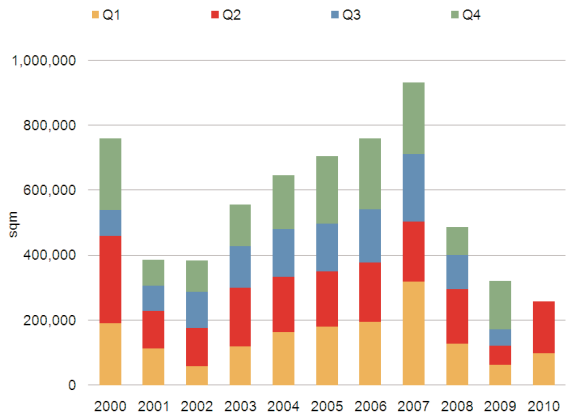
Madrid office market

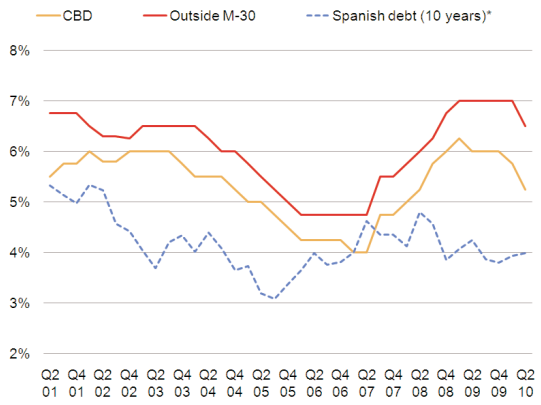
Summer 2010

Annual take-up



Source: Savills Research

Prime yields vs Spanish Bond yield



Source: Savills Research/INE / *Provisional figure for Q2 2010

"One of the most significant investment deals lately, Paseo de Recoletos 3, has set a new record for the length of negotiation period and has exceeded the previous records for yield and price/sqm set in recent years. The number of buyers reflects the demand for this type of assets in the market".

Luis Espadas - Capital Markets Director

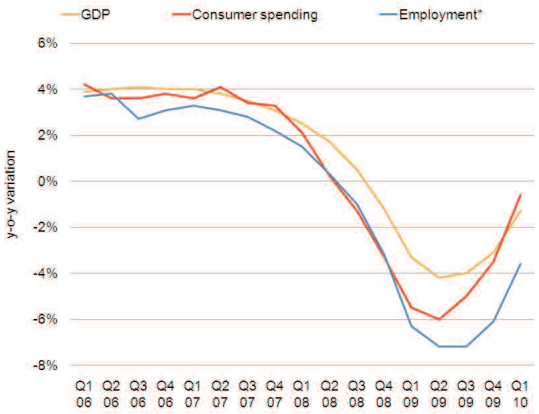
- The near 160,000 sqm that were taken up in the office market in Q2 2010 is more than three times higher than the amount achieved in the same time last year. The figure encourages cautious optimism but it is important to note that nearly 30% of this total is down to three transactions of over 10,000 sqm. As for the first six months of 2010, the 250,000 sqm taken up is double the total for the first six months of 2009.
- The vacancy rate has been rising since mid-2007, and for the third consecutive quarter it has reached a historic high. The rate touched 12% in June, driven by the completion of Torre Cristal and the third phase of Parque Empresarial Rivas Futura.
- Rental values are still on the decline, but year-on year changes are becoming more tenuous in every sub-market. Rents in the CBD remain unchanged from the last quarter, at between €28-29/sqm/month.
- Office investment activity is moving steadily forwards thanks to national investors. Between April and June nearly €370 million was invested, a far cry from just €45 million in Q1 2010. The 2010 first-half total is 7% higher than that of 2009. The most demanded assets are prime office buildings in prime locations, such as Paseo de Recoletos 3, despite the fact that yields and values per sqm are way above fair market values.

Economy

Spanish economic situation

Q1 2010 saw the first year-on-year increases in European GDP according to Eurostat. Average annual GDP growth in the Eurozone countries was 0.6%, compared to just 0.2% in Q4 2009. Every economic indicator recorded improvements in year-on-year changes compared to Q4 2009: with the exception of investment in fixed capital, which fell by 4.8%, many key economic indicators (GDP, household consumption, imports and exports) are now showing positive growth. As for industry, construction is the only sector where year-on-year growth continues to fall, and it is the only sector posting worse results than the previous quarter.

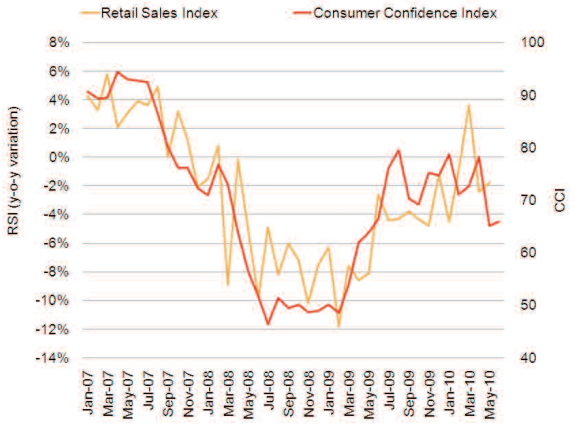
GDP, consumption and employment



Source: INE / *Full time employment

Spain has been left somewhat out on a limb from the general European recovery. Year-on-year GDP growth in Q1 2010 was -1.3%, although this reflected a 0.1% increase from Q4 2009, the first positive change in two years. Household consumption has fallen by just 0.6% year-on-year (compared to previous falls of up to 6% three quarters ago), investment in fixed capital remains in the red and has nearly reached double-digits, having been dragged down by the deterioration of the construction sector, and the negative effect of national demand on GDP is slowly diminishing. Also, imports and, to a greater extent, exports are growing substantially. As for supply, the recent sharp falls seen in the energy and industrial sectors are being reduced, whilst the livestock, construction and service sectors have seen some stagnation in recent months.

Retail sales and consumers' confidence

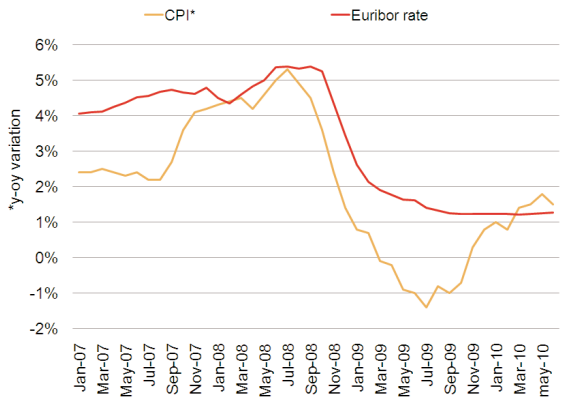


Source: INE, ICO

The recent changes in the Budget have added to the general uncertainty around the economic situation in Spain. In 2009, the public deficit shot up to 11.2% of GDP and Spanish public debt reached 53.2% of GDP; although this level is not above the European average, the international financial markets are pushing for cuts that will lead to a rapid stabilisation of the budget, which could further slow down Spain's economic recovery.

There is still no good news from Spain's labour market: latest data show that 20.1% of the active population is unemployed; this is the highest level of unemployment in the Eurozone, and is twice the average level for the remainder of Europe.

CPI and Euribor



Source: INE

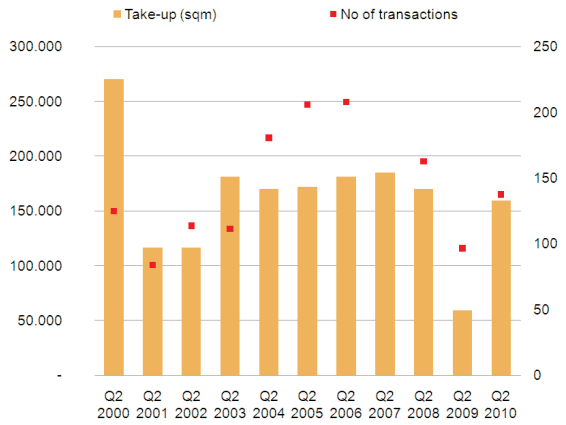
Demand

Demand

Once again the market catches us unaware

Total take-up for the second quarter exceeded expectations by reaching 160,000 sqm, more than three times the level for the same time last year. But despite the potential optimism these figures could create, we must mention that, as at the end of 2009, this total includes a number of deals of over 10,000 sqm. Nearly a third of the total take-up is down to three "mega deals". The state's Spanish Airports and Air Navigation (AENA) set the bar high at the start of April when it confirmed that its new HQ will be located in Pegaso City business park, making it the first tenant in the park. Alcatel will move its offices to the northern part of the city, next to the Las Tablas zone. Finally, after several months looking for offices, AMPER has chosen a turn-key unit in the La Dehesa de Vicálvaro business park. This means that the new building can be adapted to AMPER's specific requirements.

Take-up and number of transactions

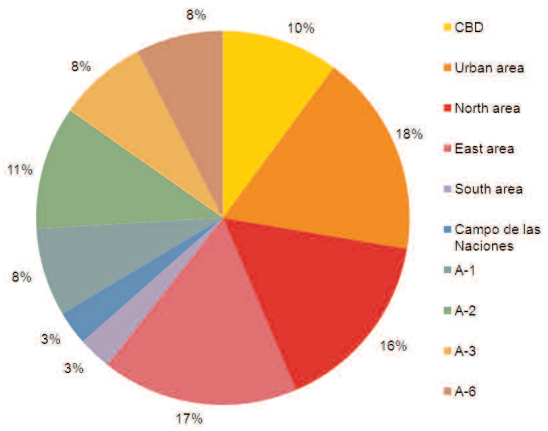


Source: Savills Research

56% of deals signed over 1,000 sqm were outside the M-30, pushing the total proportion of deals closed in the periphery up to 68%. In addition to the areas where the afore-mentioned "mega deals" were closed, the eastern part of the near suburbs is of interest, where a number of lettings of between 6,000 sqm and 9,000 sqm were agreed. The city centre also has a number of options for occupiers looking for large floor areas. For example, Banca Cívica, the new financial entity created by the merger of Caja Navarra, Caja Canarias and Caja de Burgos, will set up its operations centre in the building recently refurbished by Colonial in Paseo de Recoletos.

At the other end of the scale, demand for small offices (<500 sqm) is getting much stronger, and accounts for 60% of the total number of deals closed, as opposed to 50% in the previous quarter.

Geographical distribution of the take-up - Q2 2010



Source: Savills Research

As for building types, buildings in exclusive office use are still the favourite option for occupiers, followed by hi-tech buildings. Offices in residential buildings have been one of the least popular property types in recent years, in terms of both number and size of deals closed. This is not surprising, given the high vacancy rate and currently low prices of traditional office space.

In terms of commercialization there are some key points to note. Firstly, the number of turn-key deals being closed is encouraging. Pre-lets are still being signed, although as we have seen in recent months, these deals are only being closed in buildings that are very near to completion.

Finally, sales to owner-occupiers seem to be on the rise again. This type of deal has headed back into double digits of overall percentage of deals closed, following several years of continued decline. The increased market activity could be due to the "contagious" effect of the increase in residential sales prior to 1st July, with purchasers avoiding the 2% increase in VAT that came into effect on that date, though companies can re-claim the VAT later.

It is clear that there is a latent level of demand which, in the face of a shortage of quality product, is waiting for the right opportunity to come along. The most sought-after space comprises empty floors in exclusive city centre buildings, for less than €5,000 per sqm. Within the M-30 ring road there is fierce competition between private investors who, although more aggressive when it comes to price, are generally quicker to make the decision to purchase.

Supply

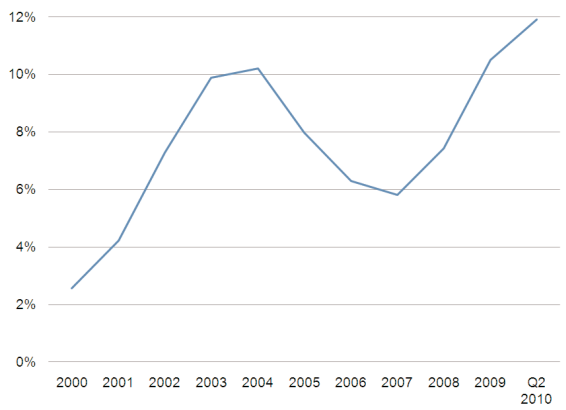
Supply

Availability is on the rise

There are now over 1.5 million sqm of vacant space in the Madrid office market. The final blow was delivered by two developments whose completion was delayed for a number of reasons. With the third phase of the Rivas Futura complex and the Torre Cristal both coming onto the market, the vacancy rate has just hit 12%. But despite the healthy take-up figures, and taking into account that some 20% of space taken-up has yet to be incorporated into the building stock, it seems that current demand will still be unable to absorb the excess of available space in the capital.

On the other hand, and despite the fact that these figures suggest oversupply, in reality the market is suffering from an acute lack of supply of the best quality product. In other words, there is a high proportion of obsolete stock in the Madrid office market, which is more prominent in the urban centre than in the periphery. The completion of new or comprehensively refurbished properties helps rekindle occupier interest, and therefore a number of buildings that have recently come onto the market have already been partially occupied or let in the last few months. For example: Torrelaguna 56, several buildings in Vía Norte (Metrovacesa's new business park in Las Tablas), or the former HQ of Banco Urquijo in Príncipe de Vergara, which will be part-occupied by the new owner. Whereas in any other quarter this would mean a high proportion of space not being marketed, out of the 160,000 sqm of new space coming to the market in Q2 2010, only around 20,000 sqm is left.

Availability rate



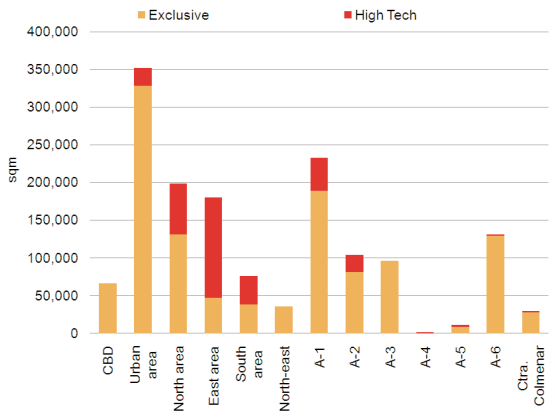
Source: Savills Research

Before the year end, just over 70,000 sqm are due for completion, including (in order of size) two buildings in Ciudad Empresarial ADEQUA and the second phase of Parque Empresarial Vía Norte, both of which are in the northern part of the city.

Some schemes originally due for completion before the end of 2010 have been delayed by several months. As has been the case in recent years, developers either bring the completion date forward or push it back, based on market conditions and tenant interest. Therefore, the outlook for 2011 is currently unclear. Current expectations are for around 205,000 sqm of new office space in Madrid, 40% less than in 2010. But if the two largest schemes, which have been delayed by over a year, are taken out of the equation, the total floor space is similar to the current quarter, at just 15% less.

There are few surprises when it comes to the location of vacant space. The city centre and the A-3 zone make up the lion's share of vacant space following the completion of two "colossal" schemes (around 50,000 sqm each), but the spread is much the same as last quarter. Around 28% of supply is in the CBD and the remainder of the city. The near periphery (areas near the M-30) accounts for 32%, with the remaining 40% in the business parks along the city's main access routes.

Distribution of the available space - June 2010



Source: Savills Research

Interestingly, the vacancy rate in the CBD has fallen considerably from nearly 11% last quarter to just over 7% in June. The return to market of one of Telefónica's vacant but fully refurbished former HQ buildings in March helped the prime vacancy rate to be closer to the global market vacancy rate. The area accounts for 10% of take-up between April and June, including the letting of half the building by Banca Cívica, which significantly reduced the level of supply in the financial centre.

Rents and transactions

Rents and transactions

Stability in the prime market?

It's still too early to be talking about rental growth, but the falls in rental values are getting ever smaller. Nonetheless, the market is not evolving consistently, and so there are two different sub-markets for rental behaviour. Whilst rents in the CBD remain unchanged from last quarter, rental values continue to fall in some areas. Year-on-year rental changes are still in the red for every sub-market, with the smallest change, at around -11%, being recorded in prime areas. At the other end of the scale is the outer periphery, with rental changes still greater than -20%. Compared to the peak of the market, rents are 32% lower in the CBD and its surroundings, and up to 40% lower in the furthest outskirts of the city.

Prime rents within the M-30 in Q2 2010 remain unchanged from Q1, at between €28/sqm/month and €29/sqm/month. But this is just a theoretical figure, since some deals have been closed at higher rents. Nonetheless, the law of supply and demand still favours the occupier, who is being given large margins for negotiation. If one looks in more detail at some deals closed at or above a headline rent of €30/sqm/month, these deals are often hiding scaled rental increases throughout the term of the contract, extended rent-free periods, shared fit-out costs and free parking places.

These and other incentives are ubiquitous throughout the market. It is easy to draw the wrong conclusions from the positive quarterly take-up figures, as there are enough alternatives for potential office occupiers for them to cherry-pick their best option. Although there are clearly a number of obsolete buildings with antiquated infrastructure and services, these can still prove very attractive to certain tenants because of their location, easy access to the area, good public transport links, local services, or interior layout. In these cases the inevitable flexibility of the owners on rents means that a deal is normally agreed.

In the least sought after areas, i.e. the submarkets where supply continues to rise, rents can fall to almost the same level as industrial units, which means that owners' margins are drastically cut, and in some cases, deals can even become uneconomical.

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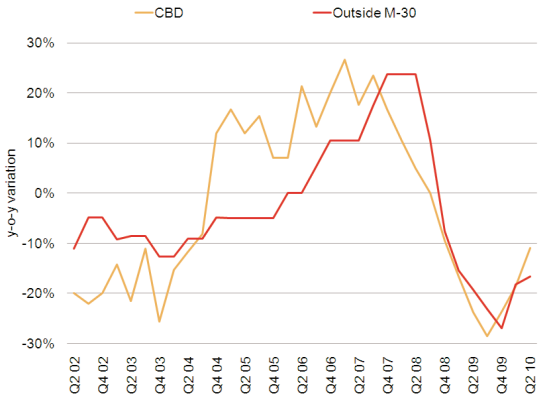
Prime rents



Source: Savills Research

Major leasing transactions - Q2 2010

Tenant	Area	Size (sqm)	Sector
Alcatel	North	17,500	IT
Aena	A-2	15,000	Public Administration
Amper	A-3	11,000	IT
Fundación Tripartita	East	9,000	Public Administration
Banca Cívica	CBD	7,600	Bank
Samsung	A-1	7,500	IT
Cofeli GDF Suez	East	6,500	Energy

Source: Savills Research

Major investment transactions - Q2 2010

Purchaser	Area	€ m	Address
SEB	A-6	108	Caja Madrid HQ
C. Compensacón de Seguros	AZCA	105 *	Master's II
Banco Sabadell	A-1	51	Valgrande, 6
Private investor	CBD	48	Pº Recoletos, 3 **

Source: Savills Research / *Estimated / **Advised by Savills

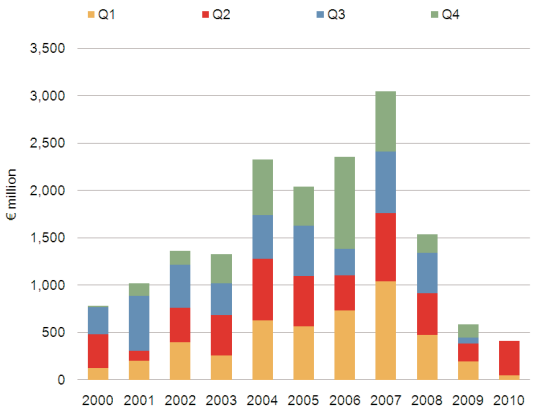
Investment

Investment market

The market awakes from its slumber

It would seem that the investment market is coming back to life. The total amount invested in the second quarter of 2010 is far greater than in the first quarter, when the total was only €45 million. Between April and June a total of €370 million was invested, nearly double the total for the whole of the same period in 2009. The half-yearly total is over €400 million, some 7% higher than in the first half of 2009. With the drive provided by Q2, the average investment volume has risen to €34 million, from €15 million reached in Q1.

Investment volume



Source: Savills Research

Investment transactions are still currently focused within the M-30, which accounts for 56% of all investment so far. In the current market, national investors are free to roam as they please. They know the market like the back of their hand and are very aggressive on prices, achieving yields that are out of reach of international investors (always sub-7%). Only the French firm Continental Property has dared to dip its toe into the urban office market, buying into a complex by Metrovacesa that comprises two hotels and an office building.

The ideal product is an exclusive office building, located in the CBD or adjacent to it, occupied by solvent tenants with long unexpired lease terms. The typical purchaser would be a private national investor. Average lot size ranges from €20 million to €50 million, the investors have good liquidity and they may not even need finance.

Although the urban area is their usual hunting ground, they will not dismiss opportunities further afield; a number of deals have already been closed in the Julián Camarillo area. Yields are higher in this submarket, though the product they are looking for is still only available in small lot sizes.

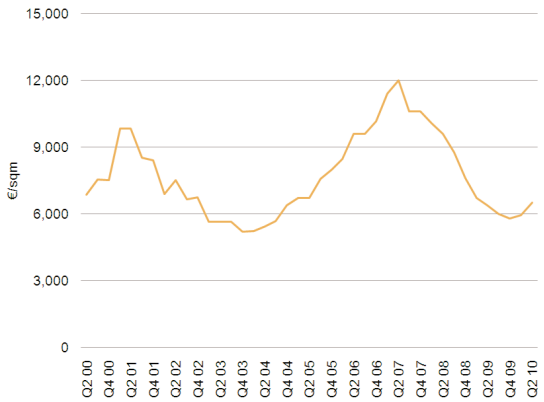
The sale & leaseback of Caja Madrid's HQ in Las Rozas was a particularly large transaction, and yet again a foreign investor was involved: SEB acquired the building in which Caja Madrid has a lease term of 30 years, for €108 million.

But sale & leaseback deals are no longer the exclusive realm of the banking sector. Ferrovial's disinvestment strategy, which started at the end of 2009, continues with the sale of the building occupied by its waste disposal affiliate, Cespa.

One of the landmark deals of the quarter was for Paseo de Recoletos 3, in which Savills Capital Markets division acted as advisor to the vendor. The building, which marked the peak of values per sqm when Grupo Ballester acquired it in 2006 (around €12,000 per sqm), has now changed hands. A Spanish private family investor came up with the best offer from a select group of investors that showed interest as soon as the "For Sale" sign appeared. The price of €48 million is a third less than the price originally paid for the building; the market conditions, combined with the economic contraction, are markedly different now but, despite everything, the price per sqm has reached another milestone, overcoming €8.000 per sqm. We believe that this is the first of a number of similar interesting opportunities that will result in capital values being well above market expectations compared with recent years.

The building perfectly suits national investor requirements. It benefits from a Prime location (it is in the first section of the CBD axis), high quality specification (it was refurbished in 2001) and is occupied by a tenant of good covenant strength. It currently has several vacant floors, but the extent of tenant demand in the area should result in the building once again achieving 100 % occupation in the short term.

Prime capital values in CBD



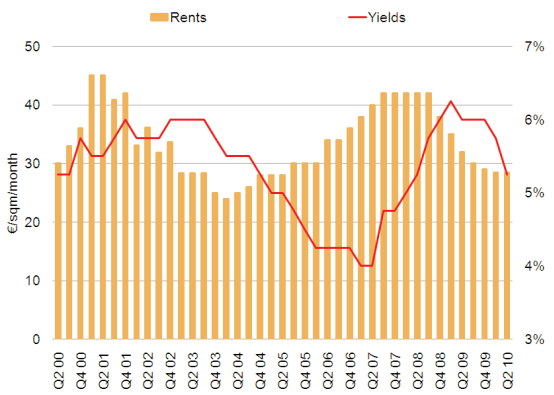
Source: Savills Research

Yields and outlook

Yield shifts reach the whole market

Yields are being forced down by ever-increasing levels of demand. In the CBD, stability in rental values has led to an increase in capital values, but we are talking about a very specific product: prime buildings in prime locations. Rising values do not pose a problem to national investors, who are confident that when the market finally recovers, the recovery will start in this area.

Outside the M-30, investors have set their sights on the prime areas. There are new, semi-new and refurbished buildings, either fully let or with high occupancy levels, located in dominant locations within their submarkets, that are giving yields more akin to those sought by the international investors. The only unconvincing element for foreign investors looking to buy into these markets is contract length. The traditional 3+2 year term in Spain is in stark contrast to the long contracts found elsewhere in Europe. In their opinion, this increases risk and should therefore be offset by higher yields.



Prime rents and yields in CBD

Source: Savills Research

Outlook

Economic outlook

The economic austerity measures and public spending cuts announced by the Government of Spain to control the public deficit, have shattered expectations of good economic growth in both the short and medium term.

Having technically come out of recession on Q1 2010 with quarterly growth of 0.1%, it is possible that some economic indicators, such as household consumption, will once again deteriorate in the coming quarters. This would be the result of increased taxes, reduced salaries and deterioration of the labour market, among other factors. In any case, the trend of long-term gradual improvement of the Spanish economy will continue, though we will have to wait to find out how rapidly and intensively this will be.

	2009	2010	2011
GDP	-3.6%	-0.5%	0.6%
Consumer spending	-5.0%	0.0%	0.4%
CPI	-0.3%	1.5%	1.4%

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

Source: Consensus Forecast (July)

Market forecast

The positive results from Q1 and Q2 2010 are in contrast with what were previously cautious forecasts for 2010. Combined take-up between January and June is just under 260,000 sqm, double the level for the same period last year. On the other hand, take-up figures for the first half of 2010 are only 20% below the total take-up for the whole of 2009, which makes it highly likely that total take-up for 2010 could reach between 350,000 sqm and 400,000 sqm. The large transactions completed will determine whether the total for 2010 is nearer one extreme or another.

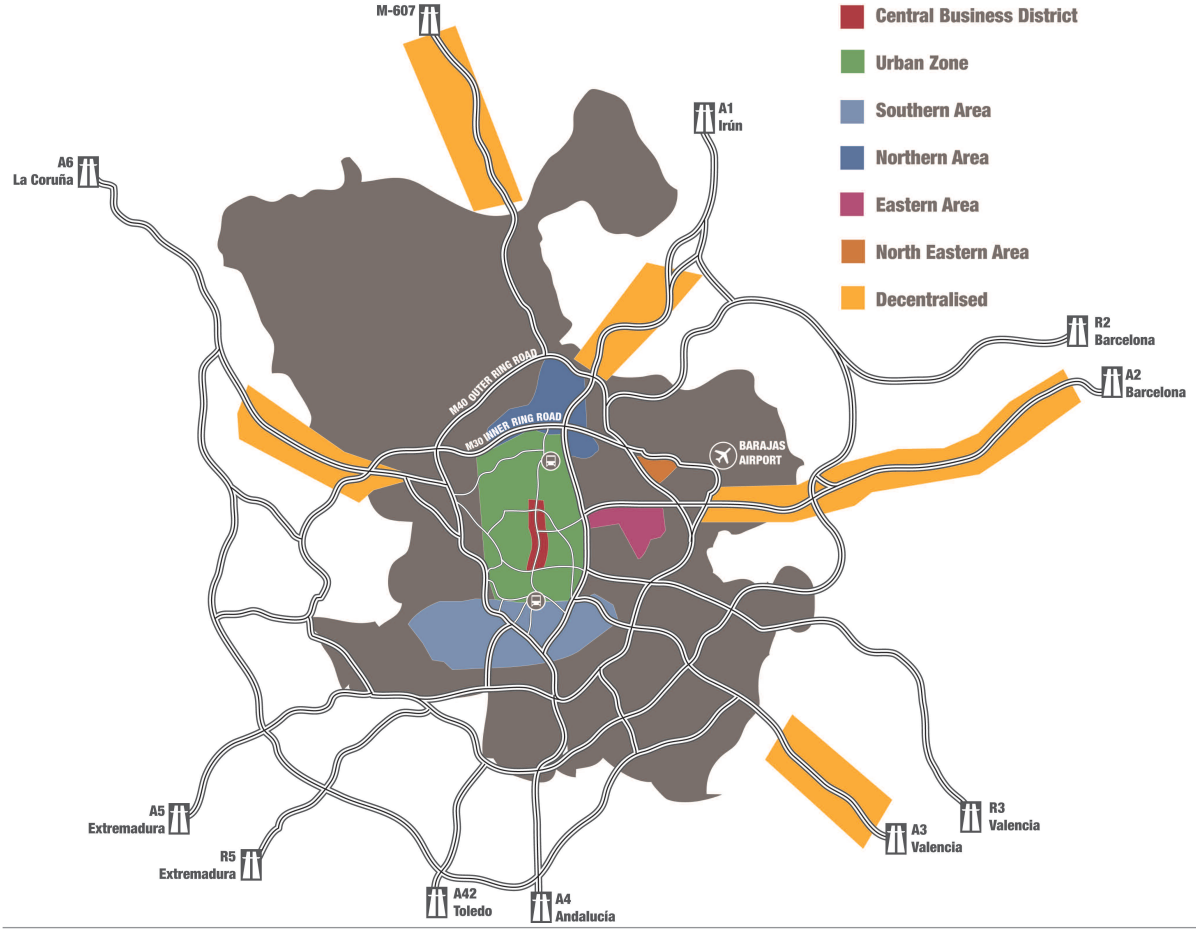
As per usual, during the summer break market activity will slow down, but despite the fact that there was a drop in demand for offices in June, LG signed the lease for its new 5,500 sqm HQ building in Las Matas.

The CTBA has finally been finished. The completion of Torre Cristal has increased vacancy rates in the urban area, and has led to a significant rise in the vacancy rate within the complex. Flexibility from landlords appears to be the only way to get the space let quickly.

In the investment market, demand for landmark office buildings in the centre of Madrid remains strong, given the lack of available product and in spite of initial yield levels. Bearing in mind the portfolio-building approach of traditional private investors looking for this type of building, they are focusing more on the quality of buildings, their location and price per sqm. The safe bet for national investors is the CBD in Madrid, since they know the market and they know it is a safe haven. In boom years it achieves the highest rents and capital values per sqm, it is one of the first areas to come out of periods of recession and it always has vacancy rates below the market average.

Madrid office market

Survey map



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