Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

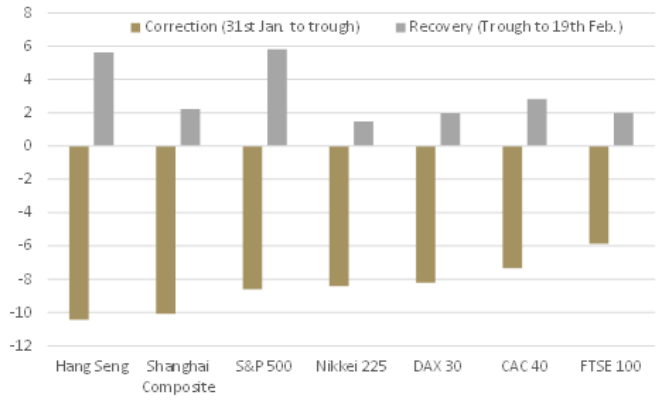
Update - February 2018

Global Factors

A revision of market participant's interest rate expectations, on the back of stronger-than-expected wage growth and inflation figures in the US and UK, resulted in major falls for equity and bond prices alike. 10-year gilt yields rose by roughly 15bps during the first half of February. Meanwhile, major stock indices fell by between 6% and 10% from their level at the end of January compared to their February low.

That said, most of the equity markets that suffered losses have regained a little ground since their trough (Chart 1). Due to these swings, broad measures of equity market volatility increased. Indeed, the S&P Implied Volatility Index (VIX) rose to 37 for the first time since mid-2015. The FTSE 100 VIX, by contrast, rose by less, only reaching 23, a level last seen after the EU referendum.

1.0 Percentage Rise/Falls of Selected Equity Market Indices in February (%)



Source: Thomson Reuters

Macroeconomic data for the US has been mixed. Encouragingly, January's Employment report showed a gain of 200,000 non-farm payrolls.

An Overview

February was a stark reminder as to how quickly market dynamics can change. Despite little new information regarding what remains a positive macro environment, equity markets, in particular, suffered their sharpest draw-downs since the summer of 2015. Commercial property however, continued the positive momentum into 2018, with £5bn in total transactions last month; particularly strong for this time of year. On a further positive note, overseas demand for UK property showed little sign of abating, with foreign investors increasing their UK portfolios by nearly £1.4bn in January.

February Top 5

1. Sharp jump in volatility as global equity markets suffer major falls
2. Investment activity into commercial property makes a strong start to the year
3. Central London office leasing activity finishes 2017 on a high
4. Leisure assets benefit from strong spending in restaurants and hotels
5. Positive outlook for Central London retail due to tight supply and strong tourism economy

And despite falling slightly, the ISM manufacturing index was consistent with annualised GDP growth of around 4%. But both industrial production and retail sales disappointed in January.

Nevertheless, there are signs that inflationary pressures are building. January's Employment Report highlighted a rise in nominal wage growth, to 2.9%y/y, the highest reading in nearly eight years. That was reinforced by January's jump in core CPI inflation, to 2.9%y/y on a three-month annualised basis.

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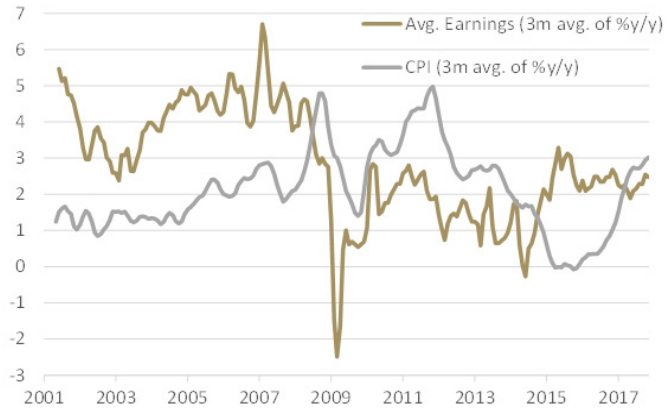
In a similar fashion, economic data for the UK has generally been upbeat. Indeed, at 88,000 in the three months to December, job creation was solid. Average earnings growth was also strengthening, rising to 2.5%y/y in the three months to December. As such, it is closing the gap with CPI inflation, which held firm at 3%y/y in December, implying that the falls in real wages may be easing (Chart 2).

2.0 Average Earnings and CPI



Source: Thomson Reuters

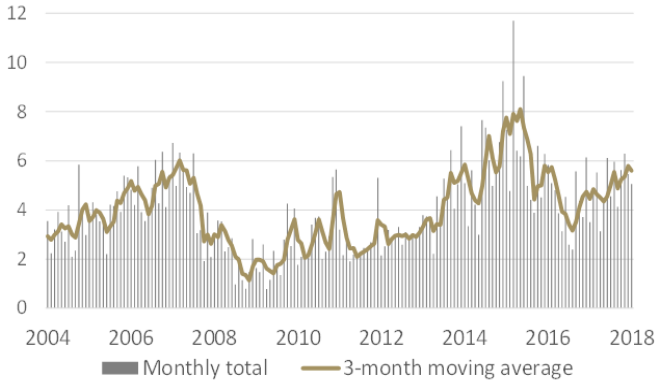
Property Overview

The latest RICS commercial property survey showed a slight softening in occupier demand and rental expectations. The balance of surveyors reporting an increase in tenant demand fell from 5% to 2%, and the net balance of surveyors expecting rents to increase edged down, from 13% to 7%.

By contrast, investor enquiries appear to be holding up. The RICS investor enquiries net balance rose slightly, from 20% to 21%. The sectoral breakdown of the data highlighted that, with a net balance of 39% and 18% respectively, demand for industrial and office assets is particularly healthy. By contrast, with a reading of 2%, investor demand for retail assets only rose marginally.

In aggregate terms, UK commercial property investment activity started the year in a strong fashion. In fact, properties with a combined value of £5bn changed hands in January (Chart 3). Granted, that is 7% weaker than in December. However, investment activity tends to pick up in the closing month of the year, then cool in January. The latest figure was 28% higher than the average seen in past Januarys.

3.0 Value of Commercial Property Deals (£bn per Month)



Source: Property Archive

However, looking beneath the surface highlights that investment activity is a little thinner than the headline figures imply. As has been the case for some time, the market was characterised by a lack of liquidity. For example, the pre-sale of Apple's future headquarters in Battersea Power Station, for a reported £1.6bn, accounted for almost a third of the monthly total. Excluding this deal would bring January's total to £3.9bn, down by 23%m/m, producing a figure that would be more in line with past Januarys.

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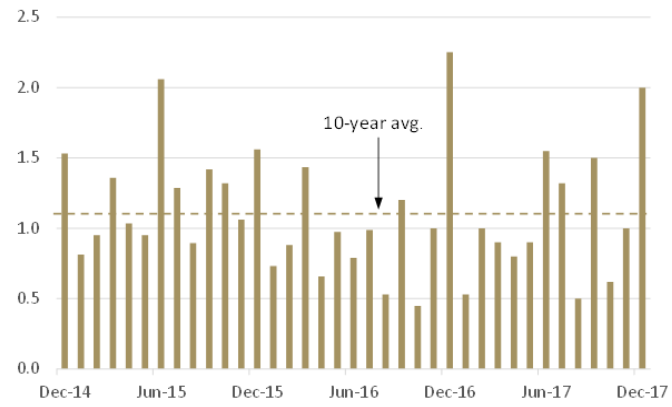
London Property Market

Central London office leasing activity closed the year on a high. Indeed, at nearly 2m sq.ft. in December, office take-up doubled compared to November (Chart 4). That was enough to bring the annual total up to 12.6m sq.ft., a figure that was 14% higher than in 2016.

4.0 Central London Office Take-Up (M Sq. Ft. Per Month)



Source: CBRE

That said, despite occupier demand holding up well, central London's office vacancy rate rose in the fourth quarter. According to Knight Frank, central London office vacancy stood at 7.3% of stock, up from 6.9% in the third quarter. It is encouraging that, despite the most recent increase, the latest rate is still lower than the level that has typically been associated with rental falls, of 8%.

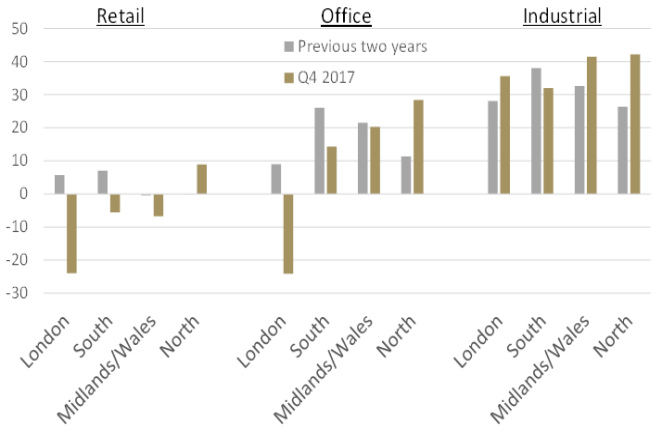
Generally speaking, with the balance of demand and supply now more favourable for tenants, rental pressures in London's office markets have started to subside. While overall rental growth is muted, going forward there are indications that pockets of the market have stronger prospects. Indeed, on the back of strong growth in employment and take-up from tech businesses, Knight Frank expects Shoreditch office rental values to rise by more than 10% annually over the next three years.

Meanwhile, the rise in vacancy rates has not dented investor demand in London. According to the RICS survey, the share of surveyors reporting stronger investor enquiries rose, from minus 3% to plus 11%. That fits well with the observation that, after having accounted for less than a third of national investment activity by value between August and November, London's share of activity rose to 72% in January. Nevertheless, January's figure was almost certainly skewed by the pre-sale of the Battersea Power Station development.

Regional Property Market

The outlook for regional property markets looks brighter than in London (excluding London offices). More surveyors reported rising than falling occupier demand in the vast majority of sectors and regions. The most notable exceptions were in the retail segment. What's more, surveyors reported falling availability in most non-London and non-retail sectors. Hence, it is not surprising that the share of surveyors expecting rental values to increase was positive in all non-London regions (Chart 5).

5.0 RICS Surveyors Expecting Rent Rises (% Net Balance)



Source: RICS

The upshot is that rising rental expectations seem to be supporting investor demand. According to RICS surveyors, investment enquiries rose in all regions. At 28% in the South, 22% in the Midlands and Wales, and 25% in the North, all the regional readings exceeded the one seen in London, of 11%. This is all broadly consistent with the trend seen over the last six months. At 62%, the share of non-London deals by value has been considerably higher than the average seen since 2003, of 54%.

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Sector Spotlight - Retail and Leisure

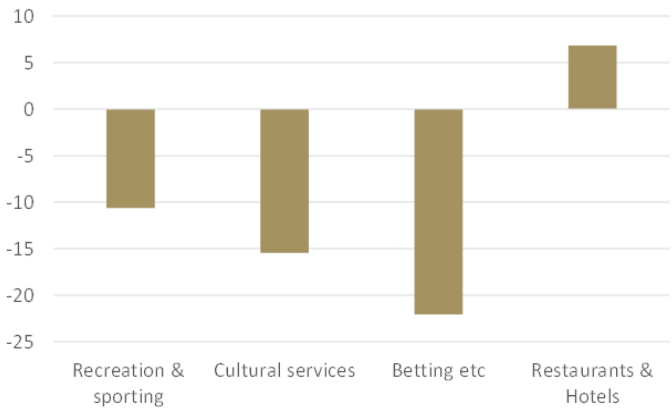
Nationally, retail rents and capital values have struggled to make up the ground lost during the financial crisis. The shortfall in occupier demand, along with oversupply of new retail space in the years preceding the crisis, combined to produce a drastic reduction in retail rental values. In addition, the advance of online retail has prevented retail rental values from recovering by curbing the demand for space. The value of retail sales conducted online increased, from 6% in 2008 to nearly 18% by the December of 2017. Outside the most prized pitches, rents currently sit some 15%-20% below their pre-GFC peak.

Uncertainty post referendum meant predications for Central London markets, including the retail sector, were muted. The reality was in fact much different as the retail market remained robust throughout 2016 and into 2017. The market is somewhat accustomed to the ambiguity of the UK markets, with constant shifting of consumer desires, coupled with seasonal influences and Forex changes, meaning that the retail sector is able endure most changes

Central London's retail pitches have operated differently to the national aggregates. In contrast to much of the retail stock, London's best located retail areas benefit from abnormally tight supply, high population density, and a strong tourism economy. These factors have combined to support rental values in the capital to buck the trend, allowing them to rise by almost 50% since their 2009 low in real terms. Hence, even though it is likely that occupier demand for retail space in London will be robust, the scope for rental values to increase is starting to look limited.

Leisure spending has held up well too. According to the latest figures, in real terms, leisure spending was 7% above its level in Q3 2008. As a result, leisure rental values rose by close to 2% in 2017, to sit some 6% above their post-crisis trough. But leisure spending has been driven by a particularly strong showing from spending in restaurants and hotels. By the third quarter of 2017, real spending in restaurants and hotels was 7% higher than in the third quarter of 2008. By contrast, spending on cultural activities and gambling has fallen (Chart 6). This seems consistent with the idea that activities that are typically harder to replicate online have held up fairly well.

6.0 Real Leisure Spending by Type, Cumulative Change Between Q3 2008 and Q3 2017 (%)



Source: Thomson Reuters

Looking ahead, with the squeeze on households' real incomes beginning to ease, rents in both the retail and leisure segments look set to rise. However, the occupier demand outlook is brighter for leisure property than for retail. Consumer spending growth looks set to average around 2% annually over the next year or two. Whereas, the equivalent figure for leisure spending is 4%. And perhaps crucially, the headwinds from the rise of online retail look unlikely to subside any time soon.

That said there has been a relative lack of leisure transactions. Indeed, despite a spike in 2015 and 2016, leisure sector deals have been rare (see Chart 7 on following page).

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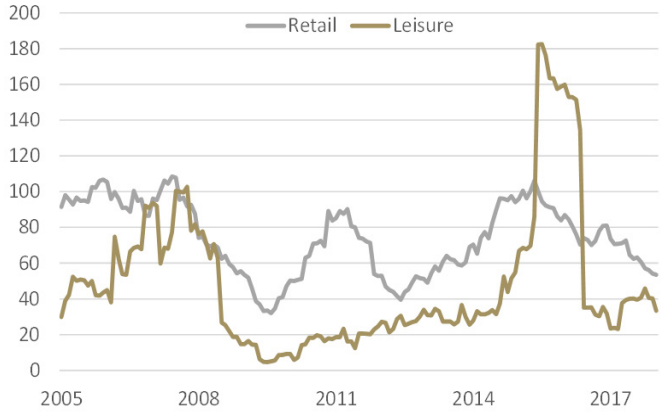
7.0 Index of Commercial Property Investment Activity, by Value (Q3 2007, Avg=11)



Source: Property Archive

Investors are increasingly enthusiastic about the sector's secure-income characteristics and strong fundamentals of the leisure sector yet will continue to be frustrated by the lack of stock that is coming to the market.

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