

Riverside
CAPITAL

THE
PROPERTY
INVESTMENT
PEOPLE

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London
Market Review
March 2016



Riverside Capital bolster research capability with market research leaders, Capital Economics

Research is at the heart of everything we do at Riverside Capital. It is at the core of our decision making and enables us to select investments that will deliver strong returns to our private investors and partners from around the world.

This month, we are delighted to announce that we have signed a partnership deal with Capital Economics that will bolster that research capability: using fresh, raw data to bring you the latest views and trends in the UK property market.

By way of an introduction, Capital Economics is one of the leading independent economic research companies in the world, producing over 4,000 publications each year. Founded in 1999, and with more than 50 experienced economists, their team is well placed to provide us with their views on the UK economy and the commercial property market. These views and statistics will be collated into a monthly report for clients and friends of Riverside Capital.

Overview: London, March 2016

We are excited to kick off this new partnership with our London Market Review. As an investment house it is well known that we were amongst the first to be buying in Central London (post-crash) when we started our business in 2010, and that we have been sellers of London assets for the last couple of years. Whilst there are some fundamentals that suggest current values could be sustained, with rents and capital values both at record levels, we are in uncharted territory in Central London, and we believe that there needs to be a rebalancing for a market that has probably gone too far for now, in terms of value increases.

In the next 12 to 18 months, there could well be a correction of sorts, and for new opportunities in the London market to present themselves. Offering deals to our investors on a deal by deal basis rather than as part of a fund strategy means we can be the first to react to these opportunities as they arise.

Our strategy since 2013 has been targeting regional property let on long leases let to strong tenants. So far this year, we have exchanged contracts to buy a further 6 assets with this profile. This includes a portfolio of 4 Travelodge hotels for a combined purchase of £19.76 million. We are currently raising equity from our investor base for this opportunity; if you would like to know more, please contact us.



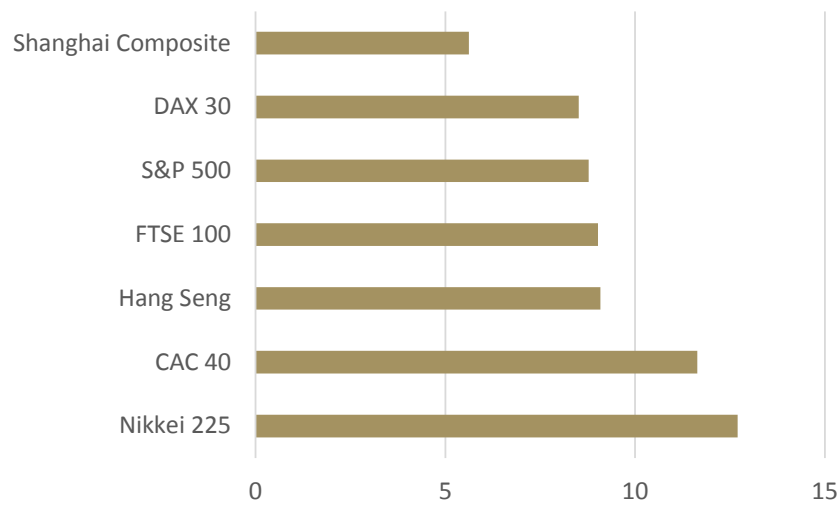
Dominic Wright, Group Chief Executive

Global Macro overview

A mixture of subsiding global growth fears, and fresh monetary stimulus meant that, after February’s sell-off, equity markets have recovered some lost ground.

In all, key stock markets rose by between 5%-13% from their mid-February lows.

Chart 1: Selected Equity Market Indices (% change from trough, latest = 17th March 2016).



Source: Thomson Datastream

US labour market and inflation data implied that fears of a recession are probably overdone. Not only was February’s 242,000 increase in non-farm payrolls strong, but the previous two months also saw upwards revisions of 30,000 each.

That said, data out of Europe was disappointing. Reflecting a slowdown in consumer spending, euro-zone GDP growth was just 0.3%q/q in Q4, unchanged from Q3. Moreover, at minus 0.2%y/y in February, CPI data pointed to the reemerging risk of deflation.

Despite the disinflationary pressure stemming from a stronger dollar, core inflation rose to a three-year high of 2.2% y/y in January.

Together, these factors mean that divergent monetary policy is likely to persist. Joining the Bank of Japan, the ECB loosened monetary policy to counteract the threat of deflation. Mario Draghi's latest announcement probably surprised on the upside, as it included a diverse set of measures, of which the most salient were a 10bps cut to the deposit rate, to -0.4%, and extending the ECB's asset purchases by €20bn to €80bn per month. Meanwhile, rising domestic price pressures mean the Fed is more likely to tighten rather than loosen its policy stance over the course of the year.

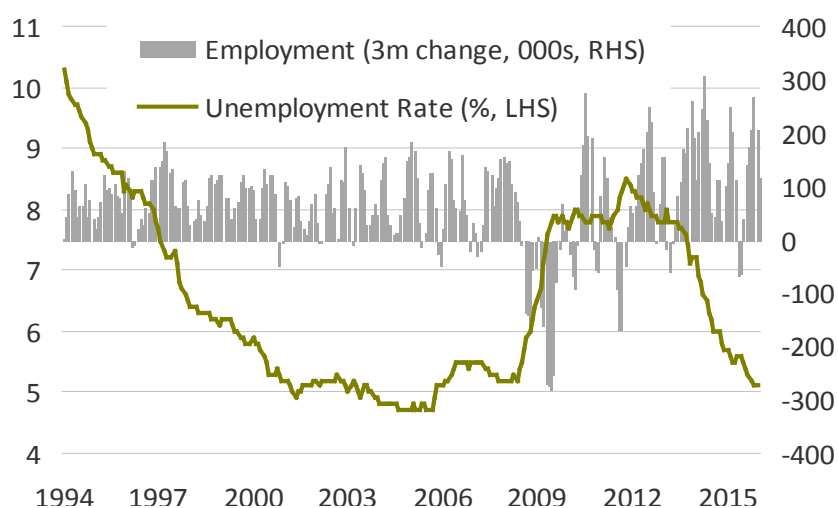
UK economy

While global growth fears appear to be receding, the uncertainty around the outcome of the EU referendum is taking centre stage. At 9% on trade weighted-basis, sterling's depreciation is larger than movements in relative interest rates and inflation expectations would suggest, implying at least some Brexit-related effects are at play. That said, the FTSE 100 index has recovered most of February's losses. Moreover, 10-year gilt yields have risen by 18bps from their February low to reach 1.54%. Both developments suggest that financial market participants are not unduly concerned.

Recent data also suggests domestic conditions are on solid footing.

At 5.1%, the unemployment rate is lower than at any point since 2006. At 106,000, job creation in the three months to January was broadly in line with the average seen over the previous year. Moreover, modest but positive nominal wage growth and near-zero inflation meant real wage growth was healthy. This, in turn, was reflected in strong retail sales volumes growth which rose from 1.8%/y in December to 5.1%/y in January.

Chart 2: UK LFS Employment Change and Unemployment Rate



Source: Thomson Datastream

Nevertheless, more timely sentiment data suggests that consumers and firms are becoming a little more cautious. In fact, financial market turbulence and the announcement of the referendum date in February coincided with a fall in consumer confidence. Elsewhere, the weighted average of the CIPS/Markit services, construction and manufacturing PMIs also fell back a little.

That said, it is unlikely that the UK is on the verge of a deflationary spiral. Indeed, CPI inflation was positive in January, albeit at just 0.3%/y. In all, muted wage and price pressures mean the MPC will probably keep rates low in the short-term and any increase in Bank Rate should be gradual.

London Residential

London housing market activity has picked up in anticipation of the upcoming stamp duty surcharge. Data from RICS suggested that, mirroring the national trend, new buyer enquiries rose in December and January.

That said, credit availability remains constrained and is likely to limit transactions. The number of mortgages extended for home purchases in London has fallen for five consecutive quarters, and aggregate transaction growth has been negative for the last year or so. That said, a breakdown by location shows that transactions in London's outer boroughs have now stabilised.

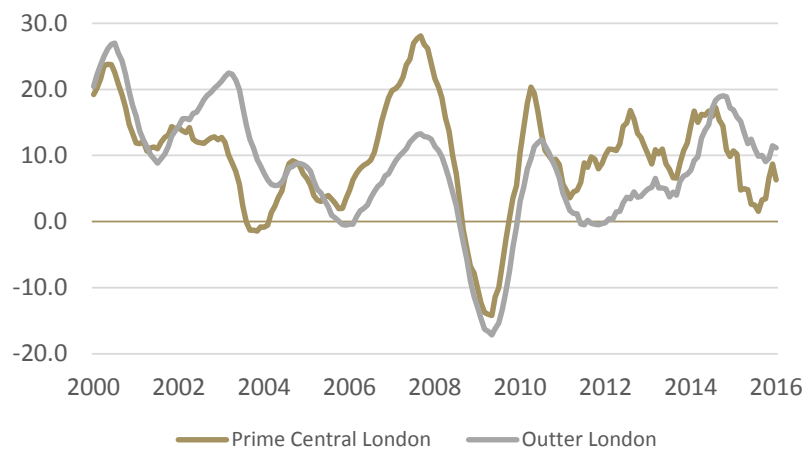
Despite poor credit availability and falling transactions, house prices inflation has accelerated in recent months. On an annual basis, Land Registry figures showed that average house price growth increased from around 5% in the middle of 2015 to 13% on the latest data.

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However, price trends in London are polarised. In January, the annual rate of house price growth in Prime Central London fell to 6.3% from 8.7% a month earlier. Meanwhile, in Outer London, house prices rose by 11.1% y/y. This pattern suggests that the effect of 2014's stamp duty reform has been more significant at the more expensive end of the market. More recently, there has been evidence of a rise in the number of properties for sale, which should dampen price pressures.

Chart 3: House Price Growth (% y/y)



Source: Land Registry

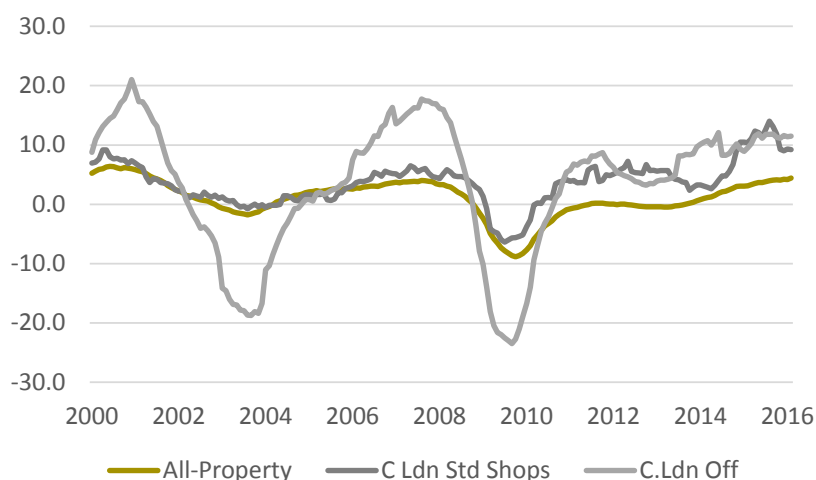
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London Commercial

Commercial property rents have started 2016 on the right foot. The IPD's monthly index for February showed that all-property rental growth picked up to 4.4%/y from 4.2%/y in January. In comparison, at 11.5%/y and 9.2%/y, Central London office and standard shop rental values grew at a considerably stronger pace although this was essentially unchanged from January.

Chart 4: Rental Value Growth (% y/y)



Source: IPD

Healthy rates of rental growth have been driven by a persistent imbalance between strong demand and constrained supply. At 13.6m sq.ft., 2015 office take-up in London was high by historic standards. This, coupled with limited completions, has put downward pressure on availability. Similarly, London's retail pitches have benefited from retailers' increased demand for flagship locations as well as the fixed nature of supply in the most sought-after locations.

Meanwhile, yields have started to show signs that they are fast approaching their floor in London. Reaching 3% and 3.1% respectively, Central London high street and office yields both rose by a modest 2bps between January and February. Putting these figures in context, office and retail yields in London are currently 30-35bps lower than they were in 2008, and almost 200bps lower than the all-property average.

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Chart 5: Initial Yields (%)



Source: IPD

Together, stable rental growth and rising yields, meant that capital value growth slowed but remained in double digit territory. At 12.4%/y, Central London offices saw capital value growth slow from 18.5%/y in the middle of 2015. In the retail sector, at 16.3%/y, high street shop capital value growth in London's significantly outstripped the national high street shops average of 4.6%/y.

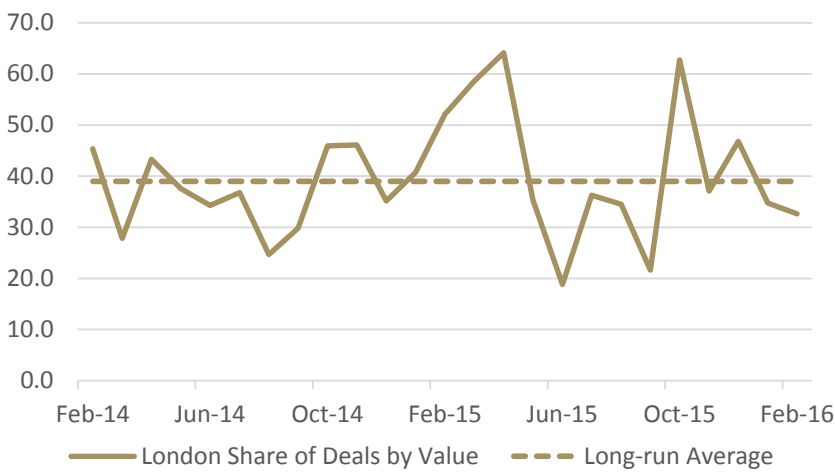
In the near-term, the relatively healthy economic fundamentals plus the low interest rate environment will probably buoy both rental values and valuations. However, at the same time that supply conditions are set to become less supportive (at least for the office sector), the uncertainty surrounding the EU referendum could delay some leasing and investment activity over coming months.

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Investment

At just under £2bn, the value of commercial property investment was weak in February. In fact, investment activity was 57% lower than in January and the lowest total since April 2011. Yet, the data is both seasonal and volatile, and February often is the weakest month in any given year.

Chart 6: Value of Commercial Property Deals



Source: Property Archive

Nevertheless, February’s decline was broad based, as activity slumped across most sectors. Compared to the previous three-month period, the value of deals signed in the traditional office, retail, and industrial sectors was down by 76%, 28% and 51% respectively.

However, London’s share of investment was not indicative of a shift in sentiment. Even though investment in London fell more significantly than the national average, at 32.7%, the share of deals transacted in the capital remained broadly in line with the long-run average.

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Furthermore, overseas investors remained active in the market. If we were facing a marked change in sentiment, overseas investors could be expected to step up sales of trophy assets. But although the data shows that foreign investors made sales of £332m in February, this represents a notable slowdown in the rate of disposals. In any case, in net terms, overseas investors acquired £648m of UK property in February.

Therefore, while Brexit fears could have played a part, the largest culprit for February's fall is the lack of large deals. In fact, at around £17m, the average lot size transacted in February was lower than most points since 2009. On balance, it seems likely that investment activity will be constrained in the short-term, but that it will rebound as the year goes on.

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