Riverside CAPITAL

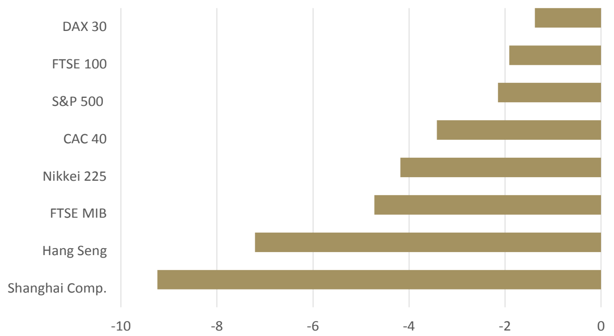
THE PROPERTY INVESTMENT PEOPLE

Update - May 2019

Global Factors

The performance of equity markets has generally worsened over the past month or so (see Chart 1). For the Shanghai Composite and Hang Seng in particular, this reflects the latest flare up in US-China trade tensions. The FTSE 100 has performed comparatively well, although it will continue to be at the whim of Brexit twists and turns. This poorer global performance is also consistent with the recent softness of the economic data. Following a reasonable improvement in economic growth in many economies in the first quarter, some momentum appears to have been lost into Q2.

1.0 Change in Selected Major Equity Market Indices over 20 Trading Days to 27/05/19 (%)



Source: Thomson Refinitiv

Indeed, in the US, activity indicators for April, such as retail sales and manufacturing output, point to some slowdown in growth in Q2. In addition, the Fed's preferred measure of core inflation (PCE) has slowed to 1.6% y/y. Fed officials have suggested this mostly reflects transitory factors. However, even stripping these out, core inflation looks to have softened. In turn, monetary policy is likely to remain supportive for some time.

Similarly, growth is expected to slow in the UK in Q2, partly reflecting some reversal of activity that was brought forward in advance of the original Brexit deadline.

Overview - May Top 5

- Growth is expected to slow in the UK in Q2, partly reflecting some reversal of activity that was brought forward in advance of the original Brexit deadline.

- Despite an overall slowdown in UK property investment, there was some return of overseas interest, with net investment at almost £800m compared to an average of less than £300m in the previous three months.

- The amount of space under construction in the City of London is high compared to the past 15-year average level of completions, reflecting declining availability.

- Office rental value growth outside of Central London is generally stronger. This outperformance is expected to continue this year as the office supply pipeline in the regions is tighter.

- Prospects for the student housing market appear solid as the supply of student accommodation remains limited. Savills has reported that there are around 1.9 million full-time students in the UK and only 625,000 purpose-built bed spaces available.

Indeed, the small increase in the IHS Markit/CIPS all-sector PMI to 50.9 in April is consistent with only slightly positive rates of quarterly growth. Surveys also suggest that labour market activity will soften. There were already some signs of this in the latest data, with employment growth slowing to 1.1% y/y in the three months to March, from 1.4% y/y previously. Even so, price pressure is building. In fact, CPI inflation rose above the Bank of England's 2% target in April. Admittedly, the MPC is not expected to hike interest rates this year while Brexit uncertainty persists. But if a deal is secured, at least one Bank Rate hike is likely next year.

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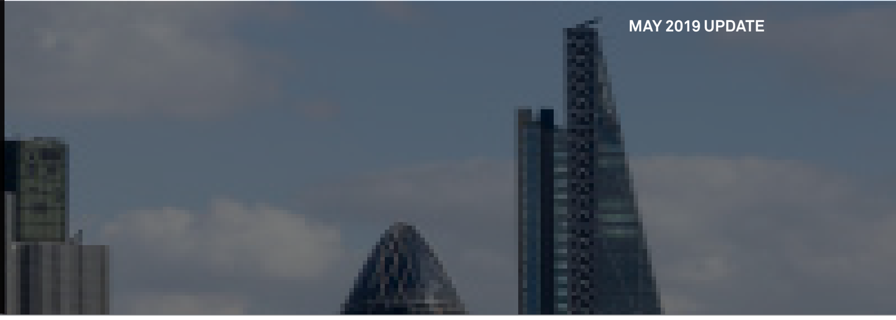
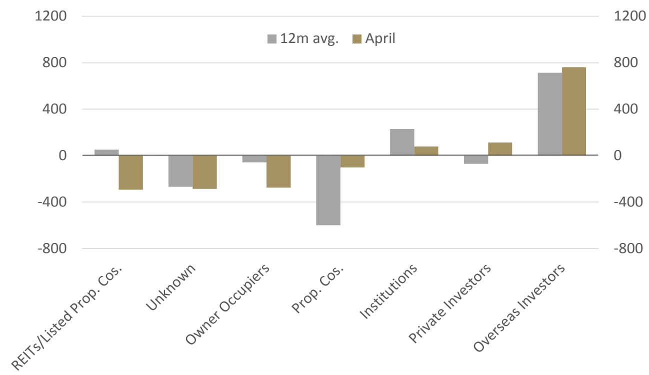


In the euro-zone, the improvement in Q1 growth was encouraging, but more timely survey measures, such as the flash PMIs, suggest that the bloc is not out of the woods yet. In particular, there have been few signs of improvement in the struggling manufacturing sector. With the boost to CPI inflation in April mainly reflecting Easter timing effects, there is little in the data to prevent the ECB's keeping its ultra-loose policy stance over the coming months, or perhaps even providing more stimulus.

Property Overview

After slowing in the lead up to the March Brexit deadline, there was no recovery in investment activity in April. According to Property Archive, the value of investment totalled just £2.3bn, around 40% lower than the previous month and the total a year ago. Encouragingly, there was some return of overseas interest, with net investment at almost £800m compared to an average of less than £300m in the previous three months. But net investment from most other buyer types was weak (see Chart 2). Looking ahead, with Brexit uncertainty prolonged and capital values under pressure, there appears to be limited prospect of a recovery in investment this year.

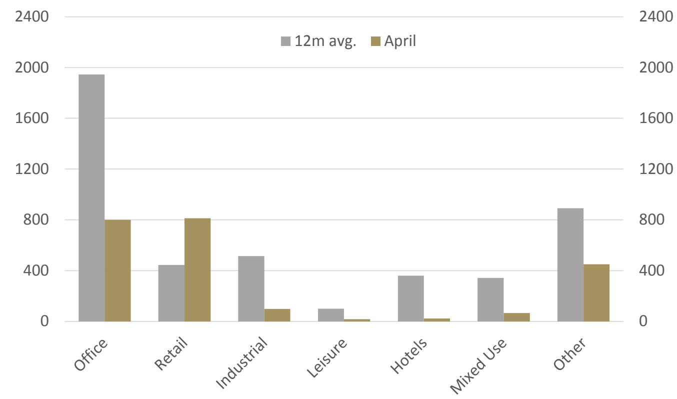
2.0 Value of Investment Deals Completed by Buyer (£m)



Source: Property Archive

At the sectoral level, retail was the only sector where the monthly value of investment was higher than its 12-month average (see Chart 3). However, this total was boosted by the sale of 12 Sainsbury's stores by the British Land joint venture with Sainsbury's. Further, this increase was not enough to change the bigger picture that investment continues to soften in the retail sector as uncertainty and concerns about pricing take their toll. Indeed, in the first quarter, CBRE data show that prime shop and shopping centre yields rose by 12bps, while prime retail warehouse yields rose by an even sharper 25bps.

3.0 Value of Investment Deals Completed by Sector (£m)



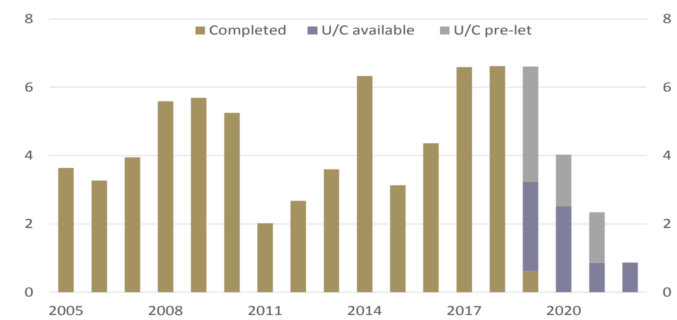
Source: Property Archive

This is consistent with the large rise in retail warehouse vacancy rates over the past year. In contrast, prime office and industrial yields held relatively steady.

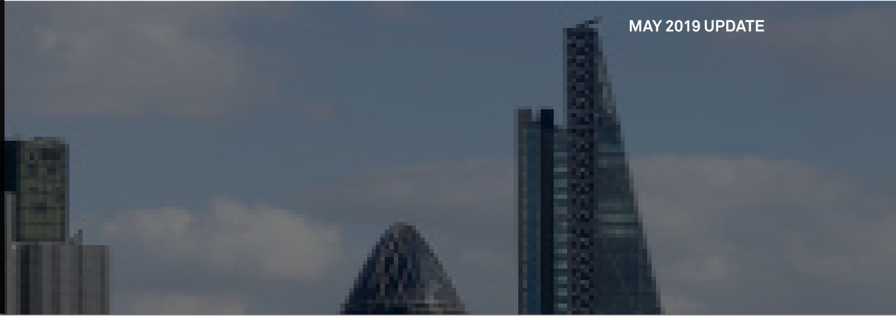
London Property Market

According to CBRE, Central London office take-up, at 0.5m sq. ft., was soft in April. Nevertheless, it was encouraging that availability continued to decline for the sixth consecutive month. Without an improvement in occupier demand, however, this is not likely to continue. This reflects a solid Central London office development pipeline. Indeed, the Q1 Deloitte Crane Survey showed that there is around 6.6m sq. ft. of space either already completed or under construction this year, a similar level to the previous two years (see Chart 4). In particular, the amount of the space under construction in the City of London is high compared to the past 15-year average level of completions.

4.0 Central London Development Pipeline (M. Sq. Ft.)



Source: Deloitte Crane Survey

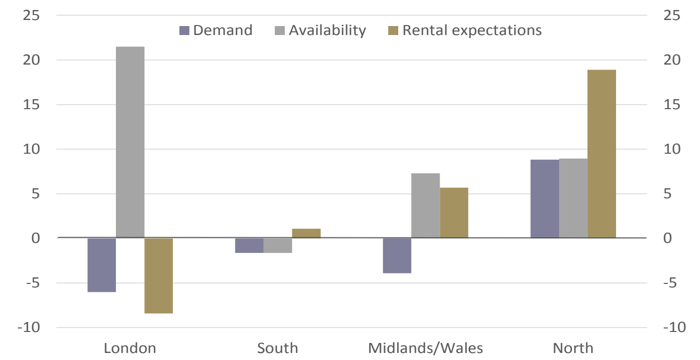


This is consistent with the Q1 RICS Commercial Property Market Survey which showed that a net balance of 21% of surveyors reported rising office availability. In turn, it seems unlikely that there will be any material improvement in Central London office rental value growth this year. Nevertheless, the same survey suggests that higher levels of availability are expected to put more downward pressure on secondary office rents compared to prime. In fact, in Q1, a net balance of 20% of surveyors expected secondary office rental values to decline in the next 12 months, while a net balance of 30% of surveyors still expect prime office rents to increase.

Regional Property Market

In the regional property markets, the RICS survey highlighted that a smaller net balance of surveyors are reporting rising office availability (see Chart 5). This is consistent with the fact that office rental value growth outside of Central London is generally stronger.

5.0 RICS Surveyors Reporting Rising Office Demand, Availability and Rents (% Net balance)



Source: RICS

This outperformance is expected to continue this year as the office supply pipeline in the regions is tighter. Indeed, Avison Young data show that, on average across the Big Nine cities, space under construction in Q1 was equivalent to around two years supply based on the average take-up in the previous five years. In the Rest of the South East, the pipeline appears even tighter, accounting for only around one year's worth of supply.

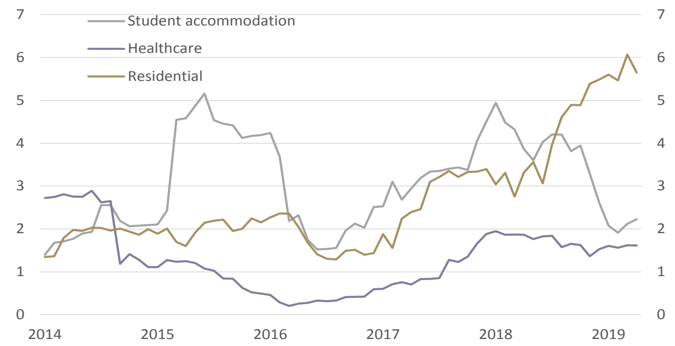
However, the performance of the retail sector in the regions has generally been worse than in London. But there are differences across regions. Indeed, LDC data show that the North West actually fared relatively well over 2018, with fewer retail stores closing than in 2017. In contrast, the East and West Midlands experienced 0.9% y/y and 0.7% y/y respective increases in net retail store closures. Meanwhile, CBRE report that the largest falls in shop rents in Q1 were in the East and South East.

Sector Spotlight

Student Accommodation

The value of student accommodation deals completed in the first four months of the year has been similar to the total in the same period of last year. But compared to the recent peak, investment activity has softened significantly (see Chart 6). In turn, Knight Frank report that yields for prime direct-let student accommodation in London and regionally have held steady for the past year at 4% and 5.25% respectively. Nevertheless, although the value of student accommodation deals completed have not kept up with residential, they have compared favourably to healthcare. Further, the softness appears to reflect a lack of available properties, rather than a lack of interest.

6.0 Value of Alternative Investment (Annual Total, £bn)



Source: Property Archive

Indeed, the prospects for the market appear solid as the supply of student accommodation is limited. In fact, Savills report that there are around 1.9 million full-time students in the UK and only 625,000 purpose-built bed spaces available. If all these students lived in purpose-built student accommodation (PBSA), this would be a provision rate of around 34%. This is higher than in other markets, such as Australia and Germany where the provision rate is around 10%, but still highlights that there is scope to increase supply.

Going forward, the development pipeline is healthy, with around 108,000 beds planned in 40 major locations outside of London according to Cushman and Wakefield. However, this is not likely to be sufficient to meet the rising trend towards living in PBSA or the expected increase in students. Indeed, Knight Frank report that, given ONS population projections and entry rates from UCAS, there could be a 15%, or 220,000, increase in full-time undergraduate students by 2030.

Admittedly, in the near-term the market faces some challenges including the uncertainty around the impact of Brexit and the Augar review on tuition fees. But at least for now the market is holding up. Indeed, Savills report that annual rental value growth was 2.8% in 2018, similar to the previous year. Further, according to UCAS figures, student applications for the 2020/21 year are up by 2,500 from the previous year, totalling 560,000. In addition, applications from EU nationals, where the impact of Brexit is more uncertain, were 1% higher than the previous year. In turn, there appears to be scope for student accommodation yields to compress further, supporting capital values.

For further information please contact:

Sarah White
Marketing, Riverside Capital
+44 (0)20 7297 4480

sw@rivercap.co.uk