Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

09/15

Quarterly Review

Q2 2015

Q2 Economic Overview

Equity markets started the year strongly, supported by falling energy prices and the start of quantitative easing (QE) by the European Central Bank (ECB). However, there was an increased level of volatility as we approached the half-way point of the year.

	Q1 2015	Q2 2015	Change
FTSE 100	6,773	6,520	-3.72%
DOW JONES	17,776	17,619	-0.88%
DAX	11,966	10,944	-8.53%
CAC 40	5,033	4,790	-4.84%
NIKKEI 225	19,206	20,235	5.36%
USD v GBP	$1.484	$1,572	5.94%
GOLD	$1,187.4	$1,169	-1.54%
OIL BRENT	$54.5	$61.2	12.17%

Greece's precarious finances dominated the headlines in June amid concern over whether the Syriza-led government would agree to make the reforms needed to obtain further funds following the 30th June expiry of the existing bailout programme.

As negotiations with creditors broke down, Prime Minister Tsipras stunned both markets and his EU counterparts by announcing plans to hold a referendum on what was essentially a yes/no vote on Greece remaining in the single currency.

The government subsequently reached a deal with creditors to implement reforms in exchange for short-term financing. With a "Grexit" avoided (for the time being), this enabled banks to re-open and paved the way for further talks to secure a new €86 billion bailout programme.

As we move into the second half of the year the question that investors are now asking is when, and at what pace, will rates rise? The market predicts that the first rise in the UK Bank Rate will occur around March or April next year (2016), despite warnings from Mark Carney (Bank of England Governor) that a rise could come as soon as January. Expectations have shifted since the end of May when trading suggested the first increase would come in August or even September. With Inflation still trending at 0%, there is little short-term reason to act.

The US, on the other hand, appears to be slightly ahead of the curve. The Fed chair, Janet Yellen, has left little doubt that rates will rise this year. The US Fed has still left itself room to manoeuvre as it has set no timetable and has stated that rates would only be raised if the economy continues to improve and unemployment continues to fall. Expectations are, however, that they are targeting the 16-17 September policy meeting for a rate hike.

In both the case of the UK and the US, even after the first rise, the market is pricing in only very slow increases: far slower than seen in previous cycles of rising rates.

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The second quarter of 2015 saw bond yields climbing sharply across most major bond markets, in- spite of ongoing fragility in macroeconomic data from the US. Unequivocal statements from the Fed warned that investors should expect rate hikes to begin in 2015 pushing Treasury yields higher.

In the UK, the BoE central view remains that the economy is strengthening; GDP growth for Q1 was revised upwards ,leading to a rise in gilt yields.

10-year Treasury yields rose from 1.92% to 2.35% in Q2 whilst 10-year gilt yields rose from 1.58% to 2.02%.

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UK Economy

- The UK economy slowed a little in early 2015 but domestic demand growth remained relatively strong, helped by lower oil prices. The third official estimate for Q1 2015 growth in GDP revealed that the UK economy grew by 0.4% in Q1 2015, revised up slightly from the previous estimate of 0.3%. GDP growth for 2014 as a whole was also revised up to 3.0% from 2.8%, the fastest pace of growth since 2006.
- UK GDP growth is expected to average around 2.6% in 2015 and around 2.4% in 2016. This is broadly similar to the latest consensus and OBR forecasts.
- Consumer spending growth is projected to be slightly stronger than GDP growth, with a boost from lower oil prices and increased real earnings growth, but follows a similar path over time.

	OBR forecasts		Independent forecasts	
	2015	2016	2015	2016
Economic growth (GDP)	2.40%	2.30%	2.50%	2.30%
Consumer Spending	3.00%	2.50%	2.70%	2.40%

Source: Office for Budget Responsibility (July 2015)

- There were concerns over the quarter that the improvement in Britain's labour market had stalled due to a second successive month of job losses. Official data showed that the number of people in work was 63,000 lower in the three months to June than in the previous quarter, while the number unemployed rose by 25,000. John Allan, national chairman of the Federation of Small Businesses, said "although unemployment is marginally up again this month, the wider long-term trend is of a strong performing labour market, with high employment rates and low levels of economic inactivity. This is backed up with continuing good news on pay, up by 2.8pc this month. With interest rates flat and recent improvements in productivity, employers are feeling better placed to share the gains of economic growth in the form of higher wages".

UK Property Market

Residential

- A report by RICS stated that the number of homes listed for sale with each of its members was at its lowest level since records began in 1978. The number of homes on the market fell to a 37-year low in June, helping send prices surging and prompting warnings that they will be pushed to ever more unaffordable levels.
- Britain's biggest mortgage lender, Halifax, reported that the average UK house price had broken through the £200,000 barrier for the first time on its measure, following an unexpected 1.7% surge in June. Halifax's monthly snapshot of the market, which is based on mortgages it has approved during the month, showed that prices had risen for a fourth month running, and were now higher than the previous pre-crisis peak. Over the quarter they were up by 3.3% – the biggest three-month increase since November 2009.
- The supply of credit also appears to be increasing as data released by the BoE showed that risky mortgages are back on the rise. While mortgages are now harder to secure for borrowers with deposits of 25pc or less, those worth more than 90pc of the property's value had risen for the first time in nine months.

Commercial Property Outlook

Performance driven by "exceptionally low" bond yields and continued weight of money

- The UK commercial property market delivered a 24th consecutive quarter of positive total returns in Q2 2015, according to data by Investment Property Databank (IPD).
- The IPD UK Quarterly Property Index returned 3.5% in the second quarter of 2015, driven by industrial and commercial property. Total returns from offices rose by 4.9%, the fastest of any sector, with industrial returns up by 3.4% and retail up by just 2.2%.
- Whilst we are now seeing rental growth, returns are still being driven by increases in capital values. Capital growth for All Property was up 2.2%. At a sector level, returns were once again strong as office values were up 3.8% whilst retail and industrial posted capital growth of 1.0% & 3.0% respectively.

Quarterly Performance Q2 2015	All Property	Offices	Industrials	Retail
Capital growth	2.2%	3.8%	3.0%	1.0%
Income return	1.2%	1.0%	1.0%	1.3%
Initial yield	5.0%	4.3%	5.4%	5.1%
TOTAL RETURN	**3.5%**	**4.9%**	**4.3%**	**2.2%**

Source: IPD Quarterly Property Index

The UK commercial property market delivered a 24th consecutive quarter of positive total returns in Q2 2015.

- UK commercial property outperformed UK equities over Q2, returning 3.5% compared to a loss of 1.6% from the FTSE All Share index as global economic and political events including the Greek crisis led to widespread volatility in equity markets. Over the first half of the year UK commercial property returned 6.8%. By comparison, the FTSE was up 1.4% and UK government bonds fell by 1.3%.
- From a longer term perspective (5yrs annualised), UK property once again outperformed significantly.

Quarterly Performance Q2 2015	3yr annualised returns	5yr annualised returns
All Property	12.1%	10.1%
Equities	9.0%	9.6%
Property Equities	19.4%	17.0%
Bonds (7-10 yrs.)	2.0%	5.2%
Inflation	2.3%	2.9%

Source: IPD Quarterly Property Index

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

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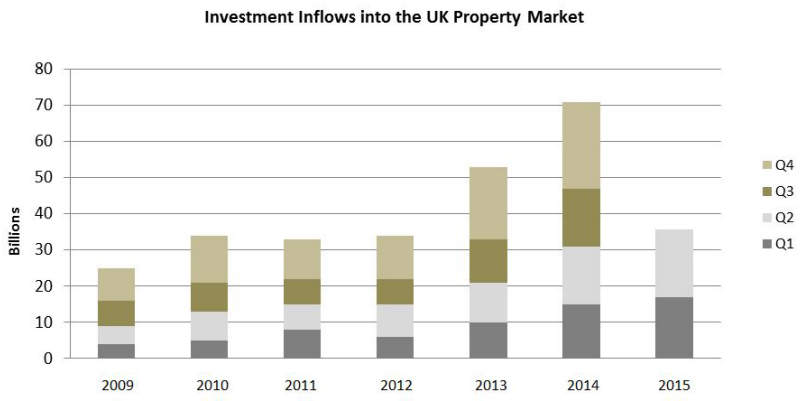
Investment Volumes

Record volumes in UK commercial property in Q2 2015 as investment demand for UK commercial property continues unabated

- Total UK investment volume into the UK was £39bn over the 1st half of the year; this was 35% higher than the same period in 2014 according to data by Property Archive.
- Transaction values in Q2 were 8% lower than Q1 (but 27% higher than the same time last year).



Source: IPD Quarterly Property Index

- If the second half of 2015 continues at the same rate as the first half, then total UK investment volume for the year will be in excess of £78bn, a record high after 2014's £68.4bn.
- Over the last 12 months, £73.6bn has poured into UK commercial real estate, including a record £30bn from overseas, and momentum shows little sign of slowing down.
- US investors continued to be the largest overseas investor for the fifth consecutive quarter at £4.2bn, just under double the purchase volume in Q1 2015.
- The largest deal over the quarter was the £2.4bn purchase of Centre Parcs UK by Brookfield group from Blackstone, followed by the £595m purchase of 48 hotels (mainly Holiday Inn Express) by TPG Capital from Atlas Hotels (owned by Lone Star).

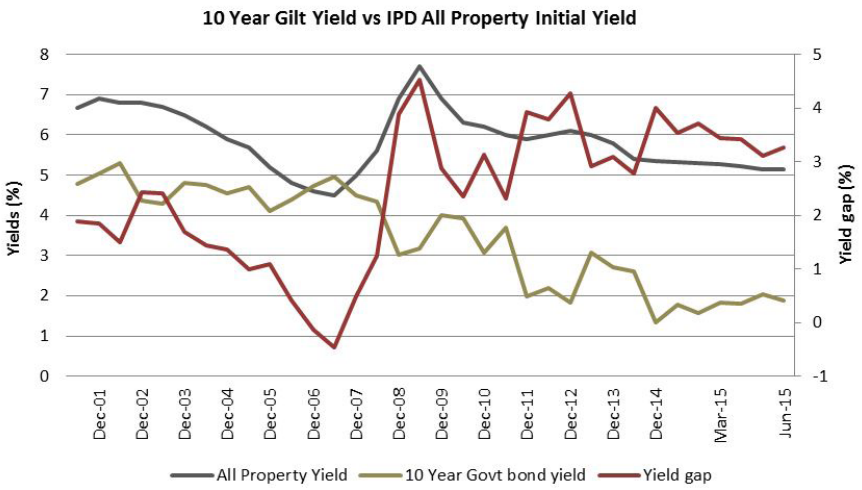
Over the last 12 months, £73.6bn has poured into commercial real estate and demand for stock has now spread to the regions.

Yield Compression

Increased investor activity continues to drive yields lower

- Under the sheer weight of capital continuing to come into the sector, the current All Property yield contracted a further 7bps to 5.7% in Q2 2015. We are now seeing the lowest initial yield recorded since the peak of December 2007.
- Demand for stock is not only highly competitive in London but has now spread to the regions. Whilst yields in London and the South East have fallen significantly, there is scope for further yield compression in other parts of the UK.

Property Yields vs Government Bonds



Source: IPD Quarterly Property Index

- There is still a relatively large gap between bonds and commercial property. The rate at which yields are contracting has slowed recently however, and due to continued significant investor demand, there remains some scope for further contraction.
- 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.

Occupational Demand

- The strength of the UK economy is continuing to support employment growth and occupier expansion.
- According to a forecast by Oxford Economics, London's economic growth will continue to outperform the UK with 3.9% growth for 2015.
- Office-based employment in Inner London, a key driver of demand for office space, is expected to increase by an average of 2.0% per year over the coming five years.
- This is not just a London story anymore either; regional office occupational markets continue to strengthen, with positive market sentiment underpinning demand and leasing activity in key cities such as Birmingham, Manchester, Edinburgh and Glasgow. Smaller cities such as Bristol are also seeing healthy levels of take-up.
- Letting activity is expected to accelerate further in the second half of 2015 as firms acquire more space and retailers seek to expand to satisfy growing consumer demand.
- Historically, the financial sector has set its base in London. However, the last 18 months has seen a number of companies' move certain functions to cities outside of the capital. A prime example of this is HSBC's recent announcement of plans to establish the head office of its UK bank in Birmingham city centre. If this trend continues it will have a significant effect on occupier demand in the regions.
- Most of the regional markets now have less than three years' supply of new and Grade A space available. At the end of the first quarter, new and Grade A availability stood at a historic low of 1.93 million sq. ft., down 8% on the previous quarter and 26% over the year. The situation is most acute in Birmingham, which currently has just over one year's supply of Grade A space available, including speculative developments.

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Rental Growth

- According to IPD data, rental growth is now at an eight year high (1.2%) which is providing fundamental support to the sector.
- Offices continued to show the highest level of growth at 2.2%, with industrials continuing to sustain strong performance (+0.7%). Retail may have also turned the corner (+0.5%), with consumer spending being boosted by a rise in real wages and a more positive outlook for the sector, this is likely to underpin positive rental growth going forward.

Rental Value growth Q2 2015			
All Property	Offices	Industrials	Retail
1.2 %	2.2 %	0 7%	0.5%

- Growth in industrial rents over the first half of the year has been at the highest rate in over 14 years whilst prime rents are, by and large, back to the levels last achieved in 2007. Given the current shortage of supply, overall rental growth is set to be maintained at the current pace.

Outlook

- The UK base rate has remained at 0.5% since March 2009, but attention is increasingly focusing on when interest rates will start to rise. The outlook has shifted forwards slightly to about February 2016, despite the BoE pushing back expectations of when inflation will return to target.
- With the strength of the UK economy supporting employment growth and occupier expansion, letting activity is expected to accelerate further over the next 12 months.
- 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 falling supply.
- As confidence and investor interest returns to prime regional markets, we can expect performance in secondary markets to be better than in recent years due to the lack of a good quality new supply.
- There is still an exceptional spread between real estate yields and government bond yields. Therefore, substantial increases in rates can be absorbed before there will be upward pressure on real estate yields.
- Overseas demand for prime assets in Central London remains exceptionally strong. This will help to maintain a high level of transactions and yields are likely to compress further, even at these low levels.
- Due to the 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.

Growth in industrial rents over the first half of the year has been at the highest rate in over 14 years whilst prime rents are back to the levels last achieved in 2007.

- 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.

Conclusion

Q2 provided another quarter of positive UK economic data and the economy is set to continue growing at a steady rate in 2015/2016.

With no signs of investment from both domestic and international investors abating, allied with the current accommodative interest rate environment, the outlook for commercial real estate remains encouraging.

Whilst the outlook remains positive, the ongoing Greek debt negotiations and the current concerns regarding Chinese growth and volatility in equity markets could act as a source of turbulence ahead.

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