Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

12/15

Quarterly Review

Q3 2015

Q3 economic overview

There was a sharp rise in volatility with Q3 (2015) representing the worst quarter for global stock markets in four years. On the back of concerns of a slowdown in China, equity indices saw falls of between 7% and 15%, making the last quarter a summer to remember for investors.

	Q2 2015	Q3 2015	Change
FTSE 100	6,520	6,061	-7.03%
DOW JONES	17,619	16,284	-7.57%
DAX	10,944	9,660	-11%
CAC 40	4,790	4,343	-9.33%
NIKKEI 225	20,235	17,388	-14%
USD v GBP	$1.572	$1.512	-6%
GOLD	$1,169	$1,115	-4.61%
OIL BRENT	$61.2	$48.37	-20%

Source: Bloomberg

The quarter had begun on a positive note; after months of inconclusive negotiations and missed payments, worries of a "Grexit" eased as Greece finally reached a deal with its creditors. Further, it became evident that the European economy is now showing strong signs of a recovery, backed by a highly supportive monetary policy.

Data out of the US was also relatively favourable. Strong consumer spending and increased investment by both the private and public sectors led to an upward revision of second Quarter GDP growth from 3.7% to 3.9% (annualised).

Despite the positive start, market volatility reappeared with a vengeance and investor sentiment was damaged by concerns for a weakening Chinese economy and uncertainty around the timing of a Federal Reserve (Fed) rate hike.

The Fed meeting proved to be the focal point of the quarter. Expectations that the zero interest rate policy would finally end were high, given that the Fed's had been preparing markets for a rate hike over the preceding months.

The meltdown in global equity markets followed China's decision to devalue its currency peg against the US dollar by 4%. This triggered concerns of a sharp slowdown in Chinese growth. This appeared to be confirmed by the Feds comments after its decision not to raise interest rates at the September meeting.

The European economy is now showing strong signs of a recovery, backed by a highly supportive monetary policy.

Despite US unemployment continuing to fall from 5.6% at the start of the year to 5.1% in August, the driving force behind the Fed's decision appears to be a lack of visible inflation. The Fed also appears to have taken on board the concerns expressed by the IMF and the World Bank about a rate hike at this point in time.

The head of the International Monetary Fund (IMF) warned that global growth will be weaker than previously expected and that emerging economies should be alert to potential shockwaves from China's slowdown.

Globally, interest rates remain accommodative and this doesn't seem likely to change any time soon. There is, however, the potential for some year-end volatility due to the prospect of a possible rate rise by the end of 2015. With another two meetings to go, Janet Yellen (Federal Reserve Chair) stated that she was confident of a US recovery amid a sluggish global economy and reiterated plans to withdraw the central bank's extraordinary stimulus by year-end. This is as long as inflation remains stable and employment levels remain strong.

UK economy

UK economic output (GDP) is estimated to have increased by 0.5% in Q3 2015, compared to a growth of 0.7% in Q2, according to the Office for national Statistics (ONS). Despite evidence that growth had slowed over the last three months, there is no real reason for concern over the prospects of the UK economy going forward.

The IMF raised its forecast for UK growth in 2015, amid downgrades "across the board" for advanced and emerging economies. It said China's slowdown and falling commodity prices, alongside an expected increase in US interest rates, would all weigh on output.

The UK's recent GDP history was also upgraded by the ONS. This is due to upward revisions to GDP growth between 2011 and 2013. The UK is now 5.8% above its pre-recession peak, up from an earlier estimate of 5.2%.

The UK labour market showed signs of improvement as companies continue to hire. The Confederation of British Industry (CBI), does however, see a slower pace of jobs growth ahead as productivity gradually picks up, with the unemployment rate likely to level out in 2017 (at 5.1%).

While job creation will ease, stronger pay growth of 3.2% in 2016 will boost prospects for households. The CBI also expects inflation to pick up from the end of the year, moving towards the Bank of England's target of 2% from mid-2017 onwards.

As expected, The Bank of England kept rates at 0.5%. With inflation falling back to 0% in September, there is no pressure in the foreseeable future for the MPC to alter the status quo. It now appears more than likely that MPC will delay any rate hike until after the Fed makes its first move.

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Summer budget

Q3 saw the first all conservative budget since 1996 and was put forward as the budget for working people. Huge welfare cuts were offset by a higher minimum wage in a bid to create a "high wage, low tax, lower welfare" economy.

George Osborne highlighted details of how the government plans to eliminate the UK's budget deficit, forecast to be £75bn this year, and run a surplus by the end of the parliament (2020). Continued austerity was at the forefront as debt as a share of GDP is forecasted to fall from 80.3% this year to 68.5% by 2020

The chancellor reiterated his commitment to devolution and put strengthening regional government at the heart of his plans to revitalise the UK's regional economies following a landmark devolution agreement with councils in Greater Manchester last year.

UK property market

Residential

- Nationwide reported a divergence in house prices across the UK in Q3. The rate of annual house price growth accelerated in Southern England, particularly in London, but continued to slow in the Midlands and most Northern areas.
- Price growth in the South exceeded that in the North for the 26th consecutive quarter.
- London was the strongest performing region, with average prices up 10.6% year-on-year, and up on Q2 growth by 7.3%.
- The CBI expects house price inflation to slow as interest rates increase, with house prices rising by 6.0% in 2015, before slowing to 3.9% in 2016 and 3.5% in 2017.
- In a move to restore the balance between those buying property to let and those buying a home, an announcement was made to phase out tax relief on mortgage interest payments (over the next 5 years) until tax relief is only available at the basic rate (20%).
- This has come on the back of concerns that the growing buy-to-let property market in the UK could post a threat to wider financial stability, according to a BoE committee. The Bank's Financial Stability Committee (FPC) stated that buy-to-let mortgage lending had the potential to "amplify" a housing boom and bust.
- The buy-to-let mortgage market in London currently accounts for 24% of the UK market and 27% of all private rented accommodation in the UK, according to the Council of Mortgage Lenders (CML).

The growing buy-to-let property market in the UK could post a threat to wider financial stability according to a BoE committee.

Commercial property outlook

Performance driven by yield compression and robust rental growth

- The UK commercial property market delivered a 25th consecutive quarter of positive total returns in Q3 2015, according to IPD.
- Average total returns across all property stood at 3.2%, a reduction from the 3.5% delivered in the previous quarter
- The best performing sector over the quarter was Industrials, with a total return of 4.4%, followed by offices, which were up 4.1%. The retail sector showed strong income return (+1.3%) but total returns still lagged (+2.2%)

Quarterly Performance Q3 2015	All Property	Offices	Industrials	Retail
Capital growth	2.0%	3.1%	3.0%	0.9%
Income return	1.2%	1.0%	1.3%	1.3%
Initial yield	4.9%	4.2%	5.4%	5.1%
TOTAL RETURN	3.2%	4.1%	4.4%	2.2%

Source: IPD UK Quarterly Property Index

- Year to date, the office sector continues to produce the highest returns across all commercial property sectors. Returns have been driven by yield compression and sustained rental growth.
- Rental values grew by 1% over the quarter, exceeding the 10yr average rate (0.6%) of quarterly rental growth.
- UK commercial property outperformed UK equities over Q3, returning 3.4% compared to a loss of 7% from the FTSE All Share index as global economic and political events led to widespread volatility in equity markets.
- From a longer term perspective (5yrs annualised), UK property continues to outperform bonds & equities.

Quarterly Performance Q3 2015	3yr annualised returns (%)	5yr annualised returns (%)
All Property	13.0	10.3
Equities	5.2	5.4
Property Equities	20.0	15.3
Bonds (7-10 yrs)	2.5	5.1
Inflation	2.1	2.9

Source: IPD UK 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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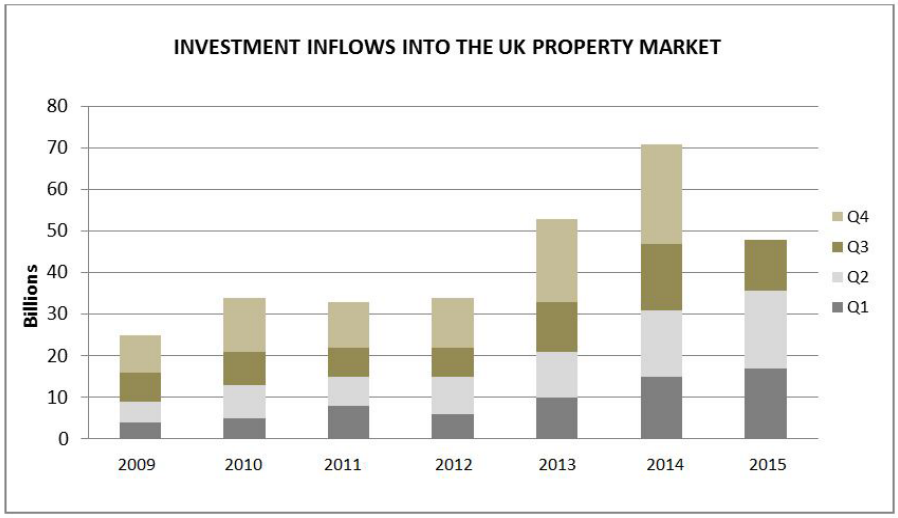
Investment volumes

Investment inflows – Lowest quarterly volume since Q2 2013

- Q3 inflows totalled £12.1bn, which was significantly down on the £20bn+ volumes we saw in Q1 and Q2 2015. This was also the lowest quarterly volume recorded since Q2 2013 according to data by Property Archive.
- Year to date however, investment volumes have totalled £51bn, an increase of 6% on the same period last year.
- Coming into the last quarter, there are a number of high profile deals yet to complete. It is therefore very possible that 2015s annual volume could still top last year's record total.



Source: Property Archive

- As a sector, offices continued to attract the bulk of inward investment and remain the investor's asset of choice.
- There was, however, a divergence in flows between London and the regions. Central London office investment totalled £2.8 billion, marking a 14% decrease on the previous quarter and a 23% decrease on the five-year quarterly average
- Regions, on the other hand saw volumes rise by 73% during the quarter reaching £1.05bn at the quarter end. According to data produced by Knight Frank, total turnover for 2015 is now the highest total for the period since 2007.
- Overseas investors remain the dominant buyers, representing 38% (£4.5bn) of all UK investment activity, followed by UK institutions at 2.7% (£3.2bn). These two groups have been the largest investors since Q3 2009.
- During the quarter there were eight purchases of over £100 million, with two of those in excess of £200 million and two in the regions.

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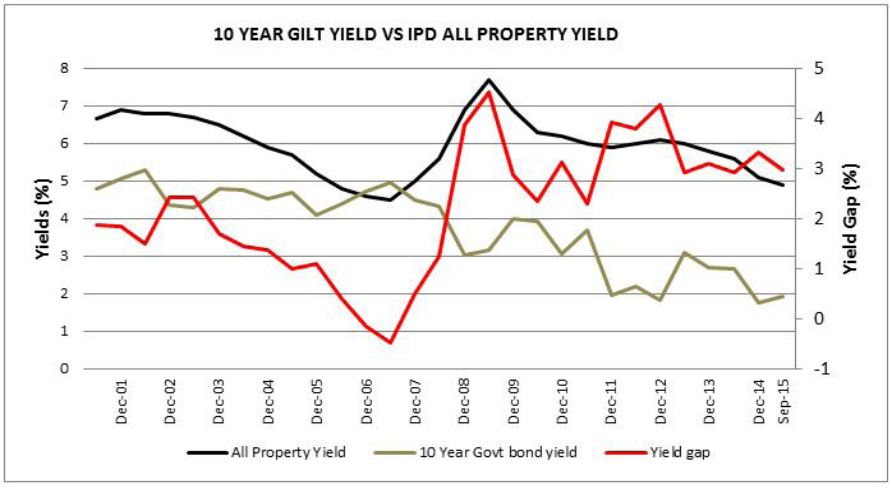
Yield compression

Increased investor activity drives yields to eight year lows

- The All Property equivalent yield contracted a further 7bps to 5.9% in Q3 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 firmly spread to the regions. Whilst yields in London and the South East have fallen significantly, we still see scope for further yield compression in other parts of the UK.

Property yield vs Government bonds

- Despite the sharp yield compression, historically low bond yields still allow for a very attractive yield gap.
- 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 remains attractive for investors.



Source: IPD UK Quarterly Property Index

Despite the sharp yield compression, historically low bond yields still allow for a very attractive yield gap.

Occupational demand

- The strength of the UK economy is continuing to support employment growth and occupier expansion. Despite the slower rate of growth in Q3, forecasts suggest that GDP growth will be close to 2.4% in 2015.
- Availability across central London offices fell from 9.3 million sq ft to 8.7 million sq ft over the quarter. The vacancy rate is now down to 4.5%, it's lowest since Q2 2008 when the vacancy rate was down at 3.9%.
- Outside of London, occupier demand continues to improve in most locations and fundamentals remain very positive. In Birmingham, Leeds, Bristol and Manchester in particular, demand for quality space is being met by a decreasing supply.
- The low levels of development activity over the past five years mean that shortages of quality space have become increasingly apparent as the economic recovery gathers pace.
- 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 was HSBC's recently announced plans to establish the head office of its UK bank in the Arena Central development in Birmingham city centre. If this trend continues it will have a significant effect on occupier demand in the regions.
- Whilst the overall availability of grade A space improved over the quarter, with an 8% increase to 2.4million sq ft, the total, remains 19.7% below the 5-year average of 3million sq ft.

Rental growth

- According to IPD data, rental growth is now at an eight year high (1.0%) which is providing fundamental support to the sector.
- Offices continued to show the highest level of growth at 2.1%, with industrials continuing to sustain positive performance (up 1.2%).

Quarterly Performance Q3 2015	All Property	Offices	Industrials	Retail
Rental Value growth	1.0 %	2.1 %	1.2%	0.2%

- Growth in industrial rents year to date 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.
- The quarterly RICS UK Commercial Market Survey (Q3 2015) reveals that North West businesses within the office and industrial sectors are likely to experience the most significant rental increases over the next 12 months, at around 4.3% and 4.6% respectively, with London seeing rises of 6%.

Despite the slower rate of growth in Q3, forecasts suggest that GDP growth will be close to 2.4% in 2015

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 around February 2016, the most likely outcome however, is that the BoE will wait until the Fed make the first move.
- With the strength of the UK economy supporting employment growth and occupier expansion, letting activity is expected to remain robust 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 accelerate due to the lack of good quality new supply.
- This situation has been exacerbated by permitted development rights, enabling many offices to be converted to residential use.
- 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 commercial property yields.
- UK institutions have been extremely active over the last 18 months and still have significant amounts of capital to invest.
- 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.
- The spread between prime and secondary yields is still more than a percentage point higher than its long-term average. This gives scope for regional property to outperform and the spread to close further over the next 12 months.
- The UK commercial property lending market is continuing to see more and more entrants and the greater availability of debt for investment in secondary property will be an important factor in the further closing of the prime-secondary yield gap.

The outlook for regional commercial property remains positive with demand increasing across the majority of key markets.

Conclusion

Q3 was a difficult quarter as concerns regarding China's slowing economy contributed to the sudden jump in market volatility. As we move forward headwinds will remain and China will stay at the top of the list, given that it accounts for 33% of global economic growth.

Investor attention will be focused on the US and the "will they/wont they" raise rates dilemma. Whatever the outcome, global interest rates remain accommodative and this doesn't seem likely to change any time soon.

As we approach the end of the year the outlook for commercial property remains positive amidst an improving UK economy, improving occupier sentiment, strong investment demand and overall lack of quality supply.

Across the asset class, yields appear to be stabilising and we will look to income growth to assert itself as the primary driver of future performance.

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