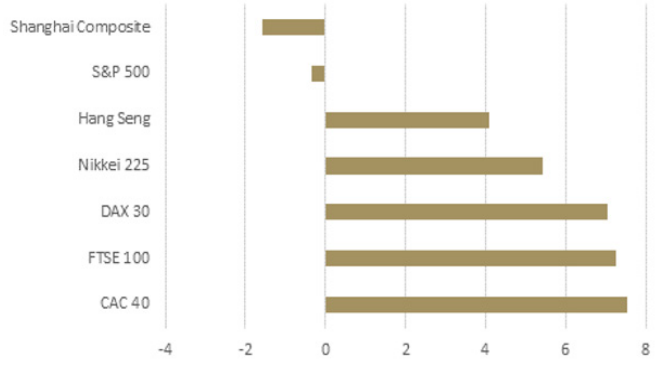
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update - April 2018

Global Factors

To some extent, the past month's economic news has been overshadowed by escalating trade tensions, and by Russia's growing isolation. However, financial markets have generally taken these concerns in their stride. Although the Shanghai Composite and S&P indices have bucked the trend, most major equity markets have made strong gains over the past 20 trading days (see Chart 1).

1.0 Changes in selected major equity market indices over the last 20 trading days (%)



Source: Thomson Reuters

In large part, that reflects further encouraging data from the world's largest economy. Admittedly, both the latest ISM manufacturing survey and University of Michigan confidence measure dipped a little. However, this does not change the basic message that the US economy is more likely to accelerate than to slow over the next couple of quarters. Retail sales growth, of around 4.5% y/y, and an unemployment rate of 4.1% both add to the impression that the outlook is solid, especially as the full effects of the tax cuts have yet to make themselves felt. The hardening of US interest rate expectations following the decision to raise the Fed Funds rate in March, therefore, appears justified.

An Overview

Global equity markets have seen a spike in volatility due to rising trade risks between the US and China and US treasury yields hit the highly anticipated 3% mark for the first time in four years. Yet, despite the recent fluctuations in financial markets, the IMF still project that the world economy is on the verge of growth expansion.

Property investors continue to be tempted by the UK's strong market fundamentals and the predicted instability surrounding the forthcoming Brexit has yet to derail the UK economy as had previously been feared. On the contrary, changes in market dynamics have created opportunities in the property market, as evidenced by our latest acquisition in the heart of the City of London.

April Top 5

1. Economic news overshadowed by escalating trade tensions
2. UK inflation slows from 3% in January to 2.5% in March
3. Slowdown in investment volumes attributable to lack of opportunities as opposed to a fall in demand
4. Outlook for retail not all bad as consumer confidence jumps to a 10-month-high
5. Industrial property continues to outperform and the rise in the number of industrial subsectors has substantially increased the number of investment opportunities

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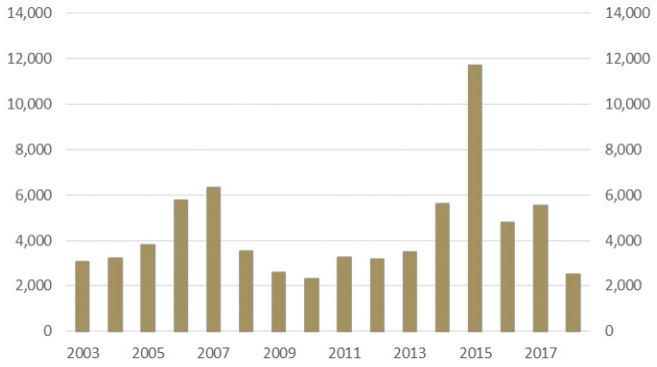
In the UK, meanwhile, activity data has been mixed. Both industrial production and construction output contracted in February, suggesting that they could act as a drag on GDP growth in Q1. By contrast, after falling in December and January, retail sales in February surprised on the upside, posting a 0.8% m/m gain, although March's bad weather then provided the impetus for another large monthly fall. Such mixed messages could mean that the MPC defers the next rise in interest rates until it becomes clear whether or not the economy has slowed and why. That said, inflation has slowed from 3% in January to 2.5% in March. Combined with further gains in wage growth, the CPI data suggest that the squeeze on real wages is now over which bodes well for the medium term outlook. Nevertheless, it seems clear that rates still have some way further to rise, even if a May rise is now in the balance.

The news from Europe has been more downbeat, however. The composite PMIs for Germany, France, Italy and Spain have all softened notably since the turn of the year. At the euro-zone level, economic sentiment has now fallen for three consecutive months and soft retail sales data also implies that the economy has started the year on weaker footing. In part, the softer data is likely to reflect problems caused by short-term capacity constraints, and perhaps the stronger euro. As such, it is too soon to declare that the recovery is about to go into reverse. But data does suggest that the steady acceleration in euro-zone growth has come to an end.

Property Overview

Commercial property markets in the UK are in good health, albeit both occupier and investor activity levels have been fairly subdued in the early stages of this year. Indeed, at £2.5bn, the value of completed investment deals in March was the weakest outturn for that month since 2010 (see Chart 2). That said, investor demand remains high, so much of this can be attributed to a general lack of available opportunities, particularly in Central London.

2.0 Investment in alternative UK property assets in March of each year



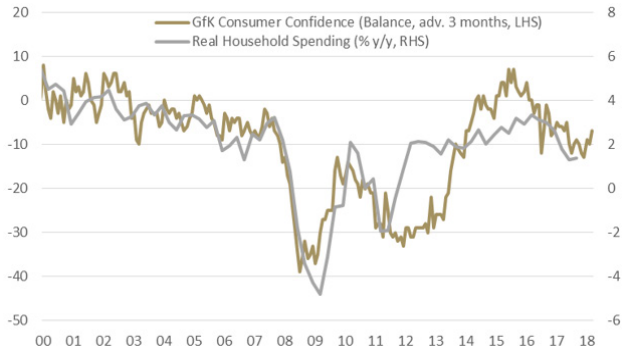
Source: Property Archive

By sector, industrial markets are still buoyant; offices less so, although they offer little reason for concern. But the problems of the retail sector continue to cast a shadow over the wider market.

News that many well-known brands are using, or are considering using, company voluntary agreements (CVAs) as a means of cutting store numbers and rent bills, has done nothing to bolster the already-weak sentiment towards retail property. Nor has news that the proposed takeover of Intu by Hammerson has been abandoned because of concerns about the deterioration in retail occupier fundamentals.

Yet it is not all bad news for retailers and their landlords. In March, consumer confidence jumped to a 10-month high. Combined with the likely recovery in wage growth and easing inflation pressures, higher confidence should mean that consumer spending receives a lift over the next quarter or two (see Chart 3).

3.0 Household spending and consumer confidence



Source: Thomson Reuters

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Moreover, Footlocker has agreed a lease on more than 13,000 sq. ft. on Oxford Street for a new flagship store, while Savills recently reported that London ranked only behind Paris as a destination for luxury brand store openings last year. Both suggest that the top end of the London retail occupier market is alive and kicking.

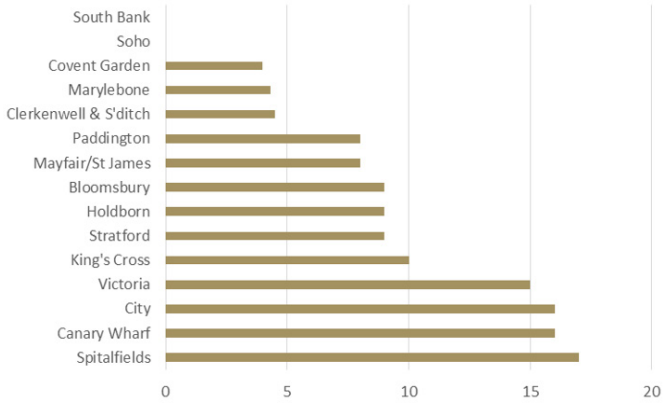
London Property Market

London office markets have had a fairly subdued start to the year. At 2.8m sq. ft. CBRE reported that take-up fell by 28%q/q. Yet such a comparison probably overstates the scale of the slowdown. After all, while a touch below the 10-year average, of 3.1m sq. ft., take up was still 10% higher than in the first quarter of 2017. Moreover, that softness appears to have been concentrated in the Docklands, Midtown and Southbank sub-markets; **in both the City and West End, take-up was above the 10-year average.**

Moreover, the amount of space under offer across the capital is above normal levels, at 3.2m sq. ft. So, even though the amount of available space has risen, on balance, it appears as though occupier fundamentals are pretty healthy, especially as London continues to create more than its fair share of new jobs.

Nevertheless, despite most sources suggesting that rents have been more or less unchanged over the past year, Carter Jonas note that total occupier costs have risen in the majority of London office sub-markets over the past year. Landlords appear to have responded by raising the level of rent-free periods implying that tenants, while still active, are becoming a little more cost conscious (see Chart 4).

4.0 Office Take-Up and Development Pipelines in the UK City Office Markets (000 Sq. Ft.)



Source: Knight Frank

Regional Property Market

Knight Frank have reported that office take-up in the main South East office markets dipped 19% q/q, in the first three months of 2018. But that fall follows a particularly strong Q4. As a result, at just under 750,000 sq. ft., take-up was more or less in line with its average for the time of year. Moreover, at the end of March, an additional 650,000 sq. ft. was under offer, suggesting that the market has a solid foundation for the second quarter.

Taking the main M25, M3 and M4 sub-markets together, there is currently about 16m sq. ft. of available space, equivalent to just under two years' worth of take-up at Q1's rate. Yet the supply outlook is relatively constrained. At present there is just 900,000 sq. ft. under construction. So, in the absence of a sharp drop in occupier demand, vacancy rates are more likely to dip than to rise, implying that rental values should remain well supported.

For now that seems to be the view of investors, who completed deals on South East offices worth a combined £696m in the first quarter – a 29% increase on the same period of last year.

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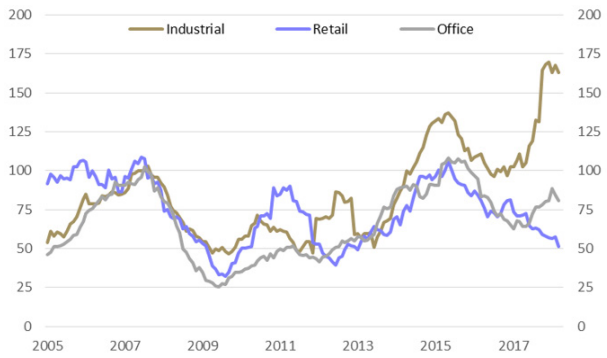
Sector Spotlight - Industrials

The overall total return delivered by the UK industrial market was very strong in 2017 at 23.0%, significantly outperforming both the office (10.3%) and retail (7.5%) sectors. Standard industrial recorded a total return of 24.8% and distribution warehouses recorded a return of 19.3%. Standard industrial properties in London and the inner South East were the star performers in the industrial sector delivering returns of 26.6% and 28.9% respectively in 2017.

The industrial sector continues to set the pace, with comparatively high levels of both occupier and investor activity. Indeed, the comparative strength of the sector can be illustrated by the fact that F&C Commercial Property Trust recently blamed disappointing 2017 results on its relative lack of industrial holdings.

More generally, while investment volumes in office and retail property are both still below their pre-crisis peaks, investment in industrial property has surpassed the same benchmark, and by some margin (see Chart 5).

5.0 Value of investment by main sector (12 month average, Jan 2008 = 100)



Source: Property Archive

Not surprisingly, figures from Colliers confirm that the distribution sector is leading the way. Investment in standard industrial property rose from £2.9bn in 2016 to £4bn in 2017. In the distribution/logistics sector, investment more than doubled, rising from £3.2bn to £7bn over the same period.

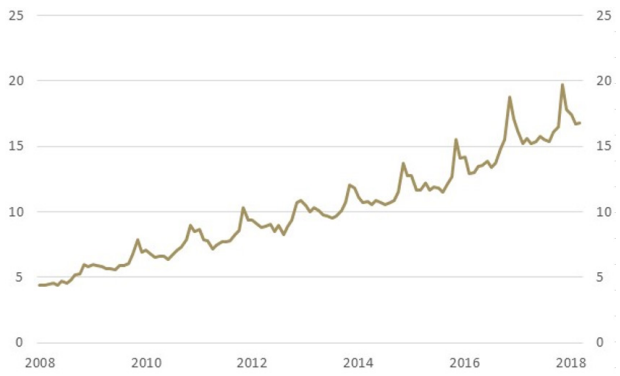
Overseas investors increased their share of the market in 2017 and now account for 25% of all purchases, up from 22% in 2016. The competition for prime assets has increased as supply remains low and the number of investors pursuing a limited quantum of stock continues to rise. Consequently, money spent by UK institutions fell to 17.5% in 2017 from 20% in 2016 as overseas buyers took advantage of currency devaluation.

Industrial property remains top of the allocation list for many domestic institutions, but they face significant competition from private equity and specialist REITs. The desire to deploy capital at scale, combined with a relative shortage of available stock, has reignited the market for portfolio deals, which in some cases now attract a small premium, and may therefore represent an attractive exit strategy for current owners.

Investor interest is, of course, being driven by the ever-growing share of business being conducted online. In March, the share of online purchases within total retail sales reached 16.8%, up from 15.6% a year ago and up from 10.3% five years earlier (see Chart 6).

Retailers adapting their own supply chains and continued growth by pure-play retailers suggest that the logistics sector will be the net beneficiary.

6.0 Online sales as a percentage of total retail sales



Source: Thomson Rueters

Take-up of logistics space dipped from 32m sq. ft. in 2016 to 27m sq. ft. last year, a total that was a little weaker than the average seen over the past 10 years. Anecdotal evidence suggests that, in part, this reflects a degree of caution amongst occupiers, but also that low supply is constraining demand. Indeed, reports that Segro secured £27m of new lettings during the first three months of 2018, a record for any single quarter, and has a largely pre-let pipeline, expected to generate an additional £55m in rents, appear to add some weight to the idea that supply-side restrictions are taking their toll.

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The past month has seen developers announce a number of new schemes. Gazely are planning two new developments totalling more than 800,000 sq.ft; Manse Opus have achieved planning consent for a 440,000 distribution centre for the retailer Kingfisher and Prologis, with First Panattoni, have respectively acquired a 10 acre site in Croydon and a 16 acre site in Borehamwood. Add in the fact that in Q1 2018, the RICS reported a rise in industrial construction workloads - the 22nd consecutive quarterly increase - and it seems clear that supply is still responding to strong levels of occupier demand.

There is a well-documented lack of logistics stock suitable for servicing the growing parcel delivery market, with the shortage most acute in London and the South East. Last mile distribution centres (urban logistics) will therefore continue to rise up the agenda for corporates, developers and investors. This is partly due to rising e-commerce and the need to reduce order lead times to customers, but also reflects wider issues centred on improving logistics in cities and urban areas whilst minimising adverse impacts, such as emissions and congestion. This could generate interest in different types of buildings and operations, including multi-storey warehouses, to make best use of land. In large cities such as London there will increasingly be consolidation centres on the town/city outskirts to reduce peak-time traffic.

Total returns for the industrials sector are expected to moderate this year. However, the continuing diversification of the sector to include multi-level, mixed-use, and urban depot solutions should create opportunities for a wide range of investors.

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