Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE

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UK Property Market Snapshot

May 2016

Whatever the result, income will be king!

As we undergo the final countdown to the EU referendum, the property industry is looking forward to a "Remain" vote followed by business as usual in the second half of this year. As well as being our view, this appears to be the view of overseas investors, who - according to our research partners, Capital Economics - continue to be the most active buyer type and are, surprisingly, still net buyers of UK commercial property, despite the risks that everyone at home is predicting for these investors.

Whilst we believe that "Remain" is the likely outcome, we are under no illusion that there is still a good deal of support for Brexit, and so property businesses like ours are making plans and considering strategies to suit both results.

The last few months have given the UK economy a dry run as to what life would be like should the country vote for Brexit; that is, volatility and uncertainty in financial and currency markets, with companies continuing to postpone investment decisions. On that basis, you may be feeling nervous if you own an empty building in The City of London right now. In fact, any letting risk in their portfolios at this stage may give investors a slightly uneasy feeling.

Conversely, once again, income producing commercial property is providing a shelter from all of this with very little volatility and improving valuations for assets with long and strong income streams.

Commercial Property in good locations outside of the capital, let on long leases to strong companies have been our focus since 2013; even in these uncertain times, these assets continue to deliver strong returns to investors.

If the country votes for a Brexit, we expect that demand for safe assets from UK based investors will strengthen over time. After all, the average UK investor will continue to invest in the UK, and income producing commercial property is about the only thing that will show any type of real income return.

In such an environment there is also likely to be some new asset management opportunities presenting themselves as overseas investors sell riskier assets. We do, however, expect these investors to continue to be attracted to the transparency and safe haven status the UK offers. Income producing UK assets may therefore become more attractive to overseas buyers if the pound devalues as expected upon a vote for Brexit.

On the other hand, if the UK votes to remain, we expect demand for commercial property to increase dramatically in the second half of 2016. A good deal of this demand will come from overseas investors as the currency risk diminishes with these investors mainly looking for income above all else.

Dominic Wright, Group Chief Executive

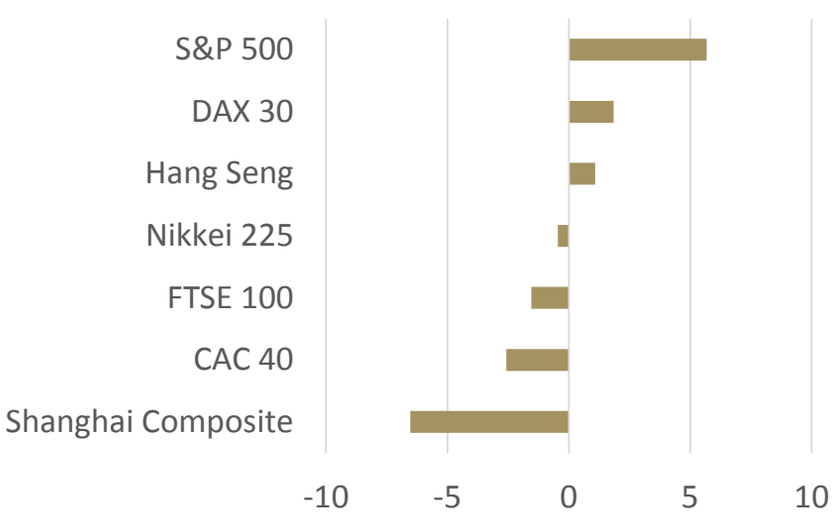
Global Macro

US GDP growth weakened signi cantly in the rst quarter. At 0.5%, the annualised rate of GDP growth slowed from an already muted 1.4% three months earlier. Jobs figures were also lacklustre. Non-farm payrolls rose by 160,000 in April, compared to 215,000 a month earlier. Nevertheless, despite soft growth and weaker job creation, core inflation dipped only marginally, from 2.3%y/y to 2.2%y/y. Thus, further rate hikes from the Fed still look likely this year.

By contrast, preliminary data suggests that economic growth was surprisingly strong in the Euro-zone. Indeed, at 0.6%q/q, GDP growth strengthened in the first quarter, from 0.3%q/q three months earlier. The labour market also gave some positive signs, unemployment fell by 226,000 between February and March, which was enough to reduce the unemployment rate from 10.4% to 10.2% over the same period. Less positively, however, in April, headline consumer prices were 0.2% lower than a year prior.

Global equity market performance was mixed over the last two calendar months. Equity markets in the US, Germany and Hong Kong were buoyant. By contrast, Chinese stocks saw the heftiest declines. Meanwhile, Japanese equities are still grappling with the effect of a stronger Yen.

Chart 1: Selected Equity Market Indices (% change last 2 calendar months, latest = May 12th 2016)



Source: Property Databank

Major central banks' policies will move in different directions over the next year or two. With the risk of deflation still looming, the ECB is likely to pursue further monetary loosening through lower rates or and expansion of their asset purchases. Similarly, the Bank of Japan and the People's Bank of China will probably continue to keep their policy stance loose. By contrast, rising inflationary pressures in the US will prompt the Fed to increase rates later this year.

Preliminary data suggests that economic growth was surprisingly strong in the Euro-zone.

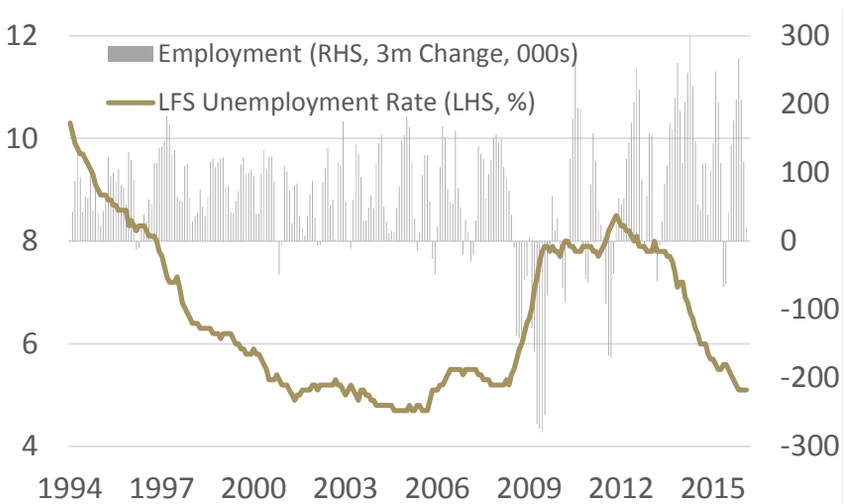
UK Macro

Financial market conditions deteriorated in April. Firstly, the FTSE 100 index 1.5% below its mid-March level, and 4% below its mid-April high-point. Meanwhile, at 1.66%, 10-year gilt yields reached their highest level since January.

This was in line with UK economic data beginning to show signs that the uncertainty surrounding the EU referendum is weighing on activity. Over the three months to February, only 20,000 jobs were created; less than a sixth of the average seen over the previous year. Annual retail sales growth also slowed for a second consecutive month, from 5.1% in January to 2.7% in March. However, with the unemployment rate unchanged at 5.1%, weaker job creation may reflect skill shortages as much as renewed caution amongst employers.

UK economic data is beginning to show signs that the uncertainty surrounding the EU referendum is weighing on activity

Chart 2: UK LFS Employment Change and Unemployment Rate



Source: Property Databank

That said, surveys typically suggest that rms and consumers are adopting a wait-and-see approach. The weighted average of PMIs for the manufacturing, construction and services sector fell from 52.6 in March to 51.1 in April, implying that economic activity has slowed to a crawl. Meanwhile, consumer confidence has eased. However, if economic activity were on the cusp of a sharp, sustained slowdown, we would expect forward-looking aspects of the surveys to fall significantly. Encouragingly, this has not been the case.

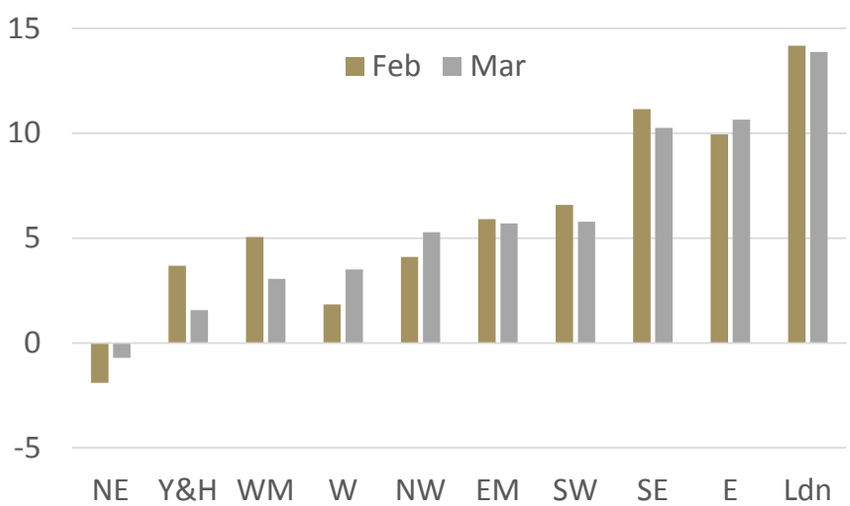
As the referendum approaches, the Monetary Policy Committee's stance will remain. However, with CPI inflation picking up from 0.3% y/y in February to 0.5% in March, as the uncertainty around the referendum dissipates after the vote, the MPC will probably begin to raise rates gradually.

UK Residential

The latest data offer some signs that the pace of house price in ation may be easing. In fact, Land Registry data recorded a 0.5%m/m fall in house prices, reducing the annual rate of house price inflation from 5.7% in February to 4.9% in March.

A regional breakdown showed house price growth trends were mixed. On an annual basis, house price growth accelerated in four regions, and slowed in six. And in keeping with the usual geographic variation, house price inflation was strongest in London, East of England, and South East.

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



Source: Property Databank

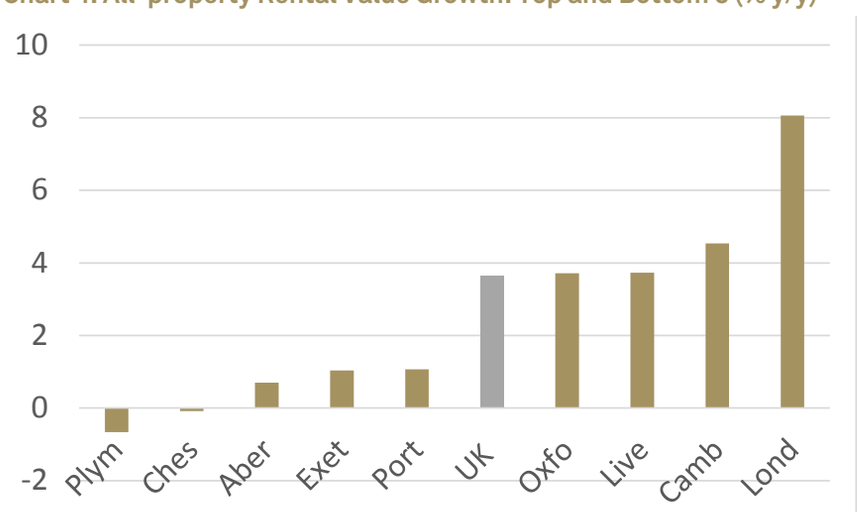
Looking ahead, there have been further signs that the market is cooling. For one thing, April's RICS survey showed that the new buyer enquiries net balance recorded its lowest reading since the crisis, at minus 22%. Meanwhile, the new sales instruction balance also fell, from minus 2.8% to minus 8.5%. With house prices already high and mortgage approvals down in Q1, house price inflation should slow through the rest of the year.

UK Commercial

UK commercial property rental value growth has held up fairly well. The IPD's quarterly index showed that that all-property rents rose by 0.8%q/q compared to the fourth quarter. Therefore, the annual rate was unchanged in Q1 2016 at 4%.

Nevertheless, rental growth outside of the capital was muted in comparison. Of the 28 centres in the IPD's regional coverage, on an annual basis, rental value growth only exceeded the national average in three cities outside of London. In Cambridge, all-property rents were 4.5% higher than a year earlier, while in Liverpool and Oxford they were up by 3.7%. By contrast, in Plymouth, rents were 0.7% lower than in the first quarter of 2015.

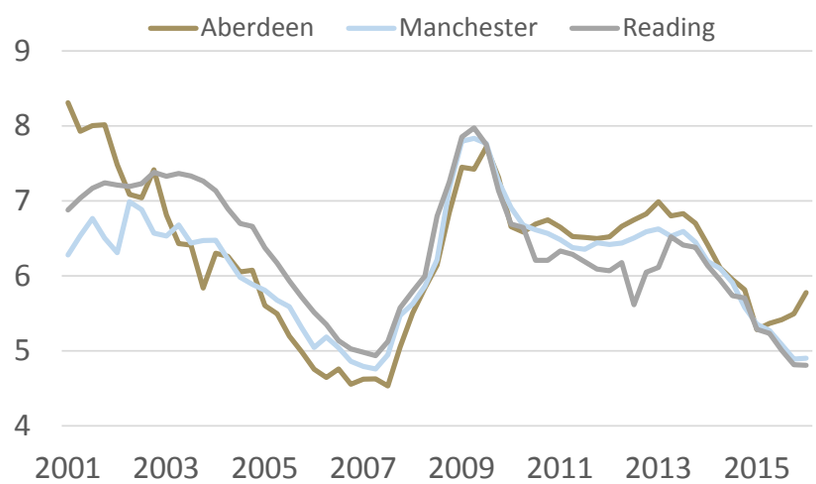
Chart 4: All-property Rental Value Growth: Top and Bottom 5 (% y/y)



Source: Property Databank

On the pricing front, yields are showing some signs of bottoming out. For instance, in both Manchester and Reading, markets where yields were already very close to their previous troughs, all-property yields were unchanged in the first three months of the year at 4.9% and 4.8% respectively. Meanwhile, given the collapse in commodity prices over the last 18 months, rental prospects in Aberdeen have been dented. As a result, yields have risen by 60bps despite still being some way away from their previous low.

Chart 5: All-property Initial Yield (%)



Source: Property Databank

Despite yields and rents being broadly stable, capital values at the national level fell. However, this probably refl cted the impact of changes to the commercial stamp duty regime. March's introduction of a banded stamp duty system, to replace a flat 4% tax, increased the effective tax rate to just under 5%, increasing transaction costs and leading to a small, one-off correction in values. For example, over the first three months of the year, national all-property yields fell by 1bp and rents rose by 0.8%q/q. Under normal circumstances, these conditions would have lead capital values to rise. However, UK all-property capital values fell by 0.1%q/q. And while there was some variation, this observation held across most markets.

And although not without short-term risks, market conditions are likely to be resilient. Tenants and investors are likely to be cautious in the run-up to the referendum vote. Nevertheless, low interest rates and steady, if unspectacular, economic growth should underpin both rental values and valuations.

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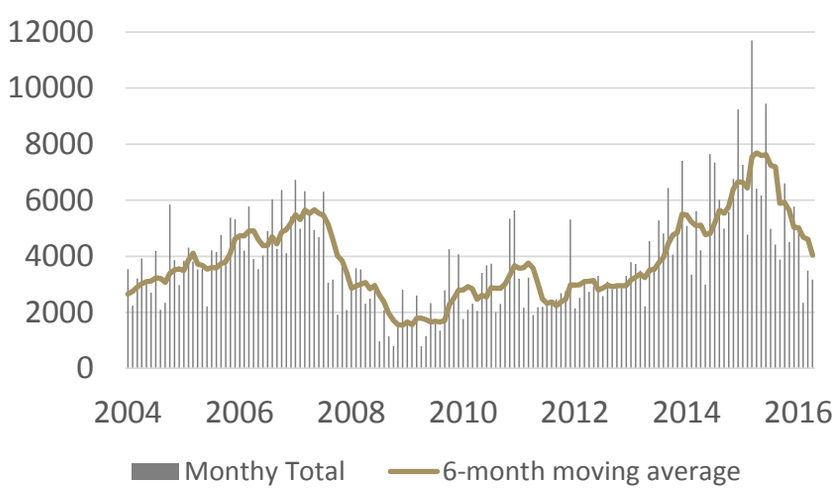
Investment

Commercial property investment activity dipped a little in April. At £3.1bn, the value of properties transacted in April fell by 9% compared to March's figure, but it was still 36% higher than February's 58-month low. Moreover, giving weight to the idea that February's lull reflected a temporary lack of liquidity, the average deal size rose to £37m in March, from £17m two months earlier.

Chart 6: Value of Commercial Property Deals (£m)



Source: Property Databank

There was little in the data to support the notion of rising risk aversion. Despite the referendum edging closer, net purchases from overseas investors are still positive. In fact, with net purchases of £949m, overseas investors were the most active buyer type. Moreover, with pricing very stretched in the capital, London seems more exposed to shifts in sentiment. Yet, at 54%, the share of investment involving Central London property stood above the long-run average of 39%.

A sectoral break down of April's gures reveals that activity has been concentrated in the traditional - of ce, retail and industrial - sectors. The value of deals signed totalled £1.8bn, £434m, and £374m respectively. Indeed, over the last year, the traditional property sectors have accounted for two thirds of investment activity.

In all likelihood, investment activity will be subdued until after the referendum. However, with pricing stretched and investment activity already on a downward trajectory, it seems likely that any post-referendum uptick in activity will be modest.

For further information please contact:

Sarah White
Head of Marketing
+44 (0)20 7297 4480
sw@rivercap.co.uk

Jaspal Phull
Head of Research
+44 (0)20 7297 4480
jp@rivercap.co.uk

www.rivercap.co.uk