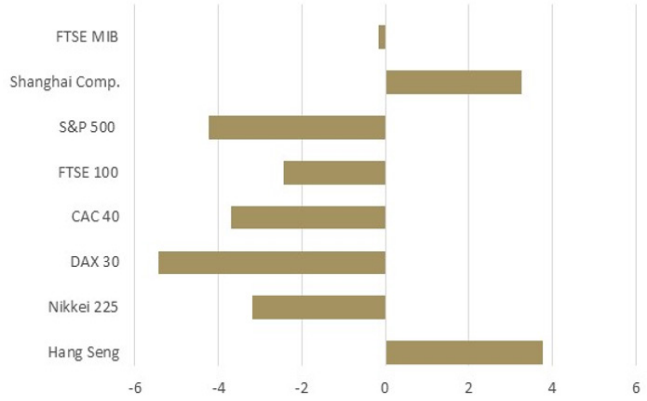
Riverside CAPITAL | THE PROPERTY INVESTMENT PEOPLE

Update - December 2018

Global Factors

Major global equity markets have been on a downward trajectory in recent months (see Chart 1). Whilst there was small upward movement in some Asian markets, in part reflecting the US-China trade truce, the bigger picture is that the prospects of slowing growth in major global economies, such as the US and China, are taking a greater toll on equity markets.

1.0 Change in selected major market indices over 40 trading days to 17/12/2018



Source: Thomson Reuters

The economic environment in the UK continues to be blurred by heightened uncertainty related to whether, or on what terms, the UK will leave the EU. To further add to the uncertainty, Theresa May survived a vote of no-confidence triggered by members of her own party having pulled the plug on a crucial parliamentary vote on her deal for the country to leave the EU. Mrs May is now facing increased calls that she puts Brexit in the hands of the Commons and allow MPs a series of votes on alternative options to her deal.

An Overview

After another turbulent few weeks in UK politics, we are still no closer to knowing what form Brexit will take. Despite preparations for a no deal scenario, we believe that the chances of a softer Brexit or no Brexit, which would be growth positive, have now also risen. The past twelve months have certainly been an eventful year for the UK property market and, as anticipated, Brexit has proved to be the dominating issue. UK commercial property has remained remarkably resilient in the face of prolonged political and economic uncertainty. The impact of a weaker pound has worked to make investments extremely attractive for foreign buyers and we see no respite in the inflows coming into property. Given the strong underlying fundamentals across most sectors, bar retail, there is no reason to suggest it will not be able to maintain its competitive edge from March 2019 and beyond.

December Top 5

- Global growth fears send markets tumbling;

- Central London office take-up remains resilient and investment volumes in the City stay at record levels;

- A resricted outlook for office supply should continue to support rental values;

- Investor interest in alternative assets has increased substantially over the past two years in spite of Brexit

- Higher returns, long-term income and a degree of defensiveness against economic uncertainty will continue to be attractive to investors and result in more alternative sectors becoming mainstream

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PMIs in November point to little or no increase in growth in Q4. Although some slowdown in growth was already expected in the fourth quarter, other indicators suggest that this movement probably overstates the weakness. Indeed, strong job creation pushed employment growth to 1.2% y/y in October, just shy of the 1.3% y/y rates seen at start of year. And a further pickup in the pace of real wage growth to the highest level since the late 2016 is expected to be supportive for consumer demand.

Events in the euro-zone, such as protests in France and political issues in Italy, are also likely to put a small dent in GDP growth for Q4. Following two months of decline in the composite PMI, the flash PMI for December fell again and points to quarter GDP growth of between 0.1% and 0.2%. Much of the decline in December was driven by France, which would be expected to bounce back as the effects of the protests fade. But, even so, economic activity in the bloc has lost momentum towards the end of the year. Indeed, the ECB confirmed that the net purchases under the asset purchase programme (APP) will end in December 2018, but noted that risks around the economic outlook were moving to the downside.

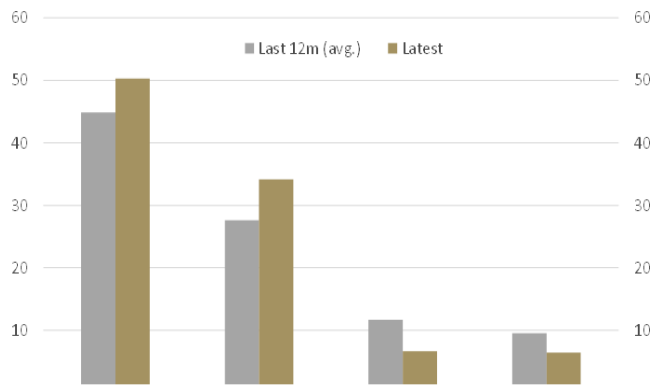
In the United States, solid domestic activity so far into the fourth quarter has buoyed business surveys, especially the ISM manufacturing index. Consumption growth has also been solid, supported by strong employment growth and lower gasoline prices. Nevertheless, as the fiscal stimulus fades and the impact of higher interest rates intensifies, economic growth is expected to slow from its current high rates. Monetary policy tightening is already starting to affect the more interest rate sensitive sectors, with business investment growth slowing markedly and residential investment contracting for the past three quarters. In addition, despite the rise in headline CPI inflation to 2.2% y/y in November, there are signs that recent dollar appreciation is starting to feed through into lower prices for imported goods.

Property Overview

Property Archive data show that commercial property investment was weak in November, totalling only £3bn. This was just half of the total for October and for the same month a year ago. The data add to the picture that investment activity has softened in 2018 compared to 2017's strong levels.

However, weakness has been concentrated in the retail sector, and more recently there has been a dip in industrial investment too. Indeed, in November, office and alternative investment accounted for a larger share of activity than the average over the past 12 months, while the opposite was true for retail and industrial investment (see Chart 2).

2.0 Share of completed investment deals by value and sector (%)

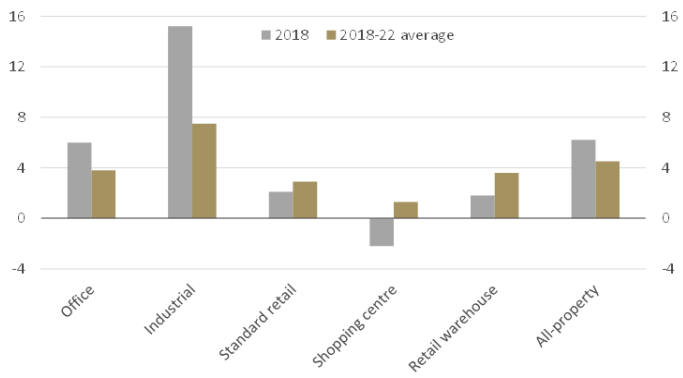


Source: Property Archive

November data also showed that overseas investors were net sellers of UK commercial property. This is in contrast to recent months where net investment from overseas has averaged £1bn. It is possible that this reflects some investor caution, particularly given recent developments have increased Brexit-related uncertainty.

Despite concerns, the latest IPF Consensus survey suggests that the central scenario of most forecasters is that commercial property will experience a soft landing. Although total returns are expected to reduce from their 2017 highs, over the next five years the IPF Consensus expect average total returns to be positive across the main property sectors (see Chart 3).

3.0 Mean forecast for total returns (% y/y)



Source: IPF Consensus

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London Property Market

Central London office take-up has been resilient over 2018. According to CBRE, take-up in November, at 0.74m sq. ft., was slightly lower than recent months. It was also below the 10-year monthly average of 1.1m sq. ft.. Nevertheless, availability was largely unchanged over the month.

Investment volumes in the City continue to be at record levels, with just a few weeks to go until year-end. Savills are updating their year-end prediction, to £11.60bn, due to the current political climate, which could delay the usual year-end rush. This would be the fourth highest annual turnover recorded, and 39% up on the long-term average of £8.37bn.

Looking across all commercial property sectors London has retained its crown as the world's most popular destination for cross-border investment into real-estate, with inward volumes more than 50% higher than Manhattan according to Savills.

In the largest transaction over the last month, Samsung sold the long leasehold interest in 30 Gresham Street, EC2 to a joint venture between Wing Tai Properties and Manhattan Garment Holdings, for £411.0m which reflects a Net Initial Yield of 4.39% and a capital value of £1,018 per sq ft.

Looking forward, the Deloitte Winter Crane Survey suggests that the outlook for central London office supply is more restrictive, which should support rental values. Indeed, at 11.8m sq. ft., the amount of office space under construction is already 20% lower than its peak at the end of 2016. And the declining balance of surveyors expecting a rise in development starts from the RICS Commercial Market survey suggests that space under construction is expected to fall further.

Nevertheless, even with a more restrictive supply pipeline, concerns have been raised that the majority of office space available is secondhand. Indeed, in November, secondhand space accounted for 70% of availability. Given the majority of demand has been for higher quality space, it's possible this secondhand space will be more slowly absorbed.

Regional Property Market

In the rest of the UK, office take-up was also solid in the third quarter. According to GVA, in the main regional cities, take-up totalled 2m sq. ft., around 40% higher than the level of take-up recorded in both Q1 and Q2. Take-up was above its five-year average in most cities, but was boosted in particular by two large deals – the letting of Buchanan Wharf in Glasgow to Barclays and the letting of Enterprise City in Manchester to Booking.com (see Chart 4).

4.0 Office-based employment growth

Source: ONS

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Nevertheless, like in central London, the supply outlook in the regions also appears relatively constrained. According to GVA, Grade A office availability in most of the main regional cities does not look high, at less than one years' worth of demand. And data from Knight Frank show that the vacancy rate in the Rest of the South East, at 7%, is much lower than before the last rental downturn. In turn, the more restrictive supply pipeline in the regions should prevent office rental values from declining.

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Sector Spotlight

Alternatives

Investor interest in alternative assets (defined as property not covered by the traditional office, retail and industrial sectors) has increased substantially over the past two years or so, particularly as a result of the Brexit turmoil. Investors are becoming increasingly aware of the core fundamentals that support Alternatives, as well as the benefits of higher returns and long dated income.

Historically the majority of long lease property was found in the more traditional property sectors and included HQ office buildings, supermarkets and distribution facilities. In recent years however, there has been a shift towards alternatives such as student housing, healthcare and budget hotels in line with an increasing weight of money targeting core assets.

Going forward, the distinction between core and alternative property investments has started to blur in many investors' minds, as we see increasing numbers of 'blended' spaces emerge in the real estate market, combining uses such as offices with hotels or logistics with retail, as users look to space to satisfy their complete lifestyle demands.

Compressed yields in other parts of the market appear to be accelerating the move to alternatives. With this the type of investor interested in alternative investment has also broadened. Indeed, Colliers note that, so far this year, overseas investors have accounted for around 40% of alternative investment. In contrast, between 2000 and 2006, this share was just 23%, with the majority of investment from private property companies. Further, quoted property companies and REITs have also become more important.

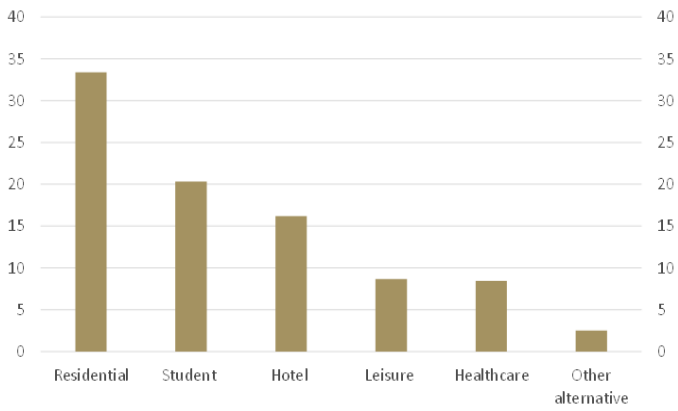
Over 2018, investment in alternative assets has accounted for around 26% of total commercial property investment (see Chart 5). This compares to a pre-crisis average share of 9%.

5.0 Alternative investment as a share of total investment

Source: Property Archive

The majority of the activity in the alternatives market over the past year has been driven by residential investment, but student accommodation and hotels have also accounted for a significant proportion (see Chart 6). In turn, yields for alternative assets have tightened. For example, Knight Frank estimate that yields for prime London direct-let student accommodation are 4.25% in London and 5.25% in the regions, while Budget hotel yields are 3.5% in London and 4% in the regions.

6.0 Share of alternative investment by sector over the past year %



Source: Property Archive

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The ongoing imbalance between supply and demand in Alternatives remains one of the main drivers for investors, but also presents one of the greatest challenges. The increase in investor demand for Alternatives in recent years is now amplifying the issue as attempts to acquire institutional grade product and establish platforms at scale are being frustrated. Investors who traditionally would look to deploy large sums are instead having to target smaller platform transactions supported by development opportunities.

Higher returns, long-term income and a degree of defensiveness against economic uncertainty have ensured that Alternatives remained a key feature of the real estate market in 2018. Given the strong fundamental drivers of demand within these sectors in general, returns are expected to perform better than the all-property average in coming years.

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