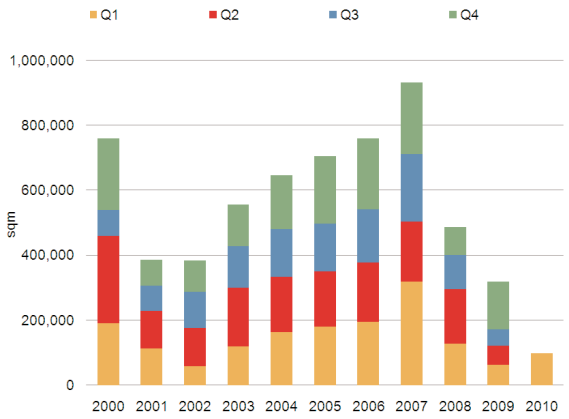
Madrid office market

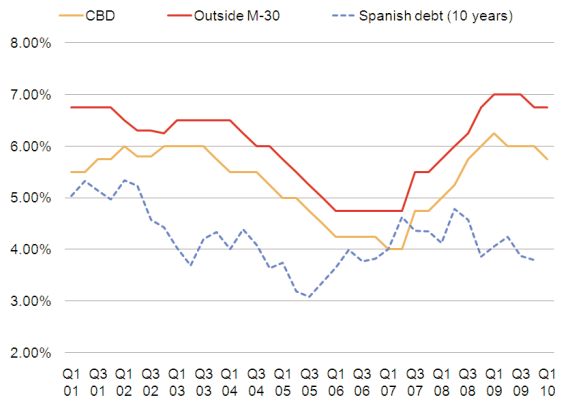
Spring 2010

Annual take-up



Source: Savills Research

Prime yields vs Spanish debt



Source: Savills Research / INE

"The investment market is currently on tenterhooks. Pressure to invest in both national and international prime office buildings (in the CBD or consolidated periphery) continues to increase, but there is no corresponding yield shift to fulfil potential sellers' price expectations. The key question is: who will be first to give in and start doing deals? It seems that demand will force investors' hands".

Luis Espadas - Capital Markets Director

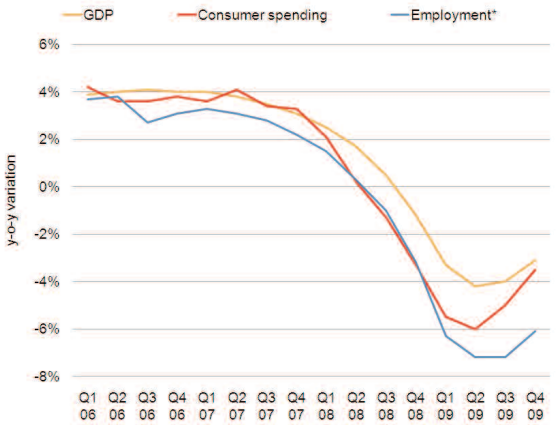
- The first quarter of 2010 has had the benefit of some large transactions that were agreed at the end of 2009. Gross take up nearly reached 100,000 sqm, an increase of 54% on the same period last year.
- Total stock is 12.57 million sqm, of which 1.44 million sqm are vacant. This has led to the highest vacancy rate of the decade: 11.5%. An additional 260,000 sqm of speculative new build are expected in 2010, although as in recent years, market forces will dictate the timing and delivery of these developments. Currently several large schemes are still delaying their completion, which is helping to keep vacancy levels down.
- Market rents are maintaining the downward trend that started at the end of 2008: seven consecutive quarters with year on year negative growth. However, the market seems as if it is slowly emerging out of the crisis, and since the end of 2009 the CBD has seen less drastic falls in rents.
- Office investment activity for this last quarter was the lowest in recent history: just €45 million. But this result distorts our view of the actual market situation. The lack of deals is down to the lack of product, since there is a decent level of demand for investment.
- The imbalance between supply and demand is starting to push yields down. In Q1 2010 the yield in the CBD was 5.75%.

Economy

Spanish economy

The economies that were most severely affected by the recent crisis (the United States, Japan, Germany, France, and the United Kingdom) have started to record quarterly GDP growth as of the end of 2009. The Eurozone recorded zero growth between Q3 and Q4 2009, with a year on year negative growth of -2.2% (average of -4.1% in 2009); household consumption fell by an average of 1%, gross capital production fell by 10.8% and imports and exports both fell by 12.6% and 11.4%, respectively. The trend in 2009 was for a reduction in the falls shown in all macroeconomic indicators.

GDP, consumption and employment



Source: INE / *Full time employment

GDP in Spain fell by 3.1% from last year, to post an average fall for the year of 3.6%; the drop from Q3 to Q4 2009 was just 0.1%. With regard to year-on-year changes, most economic indicators were still in the red at the year end, although, as in other countries, the extent of these falls is decreasing. As for demand, household consumption fell by 3.5% (an average fall of 5% in 2009) and national demand fell by 5.3% (average fall of 6.4% for the year). It is important to note the 1.3% increase in export of goods at the year end following five consecutive quarters in the red. As for supply, every sector showed improvement except energy (-8.3% in Q4 2009), and non-market services (1.2% growth). The construction sector shrank by 6.3% in 2009, with figures being similar for each of the four quarters

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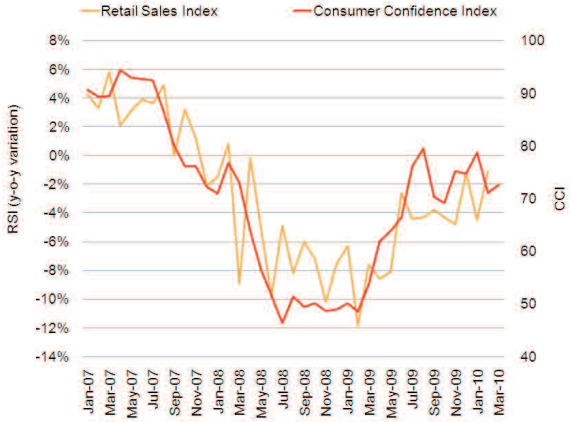
Retail sales and consumer's confidence

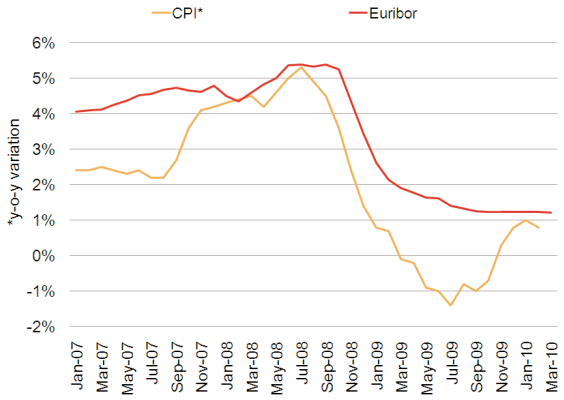


Source: INE, ICO

According to Eurostat, the average unemployment rate in the Eurozone reached 10% in February 2010. Eurostat statistics showed Spain as having 19% unemployment, and highlight a 40.7% unemployment rate for those under the age of 25 (compared with 20% in the Eurozone). As for figures produced by Spain, the INE (National Statistics Institute) showed unemployment at 18.8% at the end of 2009, whilst the Ministry of Labour and Immigration recorded a monthly increase of 35,988 unemployed in March 2010, taking the total unemployment figure to 4,166,613.

The consumer price index (IPC) in Spain has recorded five consecutive quarters of year-on-year growth (1.4% in March), following seven consecutive quarters in the red by the end of 2009. This means that the annualised IPC figure in Spain for March 2010 (1.5%) is the same as the inflation figure for the Eurozone (estimated to be 1.5% in March 2010).

CPI and Euribor



Source: INE

Demand

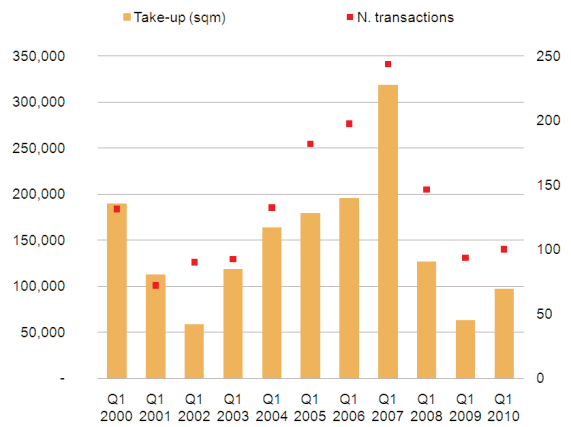
Is it really recovery or just an illusion?

The first quarter of 2010 benefited from a number of large deals agreed at the end of 2009 carrying over into 2010. Gross take up was nearly 100,000 sqm, which is 54% higher than the same time last year. Even so, the take-up rate is still a long way off levels seen five or ten years ago, when it reached 160,000 sqm and 143,000 sqm respectively.

There was a slight flicker of life from the demand side, with the average size of unit increasing to 977 sqm.

Offices of over 1,000 sqm are taking centre stage again. Between January and March 2010, some 25% of deals signed were in this size range, of which 33% were over 3,000 sqm.

Take-up and number of transactions



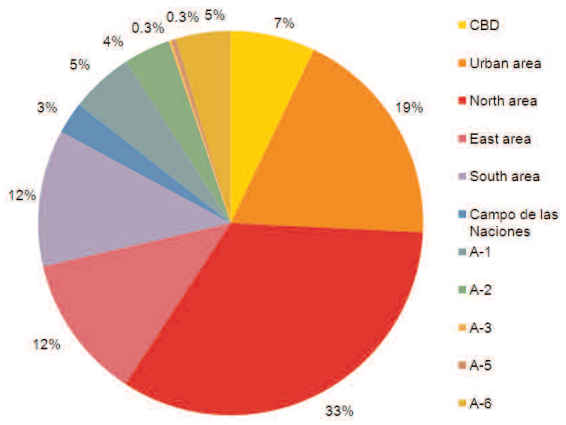
Source: Savills Research

After several quarters with stable results for the M-30 market, the periphery is back in favour, accounting for 69% of all newly occupied space. The northern zone alone accounts for one third of total take up. 33% of all deals over 1,000 sqm and 63% of all deals over 3,000 sqm were closed in this area.

As for the submarkets that make up the northern zone, it is easy to see the appeal of newly completed buildings or those due for completion soon, as well as those having undergone refurbishment: 64% of all take up is in new or refurbished buildings.

The same applies for the eastern zone, with 50% of take up occurring in recently completed buildings. This figure rises to 83% for the Julián Camarillo area

Geographical distribution of the take-up - Q1 2010



Source: Savills Research

Pre-lets are also back on the scene, with four deals of over 4,000 sqm in the northern zone. PAU's (local plans) and the Manoteras area are still encouraging new office developments, which attract office users looking for large floor areas, at competitive prices, in well connected areas near the city centre.

The latest data released by the National Agency for Administration of Revenues (AEAT) confirm this situation. In February, invoicing for large companies (ie those who regularly require large offices) increased by 0.9%. This slight increase is the first of its kind since January 2008, and could mean that the storm clouds hanging over the economy are starting to dissipate. Four consecutive months of positive export growth, good levels of national household consumption and investment in capital goods are the key drivers behind this change.

As for building types, occupants still have a strong preference for buildings exclusively in office use. 83% of deals were signed in buildings designed for business occupants, 73% of which were in buildings exclusively in office use. 10% of deals were signed in high tech buildings located in traditionally industrial areas undergoing change of use. The remaining 17% was for converted office space in residential buildings.

The sales market for owner occupiers is slowly growing. We are still a long way from the euphoria seen in the boom years, but occupiers are again starting to show their interest in owning their own headquarters. On the one hand they realise the combined benefit of a reduction in both prices and interest rates, and on the other hand that banks have started to offer finance again – albeit with strict terms and for clients with a proven track record of solvency.

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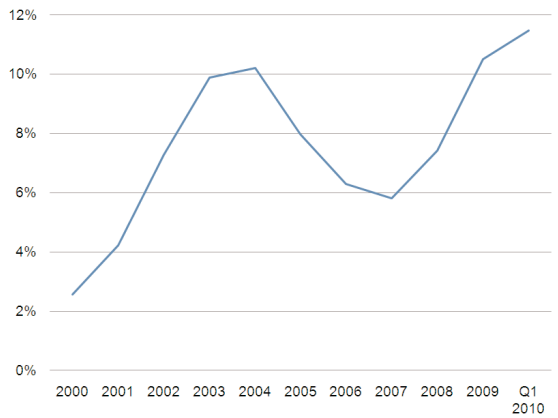
Supply

Booming supply

There is now 1.44 million sqm of vacant office space on the market, which reflects a vacancy rate of 11.5%. The completion of the 56,500 sqm Torre Caja Madrid is the largest addition this quarter, although it will not impact vacancy rates since the company intends to occupy the building as its main corporate headquarters. At the moment it looks like the move will go ahead in June, although it could be delayed depending on what happens in the Madrid office market. The move to the new tower will leave vacant space in the Torres KIO, Celenque and Las Rozas.

Turnkey developments only account for 11,000 sqm of new office space. Heineken will set up its offices in a building in the Montecarmelo PAU, and AVIVA will move into a building that has just been completed by Metrovacesa in Manoteras.

Availability rate



Source: Savills Research

On the other hand, there is nearly 20,000 sqm of newly-available office space in refurbished buildings, which means that out of 100,000 sqm of new or refurbished offices coming to market from January to March 2010, total stock has only increased by 80,000 sqm. And as a result of owner occupation or pre-let deals, the total available office stock will only increase by 34,000 sqm.

A total of 275,000 sqm new build is expected by the year end, although, as we have seen in recent years, delivery timescales can always vary according to market conditions. Mutua Madrileña will continue to delay completion of Torre Cristal for the moment until it has signed up enough tenants to cover the cost of the service charge for the building. Completion of the third phase of the Rivas Futura business park, comprising a total of 45,000 sqm, has been delayed since 2008, but according to market sources, it seems that the scheme could finally be added to Madrid's office stock.

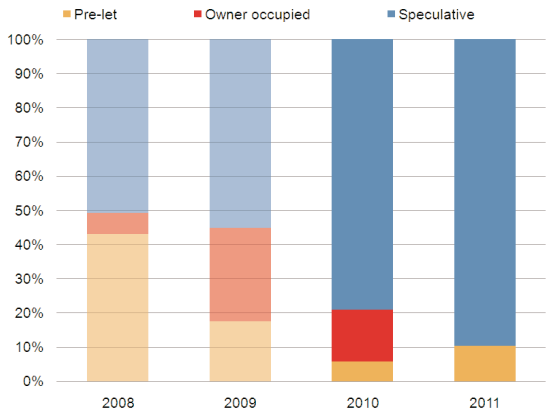
There is very little change in the geographical distribution of current supply. The CBD and the urban area account for just over 25%; business areas in the suburbs (within the M-30) account for 34%; and the remaining 41% is split between the outskirts and the city's arterial access routes.

The amount of vacant space in prime Madrid office locations has increased significantly following the recent vacation of one of Telefonica's old headquarters buildings. After an extensive programme of works, Colonial has completed the refurbishment of Paseo de Recoletos 37-39, which brings a further 17,000 sqm onto the market in the CBD.

The remaining buildings that came onto the market in Q1 2010 have not significantly increased supply, but we have seen higher vacancy rates as occupiers reduce the amount of space taken or move to smaller offices. Accordingly, vacancy rates are at very similar levels to those seen in the previous quarter.

The north-eastern market sector (i.e. between the A-1 and A-2) accounts for over 50% of all vacant space, although it is one of the most highly consolidated areas. Not taking into account the two towers due to be completed by CTBA, this area will comprise two thirds of all new office development completed in 2010. It accounts for 57% of all take up and 38% of demand in the first quarter. It has traditionally been the destination of choice for large corporations choosing to house their corporate headquarters in large buildings.

Future supply



Source: Savills Research

Rents

The fall continues, but at more moderate levels

We have all been having the same conversation about falling rents for the past year and a half. There have not been many changes in general, since the disparity between supply and demand will continue to apply downward pressure on rents.

We want to be clear that we are only talking about gross rents here. The market is still slow enough for tenants to be able negotiate incentives such as stepped rents, rent-free periods or even getting landlords to take on part of the tenant's moving costs to encourage them to move to new offices.

During Q1 2010 closing rents in the CBD were in the region of €28-29sqm/month although, as happened in the previous quarter, there have been deals where higher rents were agreed. Factors such as being located on Castellana, the quality of the building and negotiations with the landlord all have an effect on the final rent agreed.

Compared to Q4 2009, rents have remained relatively stable, with just a 2% reduction. Rents have still fallen by 18% year-on-year, but it is heartening to see that for the second consecutive quarter the rate of reduction is slowing down.

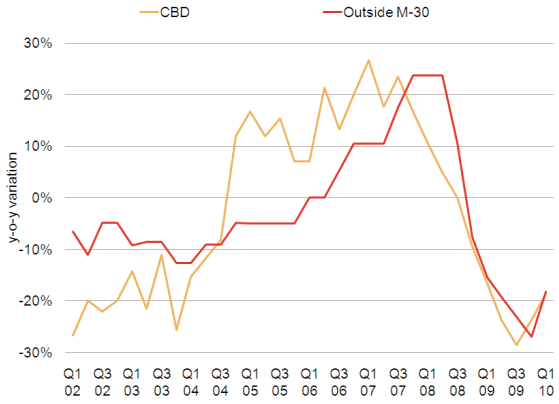
In off-prime locations rents have not changed since the end of 2009, remaining at €24sqm/month. This represents a fall of 17% from Q1 2009.

Outside the M-30, the situation for highly consolidated and secondary areas is basically the same as in the city centre.

Decreases in rents for prime business parks have now started to slow down, whilst rents in zones on the very outskirts are spiralling rapidly downwards, since this is the best way to attract demand.

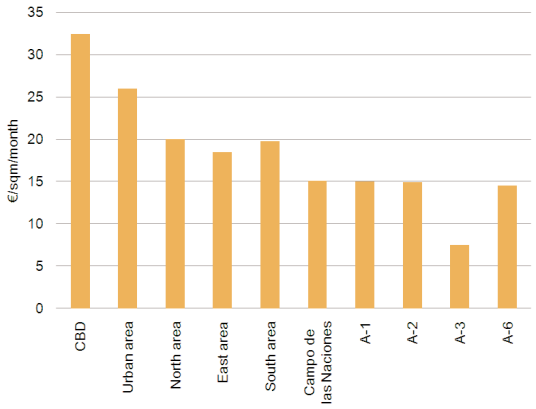
In those areas that have been adversely affected by a worryingly high excess of supply and a less than solid level of demand, rents have fallen to levels normally associated with industrial space. However, as previously mentioned, in these cases price becomes the key incentive to get occupiers to rent space in areas far away from the city where vacancy levels are so high that the place seems deserted.

Prime rents



Source: Savills Research

Top rents in exclusive office buildings - Q1 2010



Source: Savills Research

Major leasing transactions - Q1 2010

Tenant	Area	Size (sqm)	Sector
Mahou	South	7,700	Industry
OHL	North	6,600	Construction
Vivaki	North	4,500	Advertising
Avanzit	North	4,500	Engineering
Aviva	North	4,400	Insurance
Heineken	North	4,000	Industry

Source: Savills Research

Investment

Will the trend of historic lows continue in 2010?

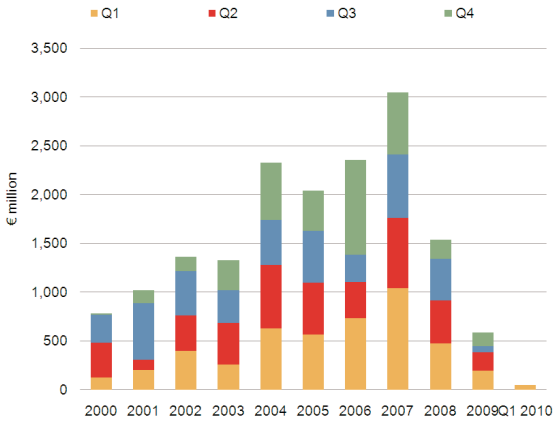
Data for the office market in Madrid at the start of 2010 brought a feeling of optimism, enthusiasm, and above all hope that the market has taken a firm step towards recovery. But the high levels of take-up compared to the same period in 2009 and the slowdown in rental reductions are in stark contradiction to results for the investment market this quarter.

Investment reached a total of just €45 million with only three deals signed, which takes the average investment volume back to levels when the market started to fall in 2008.

None of these deals was within the CBD, where almost all investment demand is focused, but instead were in secondary office locations in the city and in the area to the east of the periphery.

National investors have played the roles of both buyer and seller. Those national players who know the market's potential see the current situation as a great opportunity to purchase.

Investment volume



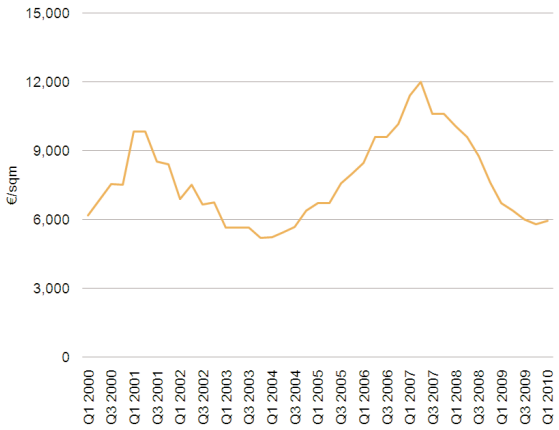
Source: Savills Research

Interestingly, private investors' funds are also being pumped into a product that lies somewhere in between retail and offices: small portfolios of bank and building society branches. Between January and March several financial entities in Madrid increased their liquidity through sale & leaseback deals. The market for purely retail units offers more appealing yields though, and the amount of capital required for this type of investment is not large.

There are still a number of large portfolios on the market. Caixa Catalunya, Banco Guipuzcoano, Caja Madrid and BBVA are still waiting for buyers for their properties, and it seems that Banco Sabadell might have closed a deal on the sale of 378 properties to a British fund; the bank informed the Comisión Nacional del Mercado de Valores that it had formally accepted a binding offer from the British fund Moor Park Capital Partners LLP.

The lack of deals in the office market is not so much down to weak levels of demand, but is more due to a worryingly low level of supply. International funds have been paying very close interest to the Madrid office market ever since yields in London dropped below 6% and since supply in Paris all but dried up. They continue to focus their interest on the CBD, but the lack of supply and the aggressive approach of national investors are hindering deals from being carried out in that market. The solution is to look outside the M-30 towards the secondary locations which, although highly consolidated, could still provide opportunities.

Prime capital values in CBD



Source: Savills Research

Change in yields

The divide between supply and demand is pushing yields down, but this is not leading to an increase in capital values per sqm, since rents have also been decreasing. The reason for this lack of supply lies in the idiosyncrasies of the Spanish market, where most lease terms are for 3+2 years and where, after seven consecutive quarters of falling rents, nearly all leases are now at or very close to market rent. This state of low rents and low yields results in very low capital values.

With prices at these levels, we would expect potential vendors to be companies in a very frail financial position; but ever since the bankruptcy of Lehman Brothers, those who were going to go out of business have done so, and those who have survived take the

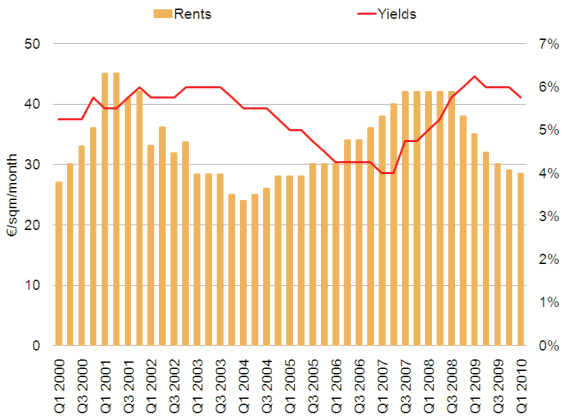
Yields and outlook

view that the best current course of action is to buy property – not to sell it. To top it all, the majority of property is in the hands of the banks (either directly or indirectly), who also do not want to sell at current price levels.

But despite the encouraging take-up figures from the first part of the year, recovery of the occupier market is not going to happen straightaway. We must not allow ourselves to forget that supply of new build offices has not stagnated; on the contrary, some of the largest schemes on the market are still waiting in the wings, but they will require a further compression of yields before they are sold.

With this backdrop, the price pressure created by demand could force yields in the CBD down to circa 5% over the coming months.

Prime rents and Yields in CBD



Source: Savills Research

Economic forecast

Economists are predicting a slight reduction in average annual GDP growth in 2010 and the first shoots of recovery in 2011, which is down to the key drivers of supply and demand: manufacturing, capital investment and household consumption.

Another key consideration over the coming months is the Spanish budget deficit which, as a result of the economic crisis, has increased exponentially to 11.4% of national GDP in 2009. The government's plan for fiscal consolidation, which aims to get the public deficit back under control over the coming years, should restore confidence to the international financial markets following the Greek national debt crisis.

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

	2009	2010	2011
GDP	-3.6%	-0.4%	1.1%
Consumer spending	-5.0%	-0.6%	0.8%
CPI	-0.3%	1.4%	1.7%

Source: Consensus forecast (March)

Market outlook

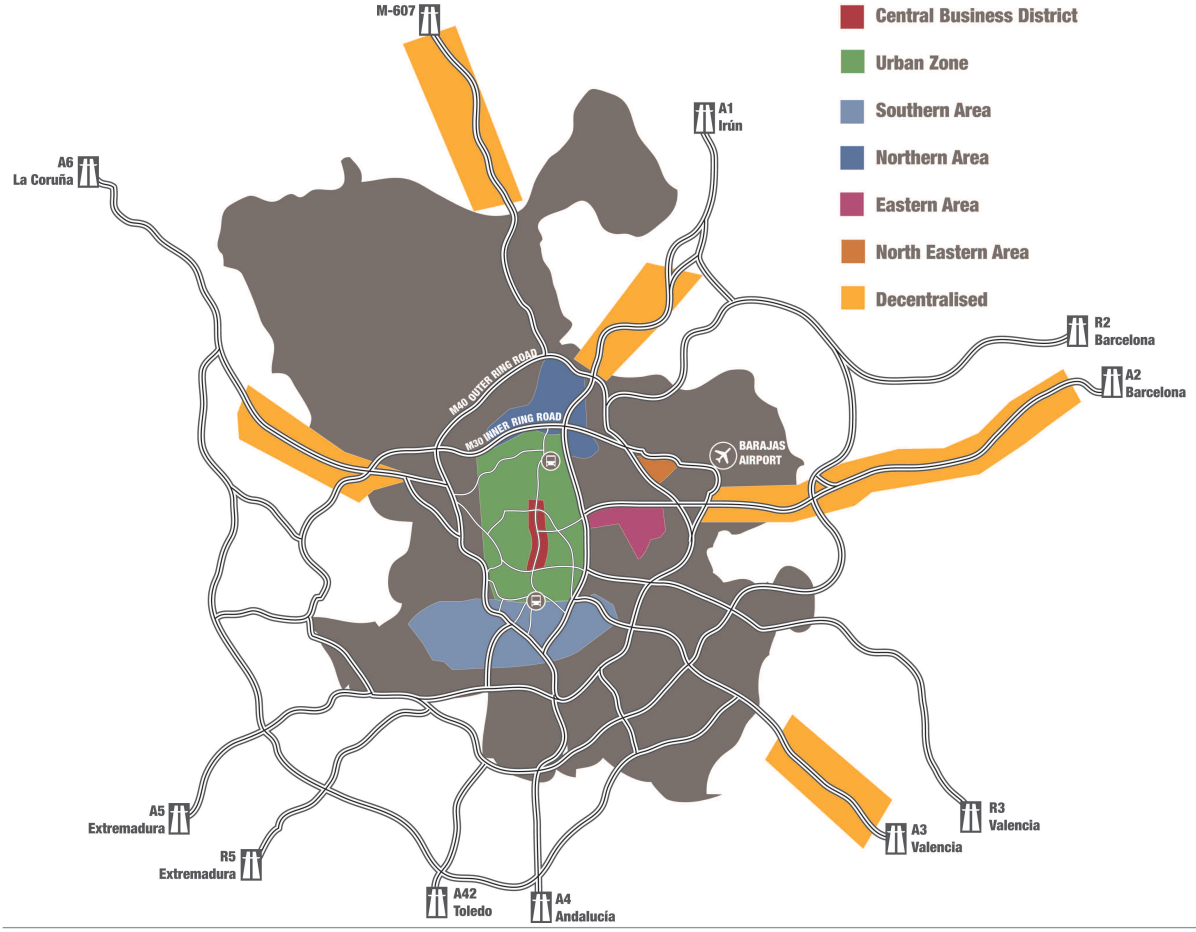
As we predicted at the end of 2009, in Q1 2010 a number of deals were completed that had dragged over from 2009. This resulted in an increase of 54% compared to the same time last year, but demand is staying stable for the moment. The reappearance of pre-lets is adding a little dose of optimism and could help to stimulate the market. Q2 2010 was kicked off by a 15,000 sqm deal – another pre-let. The state-owned AENA (Spanish Airport and Air Travel) is moving its headquarters to a building in Pegasus City Business Park. It will be the first tenant in the complex, but could act as an "anchor" and attract other related companies.

With just over 260,000 sqm of speculative new-build space anticipated before the year end, vacancy rates will continue to rise. Several schemes have been delaying completion for months or even years. If the economic and market conditions do not improve, these schemes could still be kept on stand-by, which would help moderate the increase in vacancy rates.

Everything points to rents continuing to fall. Over the past months the decreases in rents in prime areas have started to slow down more than in secondary areas, which means that we must be close to the trough of the rental market (both inside and outside the M-30). In some buildings, rents have now stabilised. Some deals are being closed in the CBD at 2009 rental levels, though they mark the upper limit of the market at the moment.

Madrid office market

Survey map



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