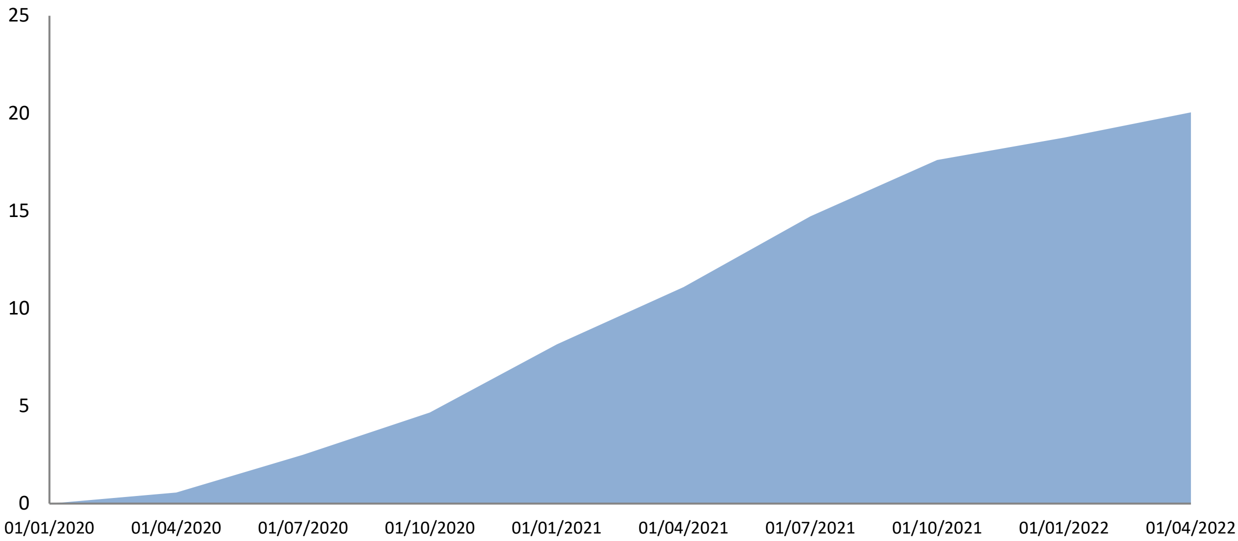
THE RIO CLUB 23 June 2022

RIO PROPERTY GROUP

RIO Property Group looks set to close the second quarter of 2022 with yet another gain. Since launch this investment has remained on target and posted net returns of 20.05%. This investment has performed exactly as expected and is both a welcome relief and far cry from the volatility seen in equity markets this year as serious losses were experienced by most mainstream equity based funds. Relative to other investments and much to the satisfaction of the members who are invested, the RIO Property Group has served as a shelter from such unpleasantness, having recorded nine consecutive gaining quarters.



Looking back, despite the delays caused by 2021 freak storm damages, material and labour shortages, lockdowns and delivery issues, which created progress disruptions, operations have resumed and we are back on track. In fact, I, myself visited all four projects during April and can confirm that they are all firmly back on target. That said, our illustrious team has continued to deliver what can only be described as a herculean effort to overcome these issues and ensure that projects are completed as planned. Looking forward, this investment is likely to post returns in line with our projections.

The UK Property Market

Looking back, the days of consistently cheap debt/loans are gone; as are the years of rents growing at a steady and predictable pace. Also gone are relatively easy to predict construction costs**,** which had previously gradually drifted upwards (during the past two years they have rocketed higher). Well, that's all gone**;** it's a wakeup call for property investors who have grown accustomed to the cheap money, with property yields drifting downwards. Things have changed but have they really gotten that complicated over the past 2 years or is it that I am still a relative novice, only having launched and successfully managed three multi-million GBP property-based investments since 1996, each of these investment products returned net gains exceeding 60% in their 5 year fixed term - forgive me if I am being cynical!

It's obvious that, with the rising cost of money, there's an immediate impact on the cash-on-cash returns for income-based investments. Ultimately, higher borrowing costs should, all other things remaining equal, provide higher yields particularly in property markets, which are less driven by emotional factors.

The NEW point - All other things have not remained equal.

Property development companies have all been negatively affected by materially higher tender price inflation, meaning that market price positioning today needs to be very realistic and allow for the obvious contingencies. That being said, there is growth to be found in rental income, particularly in Green office markets, where the rental yields have strengthened. Post-Covid recovery has benefited from limited supply levels and a lack of new developments; I have noted that potential tenants are more attracted to newer, better, and more spacious constructions that bring forth environmentally and socially responsible concepts. This, to satisfy requirements surrounding the burgeoning Environmental and social Governance. The shift in demand, to what has now become prime real-estate, has caused a supply-demand wedge and unleashed upside potential. I would anticipate that, in the coming years, the demand for commercial properties, with the correct mix of ESG and amenities, will almost certainly cause a surge in rental rates. In my view, this could be quite a radical shift where affordability isn't such an issue to the prospective tenants.

Where do we go from here?

The ongoing conflict in Ukraine resulting in a compounded energy crisis will undoubtedly lead to regional if not global economic slowdowns. This will in turn put policy makers and bankers in a difficult position as they may soon have to put a halt to any further interest rate rises because these rate hikes will in fact heighten recessionary movements in major markets. For now, the consensus remains that markets will face higher borrowing costs throughout 2022/23, which will negatively affect the UK construction sector.

Property companies that underestimate capital expenditures in today's market will likely face significant losses moving forward. In this inflationary environment, owning or seeking to acquire inferior or sub-standard quality assets will be a sure-fire way to restrict any higher rental income or even worse have a negative knock-on effect on the property's intrinsic value. Conversely, RIO is renowned for its early identification of assets convertible to a more upscale, sustainable standard with minimal intervention, which will allow it to command consistently higher rental rates and solidify investment returns.

Selective property acquisition is key to investment success in the current market, and this can only be achieved through experience and an in-depth knowledge of the demographics.

Supply and demand and covenant strength will always dictate entry prices for straight income deals and acquisition strategies need to be in place to avoid securing positions that would result in sub-threshold returns. Commercial property acquisition differs in that it is longer term and industry specific, enabling contractually agreed inflationary rental increases and property improvement ensuring extended renter commitment and steady returns; this is the type of opportunities that the well seasoned property experts at RIO seek and successfully identify while avoiding the pitfalls of seemingly "unbelievable deals".

There is still a good level of market activity in the commercial space (the residential property sector valuations will fall as both cost of living and lending costs increase) despite geopolitical events contributing to inflationary pressures affecting all aspects of the property market. Against the current backdrop of rising finance costs and construction costs, to date, pricing strength across the commercial property market, has illustrated the defensive nature of this type of investment asset class.

Today, headlines are full of stories on rising interest rates even if currently these are well below inflation levels. Cash deposits may finally be getting a slightly more positive return, but in real terms, the value of stagnant cash is deteriorating and therefore money in the bank remains a losing position. How does property stack up? Today, real estate returns still remain attractive, but this could change if long-term real interest rates continue to rise.

As the increasing cost of debt will cause a compressed yield environment, which will drive out some entirely cash-on-cash focused property investors, such entities will struggle to secure a place in core property markets. However, the departure of these investors in most core markets provides yet another opportunity for companies such as The RIO Property Group due to their non-reliance on bank debt or corporate level debt. As such, we will almost certainly benefit from the fact that we can enter a less competitive marketplace. Less competition leads to price softening, but such is the demand, that RIO is of a mind that small rises in yields will quite possibly result in a disproportionately positive reaction from the buyers who buy right.

Demand vs. Yield

The current demand continues to be focused on Green prime stock as highlighted above; there has been downward pressure placed on non-greenprime regional office space yield, which currently stands at 4.75%. Edinburgh's prime office space yields are both 25 basis points below this level. I would highlight that this is the lowest level ever recorded for these markets. Looking forward, as I have pointed out above, I fully expect to see the yield gap for prime Green office space and old prime office space or what could be considered secondary offices, widen with the office space rental growth outlook for prime green offices in the undersupplied locations remaining compelling; that is if the imbalance between supply and demand continues.

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