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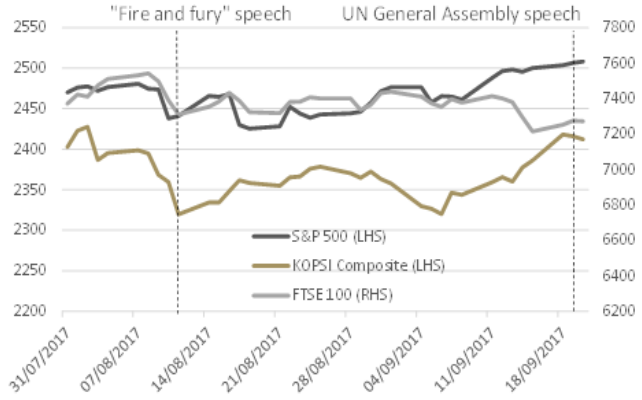
September Update

Global Factors

North Korea's latest missile tests meant that tensions in the Korean peninsula remained elevated during September. In fact, Donald Trump's maiden address of the UN's General Assembly suggested that, if provoked, the US may be forced "totally destroy North Korea". However, financial markets failed to react to the strong rhetoric. In contrast to the falls recorded in South Korean and US equity indices on the back of August's "fire and fury" speech, the same indices were broadly unchanged (Chart 1). Meanwhile, the price of gold – widely thought of as a safe haven asset – has fallen from its peak of around $1,345 per ounce in early September, to just under $1,300 per ounce at the time of writing.

1.0 Selected Equity Market Indices



Source: Thomson Reuters

Meanwhile, Theresa May's highly anticipated speech in Florence failed to deliver much in way of new detail on the UK government's approach to the Brexit negotiations. The most important point was her admission that a time-limited transition period is on the cards. During the transition, the regulatory status quo would be preserved and some financial contributions to EU budgets would continue to be paid.

An Overview

Inflation in August jumped to its joint-highest level since the vote to leave the European Union last year, as Brexit continues to push up the cost of living in the UK. Following this jump, the latest Monetary Policy Committee (MPC) meeting signalled that a hike in Bank Rate as soon as November was now a realistic possibility. Provided that this hike materialises, it would be far earlier than economists and financial markets had been expecting.

Despite the ongoing uncertainty with Brexit negotiations, business and consumer activity appears to be more buoyant than many investors had expected. Commercial property remains a popular asset class and the overall fundamentals remain attractive. Further, market indicators suggest a strong second half for 2017, as the Tech & Media sector continues to drive take-up across central London and the regions.

September Top 5

1. The war of words between North Korea and the United States could be pushing the region closer to the brink of an accidental conflict.
2. May seeks a transition period, during which financial contributions will continue to paid into the EU.
3. Expectations that we will see the first interest rate in rise in over a decade increase.
4. Commercial property yields across the UK contract as investor demand remains strong for long income assets.
5. Industrial sector continues to outperform thanks to strong occupational and investment demand.

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UK economic data was mixed over the month. On one hand, with job creation outpacing the growth in the labour force, the unemployment rate fell for the third consecutive month to 4.4% in July, the lowest figure since 1975. That said, the latest falls in unemployment failed to deliver any improvement in regular pay growth. At 2.1%y/y in July, not only was it unchanged from a month prior, but it was also lower than the rate of CPI inflation for the same month, of 2.6%y/y. And with August's data showing an increase in the rate of inflation, to 2.9%y/y, it seems likely that the squeeze on household real incomes has intensified.

Perhaps the most important change over the last month has come from the MPC. In the minutes of its latest meeting, it suggested that MPC members may well vote to hike rates as early as November. In turn, market interest rate expectations have increased and 10-year gilt yields have followed suit, rising from just under 1% on the morning of the meeting to just shy of 1.4% at the latest reading.

One consequence of higher UK interest rate expectations has been a rally in the pound against the dollar. Sterling rose against the US dollar, from $1.28 in late August to $1.35 towards the end of September.

Over the last 12 months, we have benefitted from locking in on historically low swap rates, providing our investors with the best all-in borrowing rates available. Our house policy on the majority of our deals is to lock in on debt at the point of draw-down for the duration of the loan. In the majority of circumstances, this provides investors with certainty above all else and allows us to see through property-specific business plans. With volatility surrounding swap rates and indications of a likely interest rate hike, our policy to provide certainty seems prudent. Most importantly, this policy will ensure that further equity calls are mitigated.

Property Overview

Leading indicators of occupier demand paint a relatively healthy picture for rental values during the second half of the year. For instance, employment growth is running at around 1.2%y/y. On past form, this is consistent with muted, but positive, rates of rental value growth. In addition, the fact that the lion's share of jobs created during the year up to July have been full-time positions bodes well for property. All else equal, full-time positions tend to translate into occupier demand more directly than part-time posts.

Meanwhile, there are good reasons to think that investor demand is unlikely to evaporate. Admittedly, the latest RICS survey showed that surveyors reported a softening in occupier demand. But even then, the availability balance remained firmly in negative territory, at minus 5%, suggesting an improvement in the balance between supply and demand. And while the rental expectations balance eased, from 17% in Q1 to 8%, it still pointed to rising rents. On the back of the positive readings for rents, it is perhaps unsurprising that the investor balance implied that demand from investors was still on the rise (Chart 2).

2.0 Net Balance of Surveyors Reporting Rising Investor Enquiries (%)

Source: RICS

What's more, despite the 5% appreciation of the pound against the dollar, sterling has not risen notably against other currencies. In fact, on a trade-weighted basis, sterling has depreciated by 1% during September. But perhaps most importantly, movements in the exchange rate have rarely coincided with changes in overseas investment activity. So, just as the earlier fall in in the pound was only helpful for investors at the margins, the most recent increase is unlikely to dissuade investors from entering the market.

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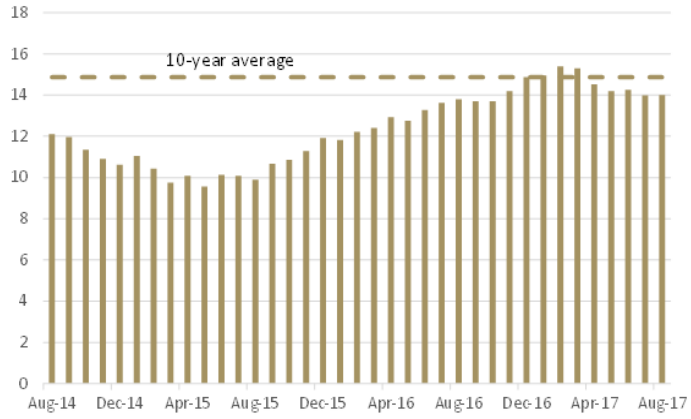
London Property Market

According to data from CBRE, office take-up was weak in London's main office markets. In fact, at 0.4m sq.ft. in August, leasing activity was 65% lower than the 10-year average. And even though August is typically a quiet month, take-up was down by 25% compared to the same month in 2016. However, despite August's soft leasing figures, availability was broadly flat on the month. In fact, at 14m sq.ft. availability is down by 6% from most recent peak, of 14.9m sq.ft. recorded in January (Chart 3).

3.0 Central London Office Availability (M Sq.Ft)



Source: CBRE

This largely reflects the fact that, looking beyond the volatility in the take-up data, office leasing in London's main sub-markets has held up fairly well this year. With a total of 6.9m sq.ft. of office space leased between January and August, take-up has been virtually on par with the same period last year, thanks largely to healthy levels of demand from TMT firms, serviced offices and co-working operators.

Meanwhile, there have been no signs of investor demand for London assets easing. Data from Property Archive showed that just over £1bn worth of London commercial property assets changed hands in August. That was almost half of the previous month's total. However, excluding the exceptional £1.3bn sale of the Walkie Talkie building in July, investment activity has risen.

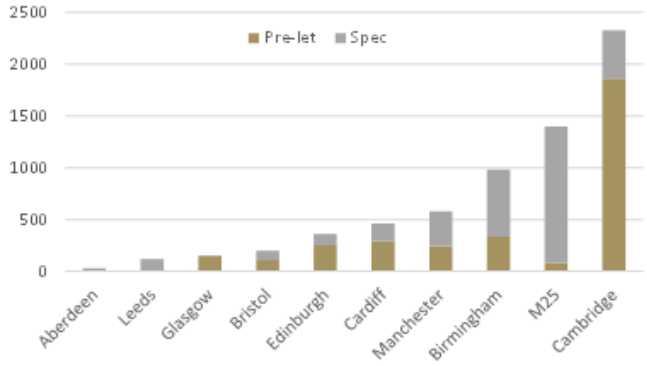
Regional Property Market

Regional office take-up was muted during the first half of the year. Indeed, the combined value of office lettings stood at 4.1m sq.ft. according to data from Savills, down by 14% compared to the same period of 2016. But, as in the capital, that level of demand was enough to help availability fall by 1%, to 30m sq.ft.

A breakdown of the figures highlights that, accounting for about a quarter of all new leases, technology, media and telecoms (TMT) firms were the most active. Meanwhile, at 13% of take-up, government entities also played an important role. Not only did the Government Property Unit (GPU) lease 190,000 sq.ft. in Edinburgh, but they have a few more deals due to complete in the second half of the year.

According to research from Savills, the outlook for regional office rents is positive. Indeed, they expect to see employment in office-occupying activities to increase by 4.6% cumulatively over the next five years. That would be equivalent to 55,000 new posts, or roughly 5m sq.ft. of office take-up. **Moreover, they expect limited new supply to help support prime rents.** Between the middle of 2017 and the end of 2019, Savills predict 6.9m sq.ft. of office developments to be delivered in the twelve regional markets in their coverage (Chart 4). Of those, 49% of the space is currently pre-let.

4.0 Office Development Pipeline (000s Sq.Ft)



Source: Savills

More generally, echoing the broad trend seen in most sub-markets, capital values have also been boosted by a hardening in regional property yields. For example, Savills data shows that prime provincial office yields sit 50bp below their August 2016 level, at 5%. Regional hotel yields have dropped by 75bp since last August, to 4.75%, which is good news for investors in our Travelodge fund. UK funds continue to target the budget hotel market given the strong covenants and inflationary linked income, which has recently resulted in record yields paid for Premier Inn and Travelodge investment opportunities.

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Sector Spotlight - Industrials

2016 was an exceptionally strong year of investment in the industrials/logistics sector, and momentum has carried into 2017. The sector remains popular given the length and security of income, particularly amongst institutional investors.

Riverside Capital has had a vested interest in the sector for several years via its acquisition of two large portfolios of Travis Perkins properties and three distribution hubs let to DPD. Earlier this year we were able to capitalise on continued strong levels of demand by selling one of the DPD investments in Northampton to Southampton City Council, delivering investors a return of 1.7x equity.

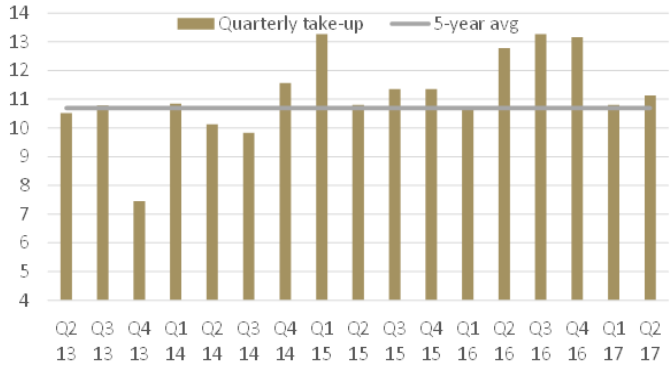
The industrial market has continued to buck the trend since last year's referendum vote. CBRE data shows that, at around 4.5%y/y in July, prime industrial rental value growth is considerably stronger than the sub-1%y/y rates recorded in the office and retail sub-markets. Similarly, at just over 15%y/y, prime industrial total returns are almost three times the rates observed in offices or retail.

In part, the industrial segment's outperformance stems from strong tenant demand. For one thing, 2016 was a record year for industrial take-up. According to Gerald Eve, 51m sq.ft. of industrial space was let over the year as a whole, up 16% on 2015's total. This contrasts with the 17%, 5% falls recorded in central London offices and the key nine regional office markets.

Even though the economy has held up better than many expected, rental values have risen more quickly than the macroeconomic context would imply for some time. This reinforces the idea that changes to the way consumers purchase goods is boosting industrial occupier demand. Indeed, very large deals from online retailers, like Amazon, have been crucial. In fact, during 2016 alone they signed three of the four largest deals nationally, ranging in size from 2.2m sq.ft to 1.1m sq.ft. And when all their activity is considered, last year Amazon leased 8.5m sq.ft. of industrial space, or one sixth of the national total.

During the first half of 2017, industrial take-up has eased a little from those record levels. Granted, at 11.3m sq.ft. in the second quarter, industrial take-up improved by 5% compared to the first. However, taking the first half of the year as a whole, leasing activity weakened by 6% compared to the same period of 2016 (Chart 5).

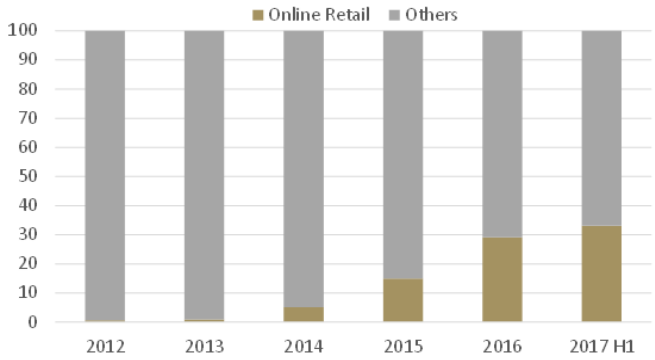
5.0 Industrial Take-Up (000s Sq.Ft per Quarter)



Source: Gerald Eve

Encouragingly, however, there is little indication that demand from online retailers is drying up. Indeed, data from CBRE highlight that 33% of industrial take-up was accounted for by online retailers, up from 29% in 2016, and 15% one year earlier (Chart 6).

6.0 Share of Industrial Take-Up from Online Retailers (%)



Source: CBRE

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But the demand side is only part of the story. In fact, limited availability has also played a large role in boosting the sector's prospects. According to the RICS commercial survey, industrial demand is still outpacing new supply. Indeed, the availability balance for the industrial sector was in negative territory for the 20th consecutive month, suggesting that rental values should continue on an upward path for some time.

The sectors superior returns in 2016, allied to projected rental growth prospects have proven highly attractive to both existing and new entrants to the sector. With alternative assets generally providing low returns there is a global search for yield and growth. As such the UK industrials sector will continue to prove popular with buyers seeking rental driven growth.

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