

March Update

Global Factors

February saw global stocks climb to record peaks and set new highs for the first time since 2015, as hopes for faster economic growth spurred markets. The Dow Jones soared through the 21,000 mark just over 3 weeks after breaking the 20,000 level for the first time. It's the quickest time ever to 1,000-point milestone, beating the record set in 1999.

In March, populist parties' run of electoral successes was broken in the Netherlands. Geert Wilders' eurosceptic Party for Freedom's (PVV) performance was underwhelming. Although the PVV gained 5 additional seats, it fell well short of predictions. The possibility that the far-Right firebrand could become the largest party in the Dutch parliament had sent tremors across Europe in recent months fearing yet further destabilisation following the UK vote for Brexit and the election of Donald Trump.

From a political perspective, recent developments in the UK have been mixed. After some Parliamentary to-ing and fro-ing, the government has triggered Article 50. In itself, however, this does nothing to clarify what kind of environment the UK economy will face post-Brexit, and pressures for a second Scottish independence referendum have been reignited. The announcement of the SNP's intentions to push for a second referendum led to a 3% fall in the pound compared to the US dollar. But that was quickly reversed on the release of a poll indicating that a "yes" vote looks unlikely.

Meanwhile, news on the UK economy has been similarly mixed. The second estimate for quarterly GDP growth was revised up, from 0.6% to 0.7% in the fourth quarter. Downward revisions to the first two quarters of the year meant that growth on an annual basis was revised down from 2% to 1.8%, however. Timelier indicators of activity suggest that an imminent slump is unlikely. At 53.7, the composite PMI is above the theoretical expansion/contraction threshold of 50 and slightly higher than the average seen over the last year. That said, CPI inflation breached the Bank of England's 2% target in February, leading suggestions that the MPC will tighten monetary policy sooner than many expect. But even then, market expectations are set for a first hike in late-2018.

An Overview

A timeline has been set for Brexit negotiations. While no conclusive quantitative argument can be made to summarise the impact of a UK exit from the EU on UK commercial property, we foresee a number of opportunities that will arise from the inevitable increase in volatility.

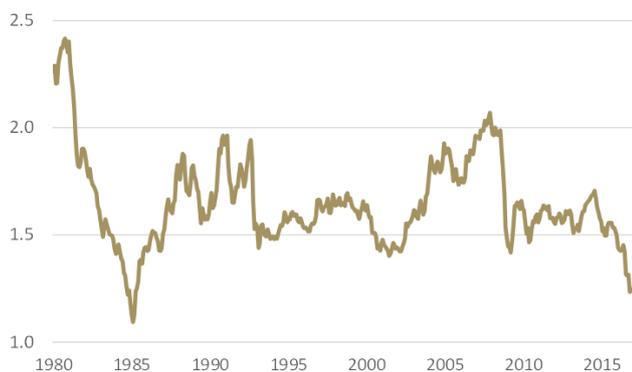
March Top 5

1. Theresa May triggered Article 50 of the Lisbon Treaty yesterday, March 29th
2. CPI inflation has breached the Bank of England's 2% target
3. February saw a sharp rise in net overseas investment
4. March has seen the largest ever City deal alongside the highest office rent on record
5. Lack of supply and unprecedented demand will continue to drive industrial property returns

Whilst inflation has not been much of an issue over the past couple of years, it is now expected to accelerate, and inflation proofing portfolios should now be at the forefront of investor priorities. **Back in 2013, we believed that it would only be a matter of time before rising inflation occurred and accordingly, began to help our investors prepare for a higher inflationary environment by offering properties with strong growth prospects and rents linked to a rise in RPI/ CPI.**

Between February and March, the sterling exchange rate has fluctuated between \$1.26 and \$1.22, and it sits lower than at most points since 1980 (Chart 1). The EU referendum explains the bulk of the drop in the pound over the past year, but the recent softness is more likely to reflect the divergent paths for monetary policy in the US and UK. Indeed, although almost universally anticipated, perhaps the most significant development during March was the Fed's decision to raise interest rates. The 25bp increase took the Fed fund's target rate to 0.75%-1.00%. Provided that the US economy continues to grow at a healthy clip and core inflation remains in check, two or three similar hikes should materialise over the rest of the year.

1.0 Exchange Rate (£/\$)



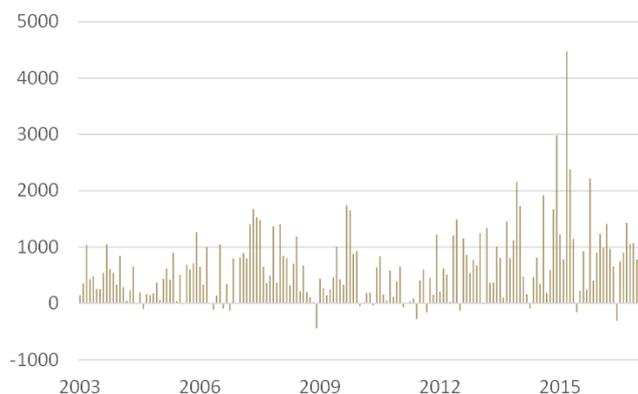
Source: Thomson Datastream

Property Overview

The latest investment market data suggests that, after a slow January, there was a modest improvement in transaction activity in February. Indeed, the value of deals signed in the UK as a whole totalled £3.7bn, up by 19% m/m. What's more, the six-monthly average value of transactions improved for the seventh consecutive time since August, strongly suggesting an improving underlying trend.

As has been the case for some time, overseas investors have been crucial to the strength of demand for UK property assets. At just shy of £1bn, net purchases of UK commercial property from foreign investors rose threefold over the month, to a level roughly in line with 2016's monthly average (Chart 2).

2.0 Net Investment into UK Commercial Property from Overseas (£m)



Source: Property Archive

Moreover, anecdotal evidence so far suggests that activity will improve again in March. Total reported activity is £3.7bn, according to Property Archive. The combined value of the two largest deals announced in March is around £2.4bn, more than two thirds of February's total. Given that activity in March has averaged £4.4bn since 2003, it would require an abnormally weak month of activity elsewhere to prevent a month-on-month increase.

Alongside greater inflows from overseas, we have also seen a rise in investment from UK institutions. Given the increase in these buyers over recent months, we have taken the opportunity to sell some of our assets that we knew would prove attractive to such buyers within the logistics and hotel sectors. Assets have been sold for prices exceeding their business plans, and ahead of their projected timescales (for more information visit www.rivercap.co.uk/news).



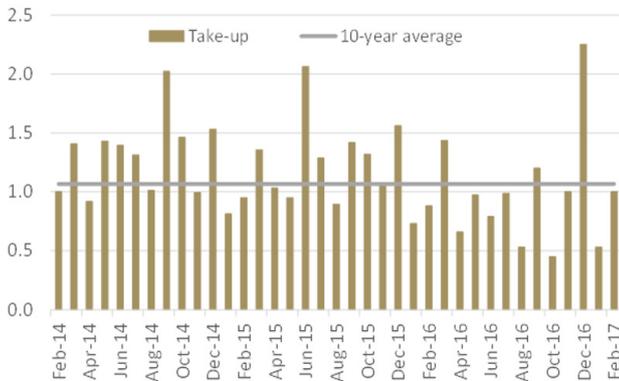
London Offices

The latest available data shows a mixed picture for prime rental and capital values in London’s main office markets.

At £70 psf in Q4, prime City office rents were unchanged over the quarter and up by 2% compared to a year earlier. But, with prime rents at £112.50 psf, on both a quarterly and annual basis, the equivalent growth rates for the West End stood at minus 6.3%. A 25bp uptick in prime yields in both submarkets in Q3 meant that capital values fell by 4% and 12.5% respectively.

Timelier data shows that take-up picked up in February, but that was not enough to keep office availability from increasing. Central London office leasing activity reached 1m sq.ft., reflecting a 92% increase compared to January and in line with the 10-year average (Chart 3). However, at 14.7m sq.ft., availability rose by 4%/m.

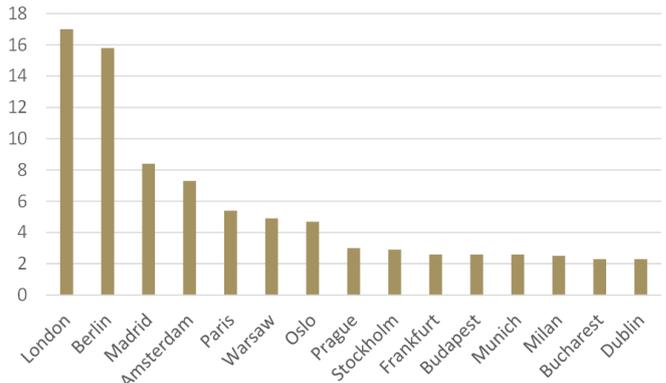
3.0 Central London Office Take-Up (Million sq. ft.)



Source: GVA Worldwide

Nevertheless, recent news points to the fact that London is still an attractive proposition for occupiers and investors alike. For one, March saw the highest office rent on record signed on St. James’ Square for a reported £190psf. And in the same month, at £1.1bn, a Chinese investor purchased the “Cheesegrater” building in the City, setting a record deal for the submarket. This extended the steadily rising share of foreign ownership of London office assets since the last financial crisis. Moreover, CBRE’s 2017 EMEA Investor Intentions Survey highlights that, with 17% of respondents quoting London as their top pick for investment in the region, the capital has not lost its shine. London sits atop the rankings above Berlin, Madrid, Amsterdam and Paris (Chart 4).

4.0 Most Attractive EMEA Cities for Investment (% Share of Respondents)



Source: CBRE

Regional Property Market

Investment activity in the regions has held up fairly well over recent months, suggesting that investors are not unduly worried about the prospects for non-London areas. At £1.7bn in February, the value of deals agreed in the regions accounted for 47% of the total, a pretty typical share of activity.

This is consistent with the idea that occupier demand seems on solid ground. For instance, at 52.7 at the latest reading, the employment sub-index national PMI implies that employment growth outside the capital should stabilise at around 1%/y. All else equal, this should support occupancy levels and rental value growth.

Sector Spotlight - Logistics

Industrial property, and logistics in particular, outperformed all other real estate sectors in 2016: a trend we foresee continuing into 2017. With the UK having now triggered Brexit negotiations, the uncertainty around the trade impacts of Brexit may lead to weaker rental and capital growth overall. However, higher levels of income return will help to continue to provide a strong level of total returns for the sector.

10 years ago, retail online and offline were two very separate worlds, but with the rise of e-commerce and in particular mobile e-commerce, there is now no distinction between the two. Companies such as Amazon, Deliveroo and ASOS are creating new markets and increasing their market share, whilst traditional brands are left in their wake. As consumers increase their spending online, technology is helping to change the shape of our cities and reducing demand for traditional retail space.

The fundamentals for growth across the sector remain strong. Greater digital literacy and greater connectivity mean that e-commerce's share of total sales is expected to continue to grow by as much as £18bn between 2016 and 2019, according to Europe Real Estate. This will help to keep demand for new warehousing high.

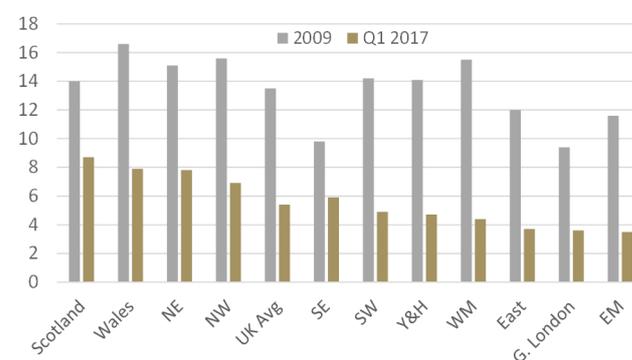
According to Savills, unprecedented levels of demand from online retailers saw just under 35m sq. ft. of warehouse space transacted across the UK in 2016, setting a new high watermark. Consistent with both strong retail sales growth and the ongoing changes in shoppers' habits, the logistics sector accounted for a substantial proportion of all activity.

Tight current and future supply conditions should continue to give the market some welcome support. Due to the extra supply chain demands of online retail, three times as much warehouse space is needed for online fulfilment compared with high street retail or an additional 775,000 sq. ft. of space for every extra €1bn spent online, according to Prologis/Aberdeen Asset Management research.

Despite favourable underlying demand conditions the availability of ready-to occupy logistics space remains a major issue for the market and is likely to escalate over the next 12 months. The supply of existing warehouse space now stands at just 27m sq. ft., which equates to just over 14 months' worth of supply. For this reason, the availability of consented land, ready for warehouse development, will become increasingly important if online retailers are to continue building their supply chains. Averaging 5.4% nationally, the industrial vacancy rate is less than half the level seen in 2009. This dearth of available industrial space has manifested itself across all of the main

regions (see Chart 5) and this seems unlikely to change any time soon. According to Colliers, at 3.5m sq.ft. in 2017, speculative developments are expected to be 65% lower than in 2016.

5.0 Industrial Vacancy Rates (% of Stock)



Source: Colliers

Uncertainty surrounding the EU Referendum has done little to hinder rental growth in the sector as an ongoing lack of supply and strong occupier demand has meant that occupiers have had to pay consistently high and rising rents. Across 60 UK markets, prime headline rents increased by 5.3% in 2016, rising from 3.9% in 2015.

The sector continues to benefit from a comparatively high income yield. With prime yields ranging between 4.5% in Heathrow and 6.5% in Glasgow and Belfast, the rental income produced by industrial properties looks attractive compared to the sub-5% yields achievable in the main prime office and retail markets in the UK.

Logistics (continued)

Income in a low yield world

The search for income remains a key concern to a large number of investors and the underlying attractiveness of industrial real estate will ensure that the sector is one that this group of buyers will continue to turn to.

With evermore technologically advanced fit outs becoming the norm and well-connected space for warehousing going at a premium, many large retailers are keen to sign up to longer leases of 20 or more years on their sheds. It's little wonder that institutional investors are increasingly viewing sheds as bond-like assets.

Commercial property has traditionally proved a good hedge against inflation and industrial property lease agreements typically include clauses that guarantee upward-only, inflation-linked rent increases. This offers useful protection for investors who are concerned that inflation is going to keep rising.

Over the next 10 years, technological change in the logistics sector will continue to influence real estate preferences.

According to a recent report by Savills, throughout 2016 Amazon spent \$14.2bn on R&D, placing it only second to Volkswagen in R&D spend. Further, research from Morgan Stanley has suggested that by 2030, all regulatory and technological hurdles will have been surpassed to provide even more innovative solutions to same day deliveries and servicing the last mile, such as drones and driverless vehicles. These will add further nodes to the supply chain, all of which require real estate and put further pressure on the supply/demand dynamic.

All of these factors are consistent with healthy investor demand for the sector. Indeed, at 10% of all deals signed over the twelve months to February, the share of investment in the industrial sector is at its highest since 2012. With rents holding up well, it is not surprising that prime yields have also held firm or fallen over the last year or so. With the weaker pound expected to give a boost to exporters, consumer spending expected to slow but not collapse and the supply pipeline looking constrained, the outlook for industrial property is bright.

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