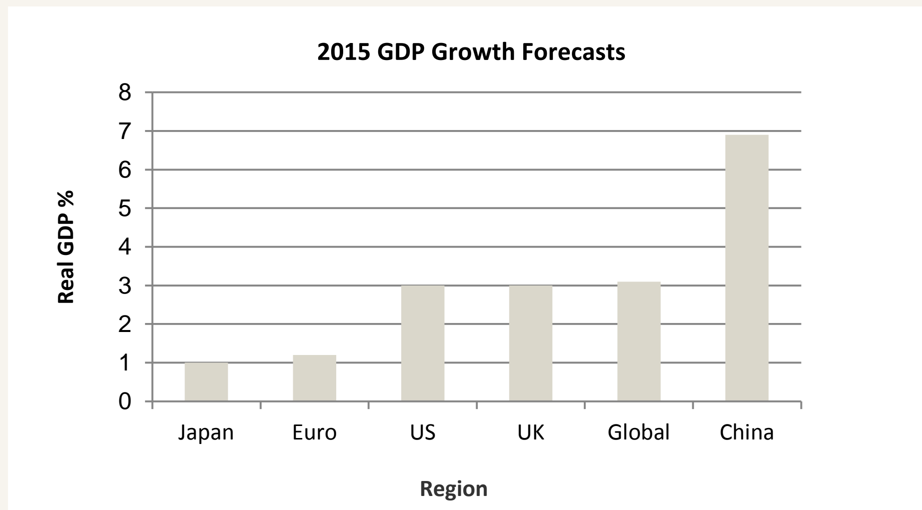
U.S equities benefited from continued accommodative policy and better economic fundamentals. Europe, on the other hand, struggled: hindered by a surprise summer slowdown in Germany and a lack of action by the European Central Bank (ECB). The global quest for income and macro uncertainties helped to drive long term (10yr) sovereign bond returns.

From a macro perspective, the main theme for 2014 was that of monetary policy divergence by the world's central banks. The US Federal Reserve (FED) finally ended their monthly bond purchases (QE3) in October, whilst both the US and UK started to raise the prospects of an interest rate rise. Conversely, both the Bank of Japan (BOJ) and the ECB started to loosen monetary policy further. This policy divergence also started to play out in currency markets as both the Euro and the Yen weakened considerably against the US dollar.

Following four years of high prices, the price of oil plummeted over the second half of the year, falling from over $100 a barrel in June, to below $50 by the year-end. Looking at the overall economic impact, lower oil prices can be a double edged sword. Whilst it could help to boost global growth, a fall in oil prices will likely also increase disinflationary pressures around the world. It is estimated that a fall in global energy prices could take as much as 0.2% off annual inflation figures.

The huge plunge in price should be a broad, positive impact, with the developed market consumer a clear winner. The price drop acts as a tax cut for consumers via lower prices at the petrol pump: the 36% decline in oil costs since June means the global economy might now save $2.0bn a day in fuel costs.

Global growth over the coming year is projected at 3.5%, a downward revision of 0.3 % relative to the October 2014 World Economic Outlook (WEO). The revision reflects a reassessment of prospects in China, Russia, the Euro area and Japan, as well as weaker activity in some major oil exporters because of the sharp drop in oil prices. The United States is the only major economy for which growth projections have been raised.



Source: Citi Research Dec 2014

The increase in deflationary pressures will lead to a further divergence of monetary policy amongst central banks. The ECB is finally adopting an aggressive form of monetary easing and may be required to put in place further stimulus. On the other hand, the FED and the Bank Of England (BOE) are expected to start raising interest rates, although they are now likely to delay the timing of the first interest rate rise until late 2015.

UK view

The UK recovery continued to gather pace over the last 12 months, with the last quarter seeing a healthy pace of job creation and strong retail sales. Unemployment declined for the 25th month in a row: the longest stretch since 1998. In addition, basic pay outpaced inflation for the first time in 5 years, ending the squeeze on real wages. There were signs however, that the housing market has started to moderate.

According to figures from the Office for National Statistics (ONS), Britain's economy grew by 0.5% in the fourth quarter of 2014, down from the 0.7% growth recorded in the previous three months. Despite the last quarter's slowdown, the UK economy grew by around 2.6% in 2014: the fastest pace since 2007 and the fastest pace amongst the world's top economies.

As we move into 2015, political and currency risks have both risen: the general election is less than five months away and uncertainty surrounding the outcome remains high. With opinion polls running very close it is highly likely that we will end up with another coalition government. However, it remains unclear as to whether this will be Labour-led or Conservative-led: both of which have different consequences for businesses.

If the Conservatives return for a second term the current Prime Minister, David Cameron, has pledged to hold a referendum on the UK's membership of the EU. This would add to the political tension in the EU and the UK, as well as putting Sterling under increased pressure.

UK house prices to moderate after a strong 2014

The UK housing market saw a spring and summer boom in 2014, particularly in London and the South of England, raising concerns that the market was entering bubble territory, before activity dropped away a little towards the end of the year.

Recently published figures from the Nationwide Building Society (House price index January 2015) , based on its own lending data, show that UK house prices rose 7.2% during the year. It does, however, mask some significant regional differences. For example, prices in London rose by 17.8% over the course of the year, compared with a 1.4% rise in Wales.

Despite UK house building growing at its fastest rate since 2003, there remains a critical imbalance between supply and demand. The net new supply of private housing was 110,000 in 2013, well below the 2000-2007 average of 180,000, according to the Bank of England.

Savills has predicted that over the next few years, house prices will rise no faster than 5% per annum. It has predicted a UK property price growth of 2% in 2015, 5% in 2016, 5% in 2017, 3% in 2018 and 3% in 2019.

Interest rate rise pushed further out as inflation falls to an all-time low and bond yields continue to fall

- Concerns over outright deflation in Europe seem to be increasing the prospect of Quantitive Easing (QE) in Europe. Along with that, the price of oil falling below $50 has helped to force Government bond yields down to near record lows.
- At the start of 2014 there was a consensus view that we would see an end to the 30 year bond bull run and that bond yields would finally start to rise. The reality, however, was that the performance of government bonds continued to surprise the investment market by compressing further: particularly when taking into consideration the rates of growth achieved by the UK economy.
- UK inflation unexpectedly halved in December 2014 asthe sharp drop in global oil prices fed through to petrol pumps and the supermarket price war cut consumer shopping bills.
- The Consumer Prices Index (CPI) measure of inflation fell to 0.5%, taking the CPI to the joint lowest level since equivalent records began in 1989. The only other time the CPI hit 0.5% was in May 2000 and has never been lower.
- The speculation that we would see an imminent interest rate rise has been with us for the last 12 months. However, against a background of falling inflation, election uncertainty and the renewed possibility of Greece exiting the Eurozone, the likely date of the UK's first interest rate rise since 2007 now appears to have been put further back.

The Bank of England's Monetary Policy Committee recently voted unanimously to keep interest rates at record lows, with the two MPC members who have been voting for a rise since August having now changed their minds.

The governor of the BoE, Mark Carney, has also made it clear that when rates do rise, they will do so slowly and the "new normal" will be at a lower level than in the past. This is reflected in market expectations for UK policy rates over the next few years.

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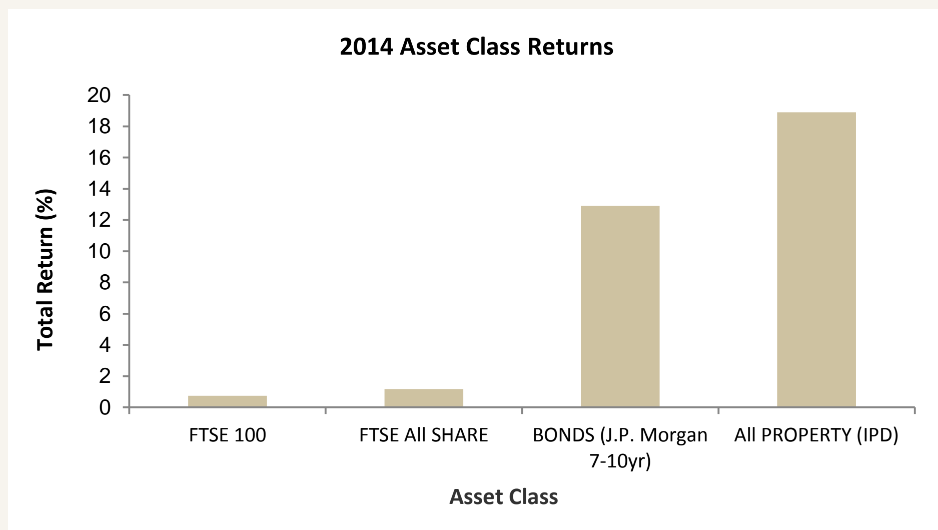
UK commercial property
Best year for UK property since 2005

2014 will go down as a year of exceptional performance for UK property and was the best performing asset class in 2014.

The total return for the year was 18.9%, (3.8% over Q4 2014,according to the latest IPD UK Quarterly Property Index) representing the best performing calendar year for commercial property since 2005.

After a strong five years, UK stock market returns were more subdued in 2014, despite the healthy outlook for the UK economy.

Gilts benefited from an environment of stable, low interest rates as well as concerns regarding the Eurozone. Investors continued to pile into gilts and push values up.



Source: IPD UK Quarterly Q4 2014, Bloomberg

The All Property Transaction Yield moved 70 basis points (bps) over the year, highlighting the strength we are currently seeing for UK commercial property. Historically, income has been the main driver of returns: 2014 however, reflected a year of yield driven returns with capital growth acting as the driver.

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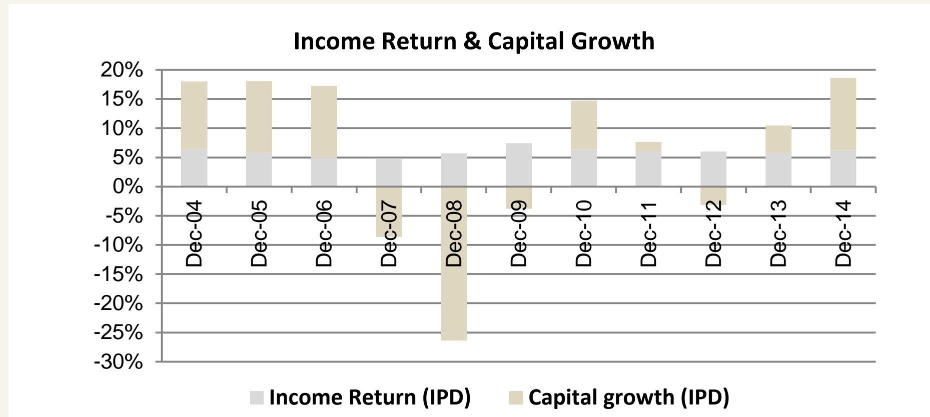
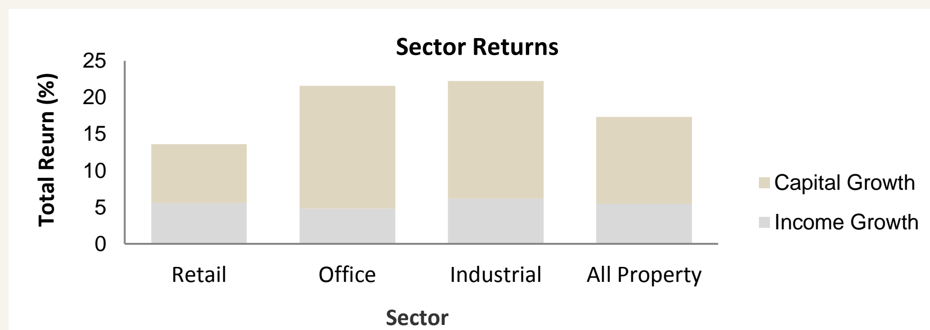


Source: IPD UK Quarterly Q4 2014, Bloomberg

2015 will see limited yield compression, with prime yields either at, or close to, their historic lows. We foresee a return to fundamentals over the next 12 months, with the income generated by the continued rental growth prospects in the occupier markets once again driving returns.

2014 sector returns

- Property values continued to move higher, with capital values rising by 11.8%, driven by an improving economic recovery and the sheer weight of capital flowing into the UK.
- Industrials were the best performing sector against a backdrop of growing occupier demand, with a return of 23.1%.
- Once again, the office sector performed strongly in 2014, with a total return of 22.3%.



Source: IPD UK Quarterly Q4 2014

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Whilst returns were driven by London offices, growth also extended outside of the capital. With the exception of Wales & Scotland, all regions saw double digit capital growth.

Capital value growth of 10.6% for the UK, excluding London, the South East and Eastern regions, provided confirmation that the economic recovery is spreading to areas outside of London.

London retail and offices performed very strongly, with a value growth of 23.9% for West End shops being the highest for any sector-region combination.

Rental growth set to drive returns

- The robust investor appetite being seen for commercial property in London - and increasingly regionally - is finally being supported by a strong outlook for rental value growth.
- Rental growth was also on the rise; UK commercial property markets recorded their highest quarterly rental value growth (a rise of 1% in Q4) since the third quarter of 2007, according to the Investment Property Database (IPD).
- In 2014, total prime rental value growth was 3.8% - up from 2.8% in 2013 - with the rate increasing steadily over the last 12 months. The average prime yield recorded a fall of 41 bps over 2014 - compared to 32 bps in 2013 - and the combination of continued falls in yields and strengthening rental value growth resulted in strong capital value growth for the year.
- Offices in the capital continued to see by far the strongest rental value growth in the UK, at 11.4% in 2014 compared with 8.1% for the UK as a whole, reflecting buoyant occupier conditions. However, yields are showing the reverse of this pattern, with the strongest falls in office yields being recorded in the rest of the UK.
- Rising rental growth will prove to be the key driver of property returns over the coming 18 months.

Improving economic sentiment and business confidence is now feeding through to a positive outlook for occupier demand and leasing activity. Previously, this had been confined to London but can now been seen across the UK's regional cities. With rents in a number of places still below their long term average, this leaves considerable room for rents to rise.

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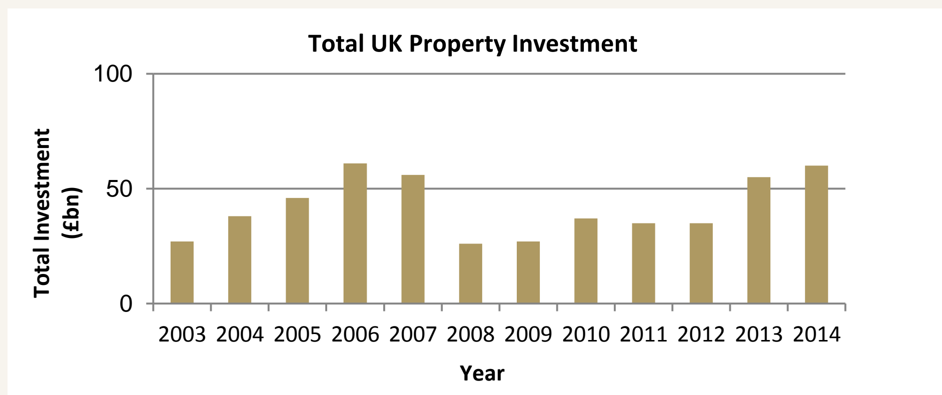
Investment inflows

- Figures released by property adviser Jones Lang LaSalle show that globally, commercial real estate volumes hit a record high in the final quarter of 2014.

- Total deal volumes across the globe hit $218bn, with $700bn being spent over the course of the full year: up 18% on 2013.

- 2014 saw investment volumes of £61.64bn into the UK. This was the second highest amount recorded and only marginally behind the £62.14bn that was invested in 2006.

- The total volume for 2014 was driven by transactions in Q4 which amounted to £20bn: the highest volume ever seen in a single quarter.



Source: Property Archive Dec 2014

- London continued to see significant inflows as the demand for assets in the capital showed no signs of slowing down. However, the overall investment into London was down on 2013.

- As economic recovery spread from the capital to the regions, so did investment inflows. Transactions in the regions hit £21bn for the year: a 40% increase on 2013.

- For the first time since 2006, inflows into the regions reflected a greater share of the overall total than London.

- Foreign investment climbed 25% to £25.4bn during the year. In the capital, the proportion of transactions by overseas purchasers rose to 61%.

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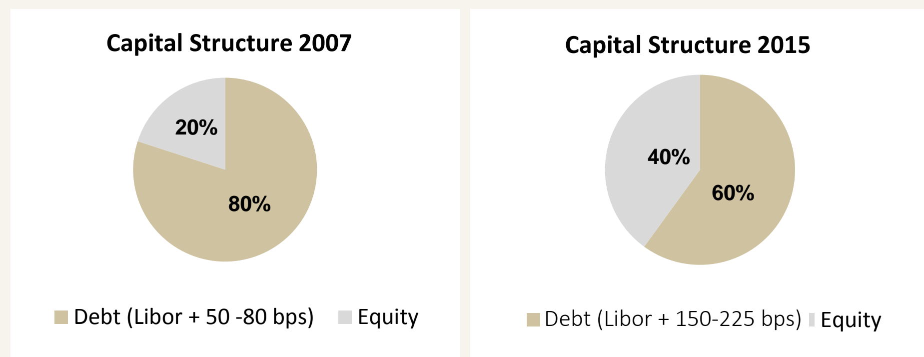
- Whilst London remains the “first port of call” for international investors, encouragingly, the inflows over the year were not simply directed towards the capital. Owing to intense competition, high prices and low yields, investors are now looking increasingly at regional UK cities.
- 2014 was also the year that we saw institutions return to the market, investing a record £16.95bn.
- The weight of money flowing into the London real estate investment market from the UK and abroad looks set to continue in 2015, with the level of demand far outstripping the available supply.

Debt finance

The outlook for commercial lending looked alot brighter by the end of 2014. According to a report produced by De Montfort University, lenders were increasingly active in the market, with UK debt finance for property deals at the highest levels since 2007.

Comparing this to a couple of years ago, there is a far greater range of lending sources. Whilst Bank’s lending has fallen, alternative lenders have stepped in to fill the void.

The same report also showed that buyers are now less reliant upon debt to finance deals, compared to the period leading up to the 2007 market crash.



Institutional investors, debt funds and other asset managers represented nearly a quarter of the lending market, up from about 5% just three years ago.

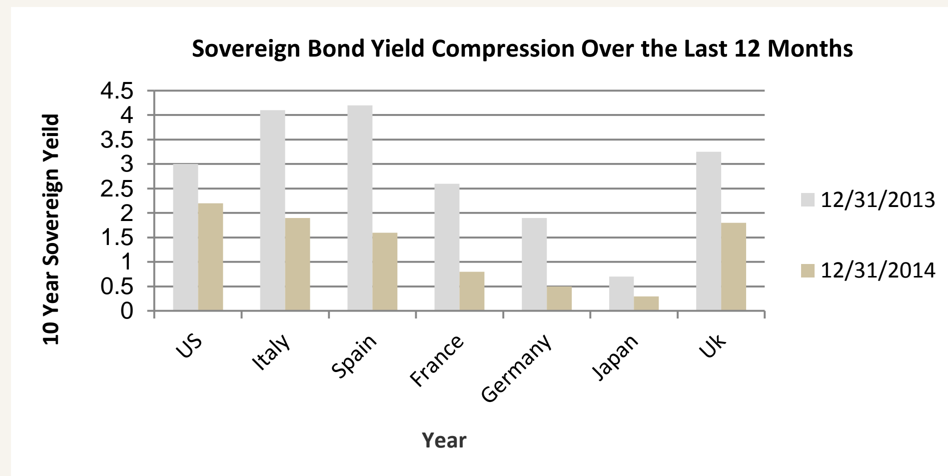
The growing availability of finance has meant that borrowers are now able to access better terms on new debt, as well as refinance debt taken on at the height of the crisis at better terms.

Given the level of demand, there have been concerns over a potential bubble developing, however this appears to be unfounded. The report points out that the increase in activity generally in the commercial property market was not debt fuelled to the same extent as before the financial crisis when, for example, some £49.2 billion of loan originations were completed in the first half of 2007.

With the vast amounts of overseas cash flowing into the country and the overall outstanding debt held against UK commercial property falling; it appears that this time round, it is equity driven.

Yield differential still attractive

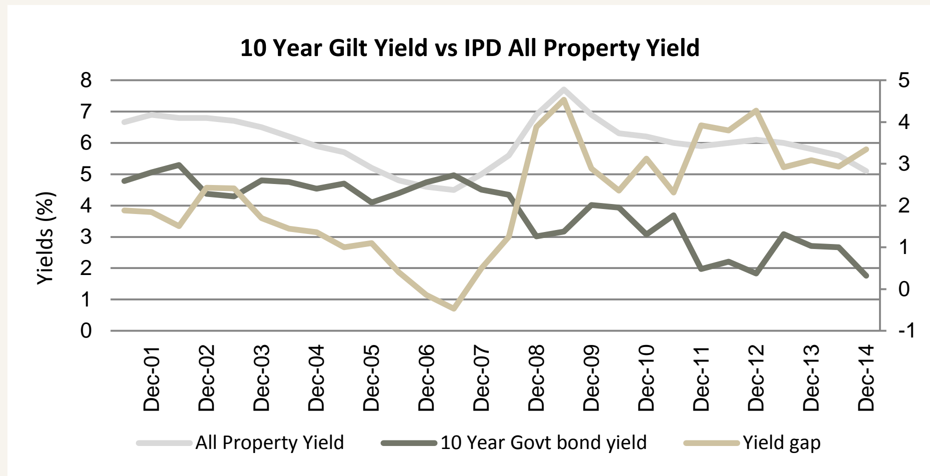
Having started the year at 3.25%, 10 year UK government bond yields fell to 1.76% by the end of December 2014. 30 year yields also dropped sharply, to post-war lows of 2.51%, amid strong demand from pension funds.



Source: Bloomberg Dec 2014

Bond yields continue to defy expectations over the long term; however, the total return from gilts should be limited by their historically extreme valuations and the risks to capital losses are greater as yields tighten.

UK real estate currently offers a margin of more than 300 basis points over government bonds (a proxy for the risk-free rate) and 200 bps over UK equities. This is a healthy buffer to compensate for properties illiquidity.



Bloomberg: IPD UK Quarterly Q4 2014

Outlook

- 2014 proved to be an exceptional year for the UK property market thanks to growing confidence in the UK/global economy. The year ahead looks promising but will not be without its tribulations given the economic (Eurozone) and political uncertainty ahead.
- Thanks to the economic recovery, commercial property returns for 2014 were the highest that we have seen since 2007. The question now is: how will returns fair over the coming 12 months?
- Whilst we do not foresee a repeat of 2014, returns should still hit double digits, which - when put into context of current gilt yields - is still highly appealing.
- We expect to see a slowdown in capital growth, with total returns moderating towards a more sustainable rate, driven by income growth.

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- Long-term interest rates are now even lower than they were a year ago and are expected to remain low for a prolonged period, with few forecasters now expecting a move before Q4.

- Low rates have helped fuel the recovery, but a rise is unlikely to have an adverse effect on the property market.

- Given the current yield differential between property and UK bonds (wider than the start of 2014) we are in a position where substantial increases in rates can be absorbed before there will be any upward pressure on real estate yields.

- The appetite for UK property remains strong and London and the South East will continue to attract large amounts of overseas investment inflows over the next 12 months. However we now have firm evidence that capital is being actively allocated to prime regional markets.

- Given the high level of demand and the lack of good quality space in the regions, total returns could outpace those of London.

- Rental growth will be the key driver of returns over the coming 12-24 months. Regional office markets are exhibiting falling vacancies and recovering tenant demand. This, coupled with little or no speculative development activity, is starting to fuel a rental recovery. The yield spread compared to London offices should also entice further investment which will help to drive capital value growth.

- It was another very good year for the industrial sector as returns were driven by high demand and the lack of good quality space. Over the next 12 months this will put upwards pressure on industrial rents.

- The pace of speculative development has picked up, as investors look to take advantage of supply shortages. However, this new supply will still not be able to keep up with demand which will help to maintain strong returns in 2015.

- There will be a level of uncertainty surrounding the May general election. However, we are only likely to see a temporary slowdown in transaction activity as we await the final outcome: at this stage this looks to be some form of a coalition.

Whilst the overall outlook remains positive there may well be some speed bumps along the way:

- Election uncertainty and unstable coalition politics will continue to undermine UK business confidence in the short term. This may dampen the upside to further occupier market recovery until the outcome is clearer.
- Europe remains a concern as any slowdown in the Eurozone will be felt in the UK. Despite these concerns, it appears that the UK recovery remains on track boosted by falling oil and commodity prices.
- Divergence continues to remain a theme in 2015 as the UK & US continue to outperform Japan and the Eurozone. This economic divergence is likely to lead to a monetary policy divergence in 2015, with the UK & US likely to start increasing rates over the next 12 months.

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