Market Overview: Quarter 1, 2019

Welcome to our inaugural quarterly Market Overview, which aims to provide an 'at a glance' summary of key economic and real estate trends for our clients. Whilst geopolitical uncertainty continues in earnest with no immediate let up in sight, we continue to witness the 'evergreen' attraction of UK real estate amongst our GCC and Asian investor base. For all the political 'noise', the UK remains attractive for inward investment due in part to our mature real estate market, established legal and regulatory framework and the oft-overlooked fact that title to real estate is guaranteed by HM Land Registry.

We hope you find this overview useful, and take this opportunity to wish you the very best for a prosperous and peaceful 2019.

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WORLD ECONOMY: 2018 REVIEW

Global

2018 was an interesting year in global financial markets. Purchasing Manager Index (**PMI**) data, normally seen as the most important leading indicator of GDP, has started to flatten off in the U.S. although is still comfortably above the 50-level indicating slowing but continued expansion. The Federal Reserve interest rate hike was fully expected but the more dovish words of Chairman Jerome Powell indicate a much lower expectation of continued hikes next year. Current market is pricing in zero hikes in 2019.

China is slowing and data is starting to show some effects from the trade war with the US. The Chinese response to this may have significant global effects if, for example, tax cuts are able to put another 'turbo boost' under Chinese GDP. Europe is in a multi-year low growth environment with particular concerns currently centring around France and Italy along with, of course, Greece whose can was kicked down the road a year ago but who is due to hit repayment points in 2019 and, therefore, more pain. Spain still has significant unemployment problems particularly with youth unemployment (under 25) sitting at 34.9% as at October 2018. Of the periphery countries, only Ireland appears to have made a full recovery from the (ongoing) Euro crisis. Oil has had another volatile year as has Gold, making it difficult to pick a specific direction of risk assets moving into Q1 2019. Volatility in the first week of 2019 has continued at high levels.

In terms of Islamic finance, 2018 was a good year, with the UK witnessing its first European Residential Mortgage backed (**RMBS**) securitisation in Sukuk format. The certificates were listed on the UK and Irish Stock exchanges. Global Sukuk issuance is expected to match that of 2017 at USD 90-100 bn (estimate by Moody's as at September 2018). Here at Rosette, we have been working on this type of product for some time and are now undertaking a feasibility study for a proposed Municipal Sukuk funding, as well as exploring Sukuk for various real estate and trade finance assets.

United Kingdom

Against the backdrop of global uncertainty, Brexit is due to take place at the end of March. Currently, there is no deal between the UK and the EU as to how they will manage their relationship going forward. The EU, collectively, is the second largest economy in the world, and the UK is the fifth largest. The UK parliament recently gained control over the Brexit process, if the ruling party fails to make a deal. However, with the opposition parties failing to agree on what would come next, the odds of holding another referendum are getting more likely.

A new "In / Out" referendum vote would be positive for GBP as polls are now showing a strong bias in favour of remaining in the EU. Our view is that the most likely outcome is that the vote in Parliament scheduled for 14 or 15 January is lost by the Government and Brexit is delayed at the last minute to give everyone more time to sort themselves out. In terms of worst-case scenarios, crashing out of the EU with no deal in place, this is likely to lead to a UK recession and rate hikes by the Bank of England to try to soften the fall in GBP. We see this as an unlikely scenario. In terms of Real Estate, against this backdrop, a report was released by Savills indicating levels of property investment have remained steady.

Potential short-term volatility in the UK market post Brexit means we see an opportunity to pick up good value properties in 2019. If structured as long income, possibly amortising transactions, we see this as mitigating some of the short-term volatility in valuations likely to be seen in the immediate aftermath of Brexit (assuming it happens).

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Europe

Anaemic growth throughout and significant problems with French and Italian deficit management. Europe continues to insist on using the same structural reforms that have not worked since 2011. We continue to be negative on Italy, France and Greece in particular and think that the Euro will continue to drop vs USD during 2019.

United States

Although the pace of growth is slowing and President Trump is very unpredictable in terms of trade policy, we do not expect the US going into recession in 2019. Given the likely problems in Europe and the UK we also see the USD continuing to remain strong. With a strong dollar making the US a good store of value and good corporate performance, we are exploring opportunities to bring Sukuk and other funding instruments to the market on behalf of US companies, in addition to our UK Sukuk project.

UK REAL ESTATE

Presently, real estate markets are intently watching and waiting to see what form Brexit will take. This was not explicitly the case in 2018 where investment volumes continued without dipping. The outcome of Brexit will dictate how the UK real estate sectors react over the year ahead.

For Rosette, acquisitions will continue to focus on core property fundamentals that will withstand the headwinds that a 'bad' Brexit might bring. As ever, a key aspect of our business plan will be income generation and not relying on capital appreciation. Long leases continue to be an intrinsic theme for our investments. Below is snap shot of the sectors where we see value in the year ahead.

Supermarket Retail

The wider retail sector continues to witness contractions, as savvy shoppers scour the high street and internet for the best deals. The effects of the gradual move to online shopping is still working its way through the retail sector. However, we see value in the larger supermarket retailers in the right locations.

Long leases in urban locations that have strong underlying site value will ride through Brexit and likely the next market event as well. It has been said by many that larger supermarket stores will become obsolete. We support the contrarian view that many larger stores actually have great potential to adapt to changing consumer trends. By changing their configuration, larger stores can service online deliveries, either through 'click and collect' on site or as local logistics hubs for deliveries. Given the very sharp yields paid for logistics facilities, could supermarket yields compress where they provide a local logistics solution? It is a thesis we are closely monitoring.

Student Accommodation

It will surprise many that the number of students from the EU in the UK is actually very low. Given the comparatively cheap pound, it is conceivable that the more predominant countries sending students abroad to UK universities will see a bargain and take-up any slack in applications.

Aside from Brexit dynamics, there has been a steady 'flight to quality' by UK students, with decreasing applications to lesser ranked universities and increased applications for the higher ranked.

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Never more so than now, location matters. We are forensic in our analysis of local student accommodation dynamics to ensure only those assets in the right location, with the right management teams and rental price points are considered for investment. The 'ever-green' nature of student accommodation income remains rightly popular with investors, though careful asset selection remains paramount.

Regional Offices

Highly skilled professionals working in office space specially fitted out to cater for the needs of their highly skilled workforce can be found across the UK. When companies have come to rely on this specialist workforce and in a particular location, we see value. Ideally, this would be compounded by the underlying site value but be complimented by the tenant's desire to invest further into the site. Specialist use for research and development or technical infrastructure, such as on-site data centres, are occupier themes and attributes that we will be looking for in our acquisitions over the year ahead.

TAX CHANGES FROM APRIL 2019

From April 2019, the current exemption from capital gains tax for non-resident investors will be abolished. In addition, from April 2020, non-resident corporates holding UK property will be subject to UK corporation tax on their rental income profits, as opposed to UK income tax as at present. These changes represent a significant departure from the existing regime and non-resident investors will need to consider the impact of these changes on their existing structures.

ABOUT ROSETTE

Based in Mayfair, Rosette Merchant Bank LLP is an independent investment advisory and asset management firm specialising in commercial real estate, capital markets, supply chain finance and bespoke family office services. Our client base includes corporates, institutions, ultra-high net worth individuals and family offices in the GCC and Asia. Founded in 2003 and regulated by the Financial Conduct Authority, we have close ties to Kuwait and the rest of the GCC states.

Please get in touch with us if you wish to discuss the contents of this report in more detail.

Rosette Merchant Bank LLP
14 January 2019

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