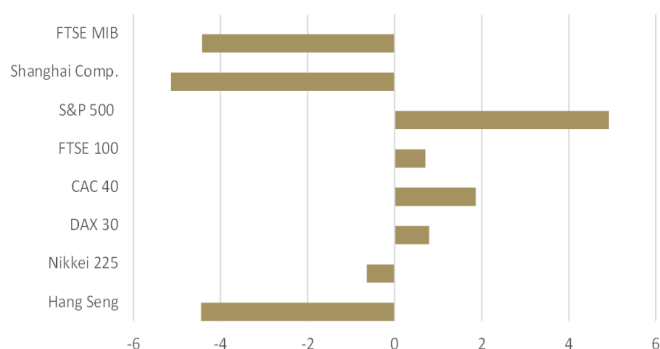


Update - August 2018

Global Factors

GDP growth in the US over the second quarter was 4.1% annualised. That healthy outturn was supported by the boost that tax reforms have given to consumption and business investment. And the latest data provide no indication that growth is slowing. For one, the 0.5% rise in retail sales in July, pushed the annual growth rate up to 6.4% y/y, from 6.1% y/y in June. This bodes well for household spending. And even though the manufacturing ISM declined to 58.1 in July, from 60.2 in June, the index at this level is still consistent with growth continuing at a similar pace to Q2. Given the strength of the economy it was unsurprising that core inflation rose by 2.4% y/y in July. In addition, the FOMC minutes suggested that the next rate hike is likely to come sooner rather than later. This solid data, combined with the strength of corporate earnings, pushed the S&P500 to a new intraday high, of above 2873, in August. Indeed, US stocks have largely shrugged off trade tensions. Meanwhile, compounded by the sluggish state of the Chinese economy, the Shanghai composite has underperformed (see Chart 1).

1.0 Changes in selected market indices over 40 trading days to 30/08/2018



Source: Thomson Reuters

An Overview

In just under 7 months, the UK will have officially left the EU. Nearly two years after the referendum there is still little clarity over what a post-Brexit trade deal may look like, although both sides seem to be making more positive noises as they look to resolve the impasse.

The commercial property market has remained surprisingly buoyant in 2018 so far. Demand for prime stock is still strong, particularly among international investors who are less concerned by the short-term uncertainty produced by the Brexit process. Transparency and liquidity are two of the main selling points of the UK real estate investment market, led by the London market which remains the 'gold standard' within the global investment market.

August Top 5

- S&P 500 touches all-time high and ties the record for longest bull market run;
- Stronger than expected office occupational story renews UK investor confidence and activity;
- Sharp pick up in investment activity, as H1 sees the second highest volume on record after 2015;
- Facebook's long-term commitment is further evidence that London is open for business and a world-leading destination for major tech companies;
- Fundamentals underpinning leisure investment remain strong as bond-like characteristics for the sector continues to attract investors.

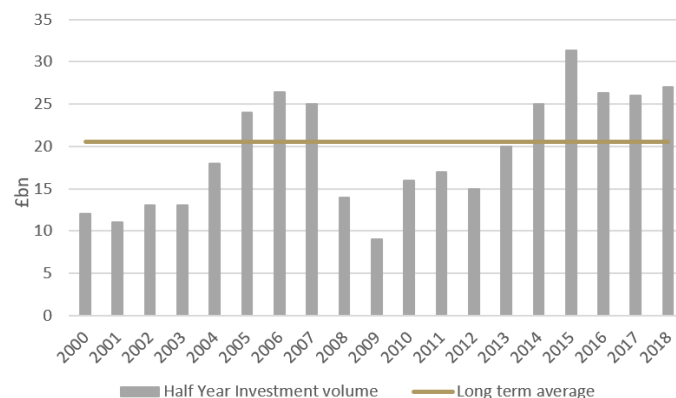
Data out of the UK has been more mixed. At 0.4% q/q, preliminary estimates for GDP growth in Q2 suggest that the economy recovered from the soft start to the year. And the latest PMI data point to growth continuing at a similar pace in Q3. Nevertheless, the employment data were softer. Only 42,000 jobs were created in the three months to June, compared to 100,000 plus in recent months. In turn, annual employment growth slowed from 1.2% to 1%. Admittedly, the unemployment rate declined to a new low of 4%. But this was mainly driven by people leaving the workforce, and it was not enough to prevent wage growth slowing from 2.5% y/y to 2.4% y/y. Inflation has moderated after last year's currency driven spike but remains above the Bank of England's 2% target which, combined with a continued strong employment picture saw the MPC hike Bank Rates to 0.75% at its August meeting. This is unlikely to impact property yields given the spread over gilt yields, which is considerably higher than historic averages.

Developments in European markets have been overshadowed by political issues in Turkey and concerns about the Italian fiscal outlook. Indeed, the euro fell to its lowest level in over a year versus the dollar, trading below \$1.15 through the middle of August. Putting these factors aside, however, the latest data paint a fairly positive picture. The latest reading for GDP growth shows that the euro-zone grew at a steady pace of 0.4% q/q in Q2. Growth was supported by an acceleration in Germany, the Netherlands and Portugal, while strikes in France were a drag. Further, the immediate impact of US tariffs on Europe appear to have been limited, with exports to the US continuing to increase in June. Moving into Q3, the flash euro-zone PMI composite index increased a touch, from 54.3 in June to 54.4 in July, indicating that the bloc continues to grow at a steady pace.

Property Overview

Following a slower start to the year, investment activity picked up in Q2, bringing overall H1 volumes to a healthy £27.0bn. This is the second highest H1 on record after 2015 (£31.3bn), 7% ahead of last year's total of £25.2bn, and 32% ahead of the 10-year H1 average of £20.5bn. Second quarter volumes reached £14.6bn, again the second highest after 2015, and 18% ahead of Q1's £12.4bn figure (see Chart 2).

2.0 Half Year Investment Volumes Above Long Term Average



Source: JLL

UK institutions, with significant amounts of capital to deploy, have seemingly begun to look at the regional office markets to make investments of significant value. In 2018 so far £2.5bn has been invested into the regional office market with UK institutions accounting for 35% of the total volume, the highest level since 2009.

Rental value growth appears to be moderating, with growth slowing to just 0.1% m/m in July, from 0.2% m/m over the three months prior. This appears to be consistent with the macroeconomic data, in particular, the latest slowdown in the pace of job creation already mentioned.

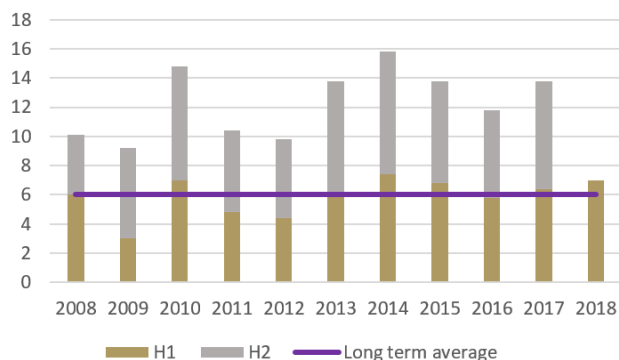
London Property Market

Strong Q2 numbers saw a resurgence in Central London volumes, where disappointing first quarter volumes of £3.6bn were followed by bumper Q2 volumes of £7.3bn, boosted by a number of major City office transactions. The largest was 5 Broadgate, purchased by Hong Kong's CK Asset Holdings for £1.0bn, at a net initial yield a shade under 4%, while there were also key deals at Ropemaker Place (£650m, 4.6%) and 20 Old Bailey (£341m, 4.2%). East London also saw a significant increase in activity in Q2 with four office deals totalling £658m, more than half of 2017's total annual volumes.

Central London take-up remained robust in Q2 2018, reaching 3.39 m sq ft, which is 7% ahead of the long-term average according to the latest Knight Frank data (see Chart 3).

In fact, only one H1 in the last ten years has seen a higher volume of leasing activity, which provides a useful reference point to demonstrate just how remarkable this year's results have been to date. The future prospects for the office market also seem solid, with the amount of space under offer, standing at 4.1m sq. ft., above its average for the 8th consecutive month.

3.0 Central London Take-Up (Million Sq.Ft.)



Source: Knight Frank

As we move into the second half of 2018, money from across the globe remains focussed on Central London as a place to invest, and occupier sentiment is positive; since quarter-end Facebook (598,000 sq ft) and Publicis Groupe (211,000 sq ft) have committed to a combined total of circa 809,000 sq ft for their new Central London headquarters. Facebook joins Google in choosing King's Cross as their UK base, as well as other tech giants like Apple and Amazon, who have put faith in London despite worries amid Brexit.

The core has been the source of the majority of demand so far this year, accounting for 68% of take-up. This is in part due to eight out of the ten largest deals so far this year being let within the core.

The rise in last month's London office take-up is clearly a positive sign for confidence in the capital. Against a backdrop of political uncertainty, the Central London property market looks resilient.

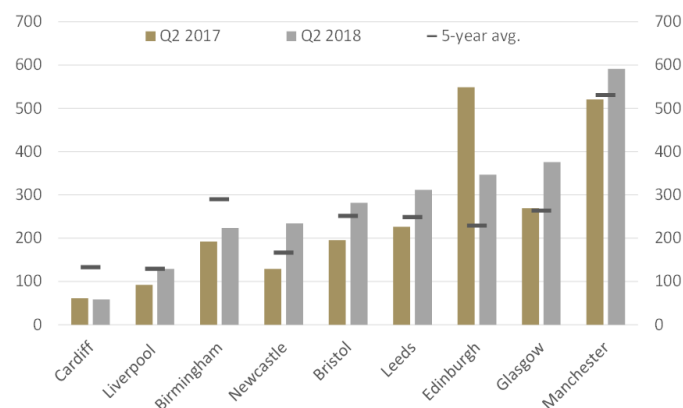
While rents overall have remained stable in the City, largely due to the surprisingly strong performance of the leasing market, we have begun to see some tailing off in the fringe locations. The average grade A rent in the Core for 2018 at the end of Q2 was £63.55/ sq ft, compared with £58.23/sq ft in the fringe. This difference of £5.32/sq ft is the largest between the two sub-markets since 2014.

Regional Property Market

There was £9.1bn of regional transactions in H1, 23% ahead of last year's H1 total. There were a number of key regions which saw significant increases in activity, with £2.1bn transacted in the South East (up 14%) and £1.2bn transacted in the North West (up 46%). We expect this level of interest in the UK regional markets to continue, with significant value on offer compared to London and similar European markets.

The level of occupier demand in regional office markets has also been encouraging. The latest Big Nine office market report shows that take-up in most of the main regional cities was above its five-year average in 2018 Q2 (see Chart 4). The exceptions were Cardiff and Birmingham. Take-up in the second quarter was also stronger than this time last year in most cities. Manchester, in particular, has experienced high levels of take-up this year. In turn, availability has reduced. At the end of the first half of 2018, there was just 2.1m sq. ft. of available office space in Manchester, equivalent to around a year's worth of take-up.

4.0 Regional Office Take-Up (000 sq. ft.)



Source: GVA

However, office demand in the South East appears to be less buoyant. In fact, take-up has been below its 5-year average, of 1.2m sq. ft, in three of the last four quarters. In turn, office vacancy rates have been rising, reaching 6.2%, 6.8% and 10.2% in Q2 in the M25, M3, and M4 markets respectively. However, the more subdued picture has also meant that space under construction has fallen to around 900,000 sq. ft., from over three times that level a year earlier. This should prevent vacancy rates from rising too much further.

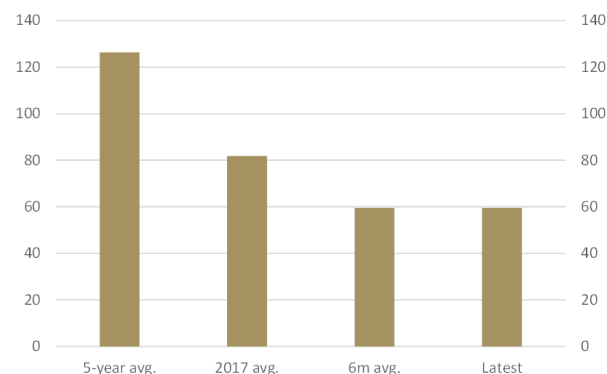
Sector Spotlight

Leisure

An overarching trend for UK property investment in 2018 is that certain sectors of the property market will continue to be robust, however, there will be further yield divergence between prime and secondary stock. Leisure property echoes this movement, as risk aversion translates into demand.

After picking up in 2017, leisure investment has been more muted in 2018. On a six-month rolling average basis, leisure transactions as a share of total investment have fallen to 1.6%, from almost 4% just over a year ago. Given the lumpy nature of leisure transactions, the value of investment can be thrown around. Nevertheless, there has been a clear step down in the average monthly value of leisure investment over the past six months when compared with the 2017 or the past five-year average. (See Chart 5.) Indeed, according to Knight Frank, after declining by 25bps to 4.75% in February, leisure park yields increased back to 5% in May.

5.0 Value of Leisure Investment (£m per Month)

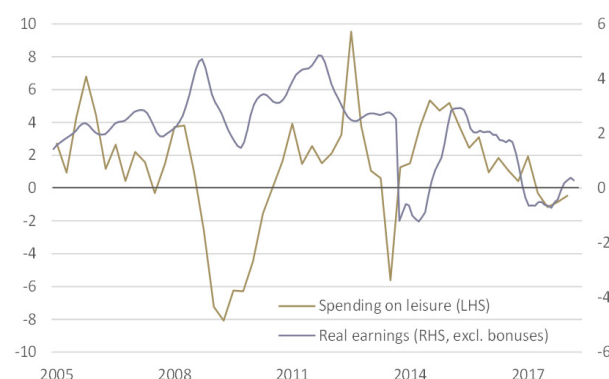


Source: Property Archive

The apparently more cautious mood around the leisure sector appears to stem from weak leisure-related spending over the past year, which has likely weighed on occupier demand. Indeed, in 2018 Q1 spending on leisure declined by 0.5% y/y. The weakness in leisure spending is consistent with the fact that real wage growth was negative for most of 2017, reaching a trough of -0.7% in November. (See Chart 6.)

However, the penetration of online sales continues to increase, and it is too soon to declare that the structural change in the way consumers purchase goods and services has run its course.

6.0 Leisure Spending and Real Earnings Growth (%y/y)



Source: ONS

The prospects for leisure spending seem more positive now that real wage growth has been positive for the past four months. Admittedly, at just 0.3% y/y, real wage growth is still fairly subdued. However, a recent report from Deloitte suggested that net leisure spending ticked up in Q2, and that spending in Q3 was likely to be even more positive given the summer holidays and World Cup.

The fact that leisure property is less likely to be affected by the rise in online spending is also expected to provide support to leisure sector rental values. After all, it is hard to replicate many leisure experiences online. Further, although consolidation in the retail sector could free up space for leisure offerings, on balance, this is not expected to put downward pressure on leisure rental value growth. This reflects the fact that, on average, shopping centre rental values are higher than for leisure property. As such, shopping centre operators are unlikely to cut rents for leisure operators to levels that are below the prevailing level of leisure rents.

In turn, leisure rental value growth is not expected to suffer to the same extent as rental value growth in the retail sector. And with leisure rental values not obviously too high relative to their historic trend, yields are not likely to increase by as much as for other types of property as risk-free rates rise.



Nevertheless, the fundamentals underpinning leisure investment are strong, with high barriers to entry, long leases and lease indexation all typical attributes of the sector that tend to attract investors. As an income-producing asset class, whether a pub, restaurant, bar, hotel or health and fitness centre, the attraction to investors continue to be the bond-type characteristics of the asset.

Market activity will continue to be dominated by the institutions for all but the very biggest London assets. Leisure property in Central London and key cities will remain a safe-haven for capital preservation, and demand for prime, secure investments will be as keen as ever. Any investment branded as core, prime, or secure will remain hotly sought-after, and the quirks of the UK leisure property lease mean that, in comparative terms, they will always look less risky than some other domains, regardless of local political issues such as Brexit. As a result, total returns in the leisure sector are likely to outperform.

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