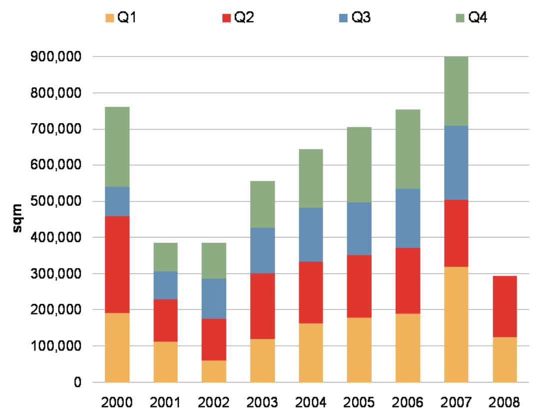
Madrid office market

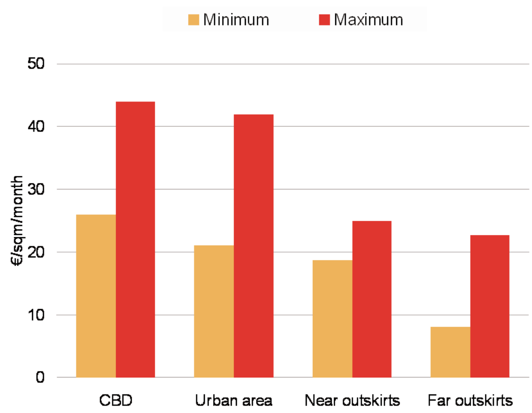
Summer 2008

Annual take-up



Source: Savills Research

Asking rents for exclusive office buildings



Source: Savills Research

"Our expectations for the office market compared to other sectors continue to be optimistic. We expect that some interesting properties will come on to the market in the coming months. Companies who are looking to dispose assets should set a clear and coherent strategy in order to maximise capital gains."

Rafael Merry del Val - Head of Savills Spain

- An analysis of the take-up volume in the second semester of the past few years shows stability and equilibrium. The significant number of transactions of more than 3,000 sqm that were signed between April and June has given the quarter a much needed boost. If we look back as far as January, total take-up for the first semester regards similar to 2003 figures.

- With regard to the number of transactions signed, in spite of the fact that recently demand has been more active than in the first semester, an analysis of both the quarter and the semester shows a notable decline compared to figures achieved last year.

- The vacancy rate has slightly increased due to the fact that only 16% of new property put on the market was not already pre-let or owner occupied.

- The maximum closing values in the CBD remained at the same level as the last quarter; prime rents have increased by 7% compared to April, reaching 45 €/sqm/month. It should be noted that maximum rents are set at 50 €/sqm/month, but only for very specific properties whose market price is always above market.

- The general economic uncertainty, the difficulty to obtain financing and the general slowing in the real estate market all combine to make investors more prudent and cautious. The total volume over the last quarter almost reached 500 million euros. The investors who took part in the transactions, both in terms of buyers and sellers, have, for the most part, been of Spanish nationality.

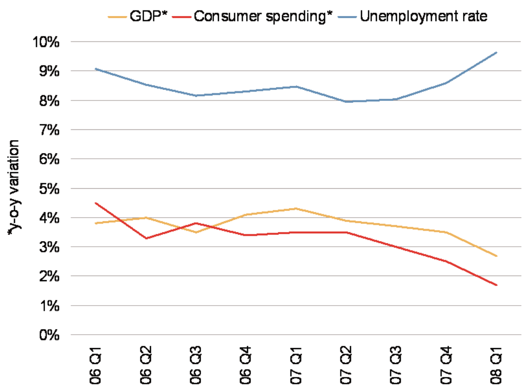
Economy

Economy

Spanish economic situation

The slowdown in Spain's economic growth that was visible at the end of 2007 has continued and indeed intensified over the first few months of 2008. While the average annual growth rate for the whole of last year was 3.8%, the GDP growth rate for the last quarter was only 3.5%. This downward trend has also been seen in the first quarter of 2008 where the Spanish economy has grown 2.7% compared to the first quarter of 2007. Government forecasts for the economy have been revised downward and the government has ruled out the possibility of GDP increasing above 3% for 2008. Instead, the government calculates that GDP growth will reach a rate of less than 2%. The gap with the eurozone is reducing; the eurozone's year on year growth rate calculation for the first quarter of 2008 was 2.2%, the same rate recorded for the last quarter of 2007. Using this calculation as a reference point, one can see that the change in the international economy's growth cycle that began last summer is having major repercussions within our country.

GDP, consumption and unemployment



Source: INE

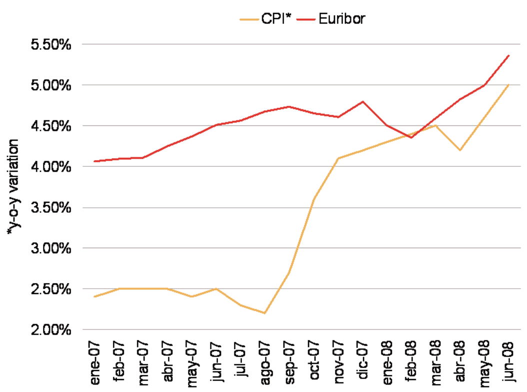
In terms of demand, household spending grew at an annualised rate of 1.7% over the first three months of this year, compared with a rate of 2.5% for the fourth quarter of last year and 3.5% for the first quarter of 2007. Consumer confidence followed along the same lines and although there was a slight improvement in February, it continued its downward trend that started in the middle of last year. With regard to supply, weakness in the construction sector is a reflection of the major changes in the housing market, which is already seeing price reductions if one discounts inflation; the contraction of this sector is one of the key factors behind the worsening employment market. Although the construction market is important in the actual context of the economic deceleration, other supply components (except agriculture) have also moderated their growth rates.

Unemployment in Spain increased in the first quarter by more than one percent compared to the unemployment rate in December (8.6%). In the first quarter, it reached 9.6% as a result of the drop in job creation combined with an increase in the active working population.

There continue to be high levels of inflation: an increase in the price of petrol and raw materials is the primary cause of increases in the CPI. After a slight slowdown in April that followed several months of increases, the year on year growth in prices calculated in June was 5.0%, which is the highest rate in the last thirteen years. These inflationary pressures have caused the Central Bank of Europe not to lower the official interest rate pegged at 4.0% since June 2007, but rather to announce possible increases in the interest rate in the short-term, which has caused the Euribor to reach an average rate of 4.99% in May and reach record daily rates in June (above 5.43%). In effect, the Central Bank of Europe increased the interest rate to 4.25% on 3rd July.

After a long period of economic expansion that was far superior to other European Union countries, Spain is now facing with the beginning of a change of cycle that will test its strength and its ability to adapt. With the growth based on the construction industry having halted and with the threats mentioned above, improvements to certain areas can not be delayed any longer, such as productivity, competitiveness and innovation. Up until now, these factors were in short supply but were put to the side because of the strong global economy. Now, these improvements must be put in place in the months and years to come.

CPI and Euribor



Source: INE

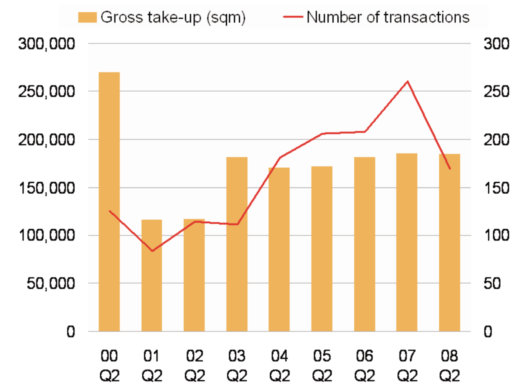
Demand

Recovery in gross take-up

The volume of contracts signed between April and June has reached nearly 170,000 sqm, which is a 37% increase when compared to the first quarter. Consequently, it would be fair to think that the market is recovering and that the slowdown in the real estate market has just been a temporary problem. Nevertheless, historical trends demonstrate that a more objective outlook is attained by comparing data from the same periods each year. Applying this method reveals a stable and balanced overview given that the total for the quarter is in line with results from the same period over the past five years.

Regarding the number of transactions signed, as expected with the even quarters, market demand has been more active. The 165 transactions reflect an 11% increase compared to the period of January to March of this year, although in comparison with the second quarters, the analysis reveals that the market is declining particularly given that the decrease has reached 37.5%.

Take-up and number of transactions - 2nd quarters



Source: Savills Research

The good gross take-up figures are clearly contrary to the more cautious nature of current potential users. This is mainly due to the positive boost from the large-scale transactions that have been completed (spaces of more than 1,000 sqm), which make up one third of all transactions completed, and, furthermore, 28% have been for properties with an area greater than 3,000 sqm. Meanwhile, the number of transactions signed within the small to medium size range reveals that these segments have been affected by the uncertain economic climate. 1,000 sqm spaces are usually in demand from SME's and we should also point out that these businesses are normally the first to show their reluctance to take decisions in turbulent times, until the effect on their business becomes clearer. Consequently, it seems that office market indicators clearly show that we find ourselves in a regressive phase.

Increase in the number of acquisitions for owner occupation

The highest number of transactions in the second quarter was carried out by end users. 15% of market transactions are attributable to this sector and make up 30% of all transactions. This is the largest amount of space acquired for own use since the last quarter of 2004, when the amount of space acquired represented 40% of all transactions in the quarter. In terms of volume, we would point out that a public institution has acquired a building in Moncloa that has an area of 16,000 sqm.

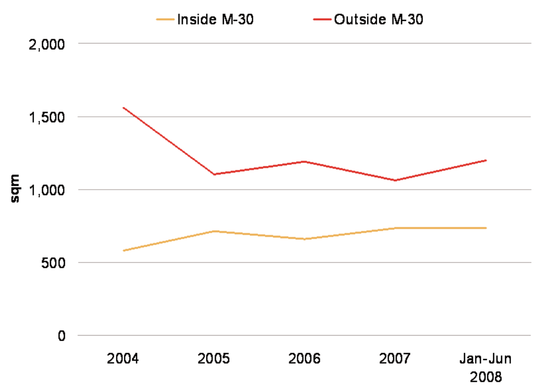
One third of leasing and sales activity is within the urban area

The urban area, excluding the CBD, has seen a higher than normal level of take-up (reaching 34%), given the fact that several of the largest transactions in terms of volume were completed in periphery business areas of the city. Again, we should emphasise the scarcity of options for large surface areas within the city centre and that the opportunities to rent or acquire these spaces do not pass unnoticed by occupiers. Assuming that this area accounts for all the space within the M-30 ring road, the rate of take-up reached 46%.

Public administrations

The three public administrations have reappeared in force, making up 20% of the total market take-up. Three of the largest transactions this quarter have been carried out with Central Government and the Community of Madrid. The Town Hall has also rented an entire building near Retiro Park. The most active sectors in the market continue to be service providers to other businesses, followed by new technologies, even if the percentage of transactions signed by both sectors has declined slightly compared to the last quarter. In contrast, offices dedicated to industry and manufacturing and some focused on distribution, have increased their presence in the market.

Average transacted area in respect to the M-30



Source: Savills Research

Supply

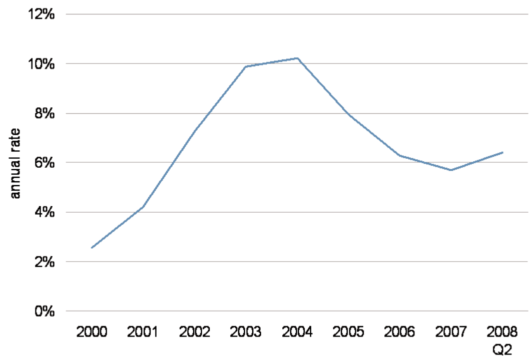
Vacancy rate, on the rise

The amount of office space on offer in buildings intended exclusively for office use has increased for the fourth consecutive quarter, reaching 775,000 sqm at the beginning of July, which is 7% more than the last data analysed. This volume only includes 16% of the developments brought to market between April and June; the remainder has been reincorporated in the rental market or has been occupied by the property owner itself. This is caused by the huge amount of contracts signed last year, when there was a shortage of quality large spaces and an economic boom which encouraged companies to take-up whole buildings and occasionally pay a year's rent in advance when the buildings were delivered.

The total stock of office space in the capital has also increased. The increase of approximately 81,000 sqm has raised the total to just over 12 million sqm. The vacancy rate has increased due to this and has now reached 6.4%.

Satisfactory take-up results have not had a notable affect on the volume of available space and it is likely that by the end of the year we will probably see a significant increase in the vacancy rate. All of this will depend on whether the 300,000 sqm forecasted for the period up to December comes on to the market. Several of the developers have already announced possible delays in the completion of works under construction. Another factor to take into account will be the amount of pre-sales of the larger projects, such as the space in the towers at the northern end of the Castellana earmarked for the rental market or Avantis's industrial park close to the A-3 and the marketing of the space that came on to the market in the first half of the year which continues to either be completely empty or remains largely empty.

Annual vacancy rate



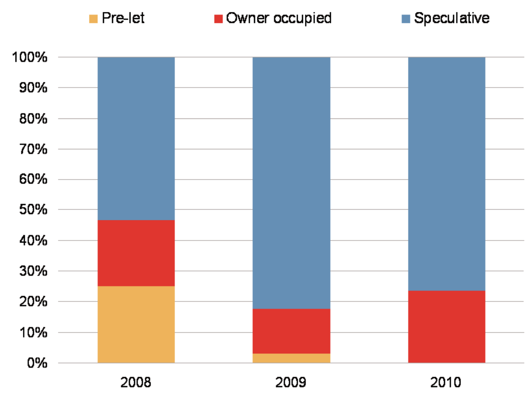
Source: Savills Research

For the moment, the index is relatively "healthy" which is preventing a pronounced decline in property values. The vacancy rate in the CBD-Castellana is still below 3%.

New developments

The shake ups in the market have delayed several developments which were expected to be finished this year and it is likely that others will be delayed by several months, as developers say that they are adhering to deadlines, but warn of possible postponements in scheduling. Hence, the amount of space expected to come on to the market in the next two years will be more than 850,000 sqm of which, unlike in recent years, more than 60% will be brought to market without any pre-let agreements with tenants or the property owners to occupy the building.

Future supply



Source: Savills Research

As we look further and further ahead, predictions on future projects become more complex to predict, particularly now that the current situation is causing the banks to refuse to finance "speculative" business complexes.

In the next 18 months, the Castellana and its surrounding area will see several buildings being fully refurbished, bringing the technical and technological features, as well as the space layout up to date, which is the only way to improve competitiveness in a market where technological advances have a greater impact.

By type of building, buildings intended exclusively for office use surpass "high tech" buildings but it is important to note the slight increase in the technological buildings sector since 2006. During 2008 and 2009, those industrial areas that continue to regenerate will dominate the market; however, other projects which began a transition from traditional industrial activity to light industry should not be forgotten. The southern area is in many developer's sights.

Rents

Year on year growth maintained

The global market is resisting a downward spiral. Year on year growth of closing rental levels in buildings used exclusively for offices still register a marginal increase of 2%. Other areas have begun to suffer from excess supply or from the elevated level of obsolescence of buildings in the area and have started to show the first signs of negativity in the market. On the other hand, the areas that are the best at resisting the negative effects of this normal decline in the sector are those where new business developments are being built and transactions related to these properties have alleviated average transaction values in the area. But we must warn that the growth in rents is occurring in very specific buildings that due to their specific location, characteristics, good connections, etc., are unique in their area. The first section of the A-1 and the A-2 and the southern area, that includes the complex that Nozar developed in Méndez Álvaro, are a clear example of this phenomenon.

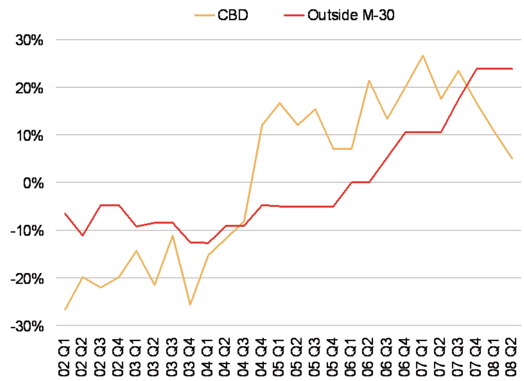
The Castellana and its immediate surrounding area have not registered a transaction of a "prime" building with prime rents. The highest closing value of 35 euros per square metre was registered for the purchase of Garrigues old headquarters in Calle Jose Abascal. Although we are aware of advanced negotiations for other properties in the area that are at similar levels to last year´s third quarter, which were between 40 and 42 euros/month.

Comparing closing rents in this quarter with the previous quarter registers a negative result of 3.75%, which has been attributed to the lack of transactions signed in "high end" buildings in the CBD. Moving away from the M-30 ring road, rents in the areas closest to the city have been positive; however, the areas furthest from the market have suffered, the decline in these areas has been set at slightly more than 2.5%.

Regarding asking rents, the same trend is repeated as in the closing prices. Rental increases are being registered in very specific buildings that are reincorporated into the market once the rental contracts have finished with the previous tenants or in new projects which offer cutting edge technical or technological installations which gives them added value over the rest of the supply in that specific catchment area and over the buildings located in comparable areas. However, the market is also beginning to show slight decreases in less modern buildings that can only compete on price.

Prime asking rents are between 42 euros and 45 euros per square metre in buildings located on the Castellana. In prime buildings in non-central areas asking rents remain stable at 25 euros per sqm. We should point out that the most notable declines have been registered in specific subzones on the periphery of the city.

Prime rents evolution



Source: Savills Research

Major leasing transactions

Tenant	Area	Size (sqm)	Sector
INECO	Campo de las Naciones	3,000	Public Administration
Arval Services	A-1	3,500	Business services
Gas Natural	A-2	4,500	Energy
Bureau Veritas	A-1	8,200	Proffesional services
CAM	Urban area	8,800	Public Administration
PWC	East	11,000	Proffesional services

Source: Savills Research

Major investment transactions

Buyer	Area	€m	Building
Drago Capital	Urban area East	292 (*)	Gran Vía, 32 Miguel Yuste, 40
Gecina	North	55	Avda. de Burgos, 118
Confidencial	CBD	28.5 (*)	Paseo de la Castellana, 40
Oppenheim	East	15.8 (*)	Albasanz, 15
Confidencial	Urban area	15.5 (*)	Alfonso XI, 3
Confidencial	A-1	12.5	P.E: Inbisa - Pirineos

Source: Savills Research   (*) estimated investment volume

Investment market

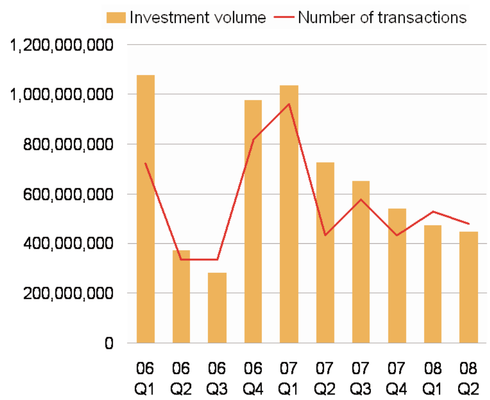
Few novelties on the investment front

The total investment volume accumulated in the first semester of the year exceeds 900 million euros. The second quarter has experienced few novelties with regard to the outlook for capital investment. The market continues to be dominated by a “wait and see” attitude that is keeping investors interested in the market, but stops them from actively participating in transactions. The macroeconomic trends, the poor growth forecasts and the difficulties in obtaining financing are some of the factors holding back investor activity. Another factor to consider is the forecast of income levels for the medium to long-term, which are forecast to fall over 2009 and 2010.

Main role of descentralised areas

Despite all of the above, various transactions have been carried out even if the common denominator of the majority of the properties has been their decentralised locations and their marked obsolescence. In addition, some buildings in the “prime” area or in the urban area are characterised by a lack of up-to-date services, both in technical and technological terms and the antiquated distribution of space, etc. Domestic investors seem more confident in this marketplace, given that they are present both in terms of buying as well as selling, but they always tend to deal with modest investment volumes and properties that are considered to be secondary.

Investment volume and number of transactions



Source: Savills Research

International players return to Spain

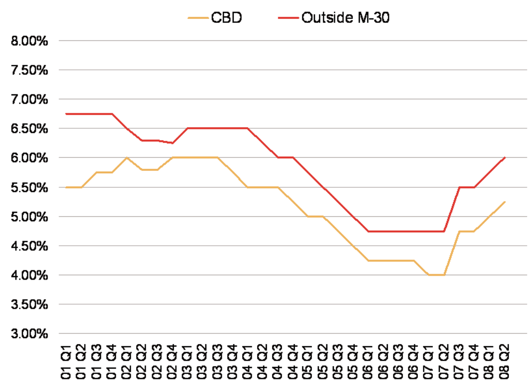
International players are returning to the market. The British management firm Pearl has reappeared in Spain via Drago Real Estate. Last year, the entity acquired the fifth BSCH lot, comprised of more than 1,200 bank branches throughout Spain. Recently, they acquired the package that Grupo PRISA brought to market that contained its office headquarters in Madrid and Barcelona and EL PAIS’s (a Spanish newspaper) editorial office, located in Julián Camarillo. The three properties will be let back to the telecommunications company for fifteen years.

International investors are looking for real estate that has few complications and implies little risk. Thus, in spite of the fact that in this particular example, the properties are not ‘prime’, the promise of having a long-term rental contract with a solvent tenant, in a consolidated area, where rental levels are not expected to see drastic fluctuation, could be a good reason to move ahead with a transaction. These characteristics could serve to spur additional proposals for transactions. Pearl Group has not been the only player in the market; nevertheless, it has been the one that has injected the most capital in to the market. The other transactions carried out by foreign funds have involved properties in decentralised areas, but that are fully developed and that include long-term rental contracts.

Yields continue to move out

Yields continued with an upward trend as they have done since the end of last year. The adjustment in sales values is happening very slowly due reluctance on behalf of primarily Spanish owners to drop prices on their properties that are not worth the same as they were in previous years. In this sense, there remains some distance between seller expectations, who are attempting to avoid a reduction in value and buyers that are arguing that values have dropped and that a drop in rental values is imminent. The fact that there have been no transactions signed in the prime areas means that we have to base our views on market “feeling”. Currently we believe that prime yields in the CBD have risen by 25 basis points since our last analysis of the market, reaching 5.25%. We must highlight that this yield is in reference to high quality buildings, with good tenants and long rental contracts. For other buildings, despite being located on the Castellana, have a high level of obsolescence, that are not 100% occupied or they have short contracts, the yield is set at 5.75%.

Prime yields



Source: Savills Research

Outlook

Predictions for the Spanish economy revised downward

The data available for July from Consensus Economics suggest that the Spanish economy will continue to fall. Accordingly, year on year projections for GDP growth are at 1.6% for 2008 and were similarly lowered to 1.1% for 2009. Consumer spending has also been revised downward based on forecasts from various financial institutions with whom we consulted; projected consumer spending increases for 2008 and 2009 are expected to be 1.1% and 0.9%, respectively. The consumer price index, on the contrary, has risen for the majority of 2007 reflecting an average increase of 4.5%, and inflation is not expected to decline until 2009 (3.1%).

The results from the first quarter of 2008, where there was an inter quarter increase of only 0.3% due to low levels of consumption and investment, have contributed to a deterioration of expectations. This pronounced economic slowdown does not appear to have reached its final resting place yet, due to concerns about inflation, troubles within the construction sector and turmoil in the employment market. These problems combined with the BEC raising the interest rate by a quarter percentage point will delay a recovery of consumer spending and, in turn, negatively affect national demand.

This leads to a convergence within the eurozone where the GDP increase will also reach 1.6% in 2008 and 1.2% in 2009. The evolution in private consumer spending will be coupled in Spain and in the countries within the eurozone where annual increases are calculated at 0.8% in 2008 and 1.2% in 2009. However, the gap widens with regard to prices; estimated inflation for the eurozone is 3.6% for the current year and 2.4% in 2009.

Spain - Economic forecast (y-o-y variation)

	2006	2007	2008	2009
GDP	3.9%	3.8%	1.6%	1.1%
Consumer spending	3.7%	3.1%	1.1%	0.9%
CPI	3.5%	2.8%	4.5%	3.1%

Source: Consensus Economics

Users continue to demand large floor spaces

Neither the economic slowdown nor the difficulties that the market is suffering prevent demand from continuing to rise. This size of space (we refer to space larger than 3,000 sqm) is sought after in the large part by multinational companies or public institutions for whom market difficulties that may arise do not affect their needs for space. Analysing the areas in demand, approximately 50% centre their property search in urban areas within the M-30 ring road, including the Castellana where the scarcity of quality product slows down the process of identifying space that would be most suitable for each user´s needs. For this reason, buildings that are undergoing a renovation or rehabilitation in the CBD and its surrounding area, are constantly being studied by the market. The CTBA promised to be the solution to the problem of insufficient alternatives of quality properties in the city; however, on the one hand the configuration of the buildings and on the other the distance from the CBD, are some of the reasons that these areas have not convinced users.

We maintain our estimate of an annual leasing turnover of approximately 550,000 sqm; this could be larger if a number of the larger users were to find properties that meet their search criteria.

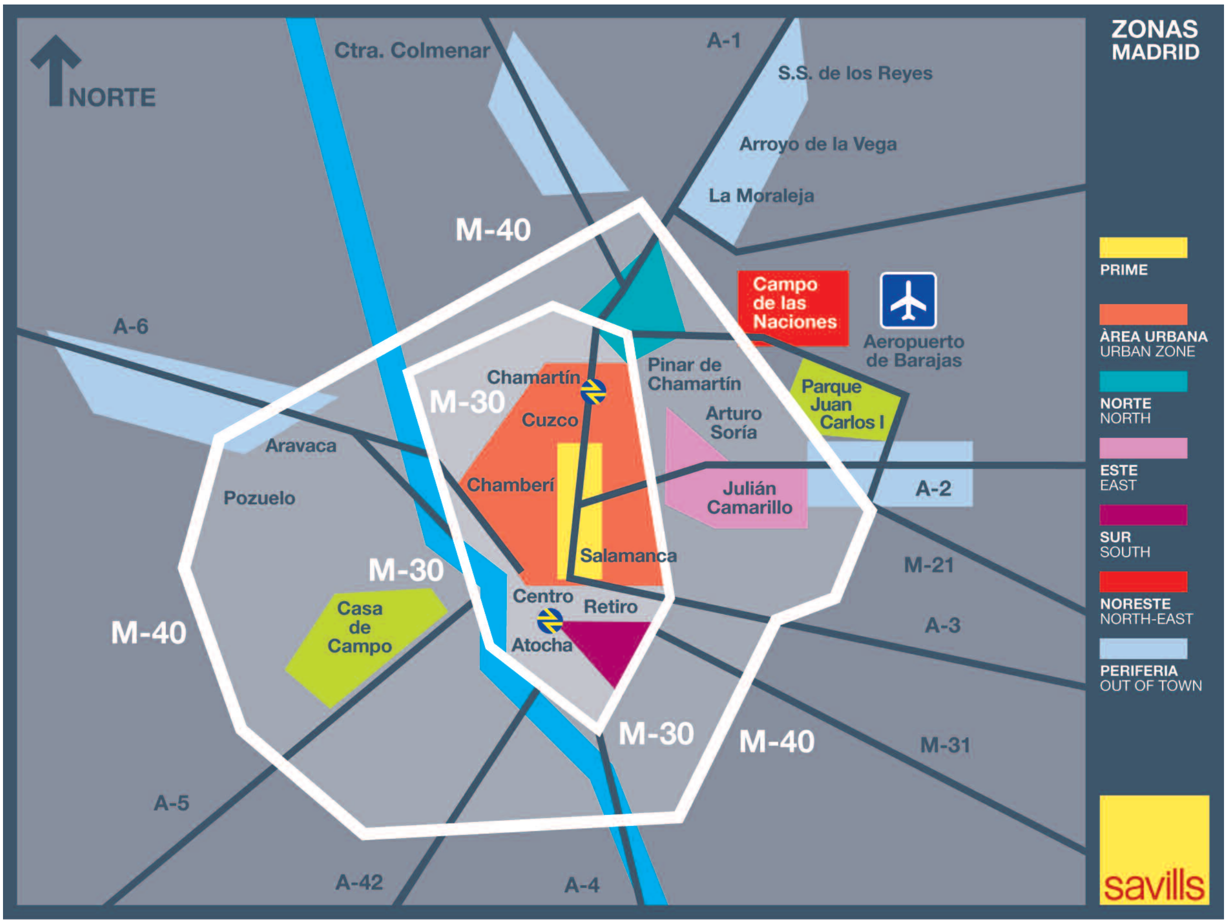
Yields moving out

The increase will be more pronounced as sellers admit their need to adapt to market reality and rental levels remain stable. Quality properties (due to location, rental contracts, etc.) are keeping the market in a holding pattern, although the market has already begun to move, even if it is in the “off market” category.

The large international funds are watching and waiting, observing the market from the sidelines and waiting for the best time to enter the market. At the moment, Spanish investors are performing as net sellers, especially those companies with elevated debt ratios, principally caused by residential business lines.

We are aware of several transactions that are in the process of being carried out, however, the difference between buyer and seller’s expectations on the final price requires an in-depth analysis for each respective party to justify its viewpoint. Drops in value of around 20% compared to last year´s property valuations in prime areas and even more in decentralised areas are hard to stomach. Nonetheless, the companies that are actively participating are those with liquidity or that have easy access to financing. In addition, they have extensive knowledge and understanding of the current market situation and the imminent recessionary rental cycle. These factors allow them to have the upper hand when it comes to deciding the final sales price.

Madrid office market map



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