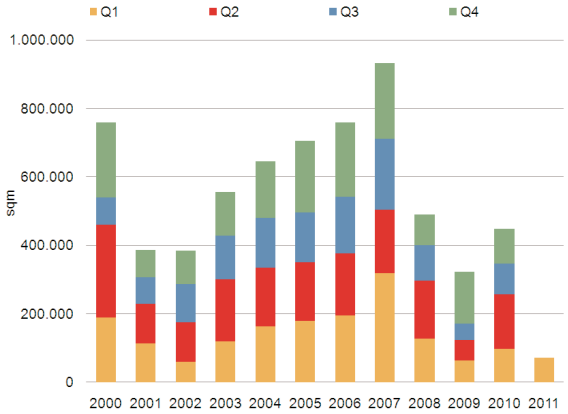
Madrid office market

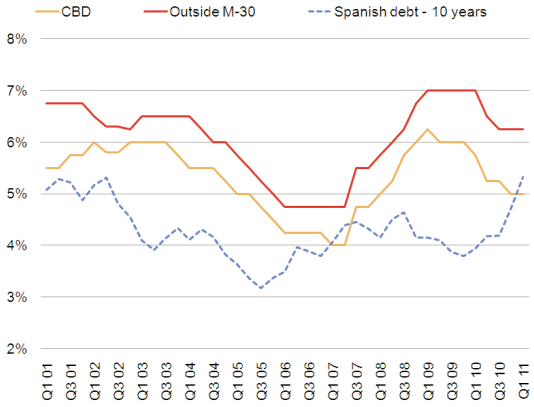
Q1 2011

Annual take-up



Source: Savills Research

Prime yields vs Spanish Bond yield



Source: Savills Research, INE

"We are in a moment of transition: the economic situation has delayed the onset of a new growth cycle in the office rental market. In the investment market, activity will be boosted by the rising supply of quality investment product".

Pablo Pavía - National Office Investment Director

- Economic uncertainty has delayed growth plans in most of the business sectors. In this uncertain environment, take-up volume for the quarter slightly exceeded 70,000 sqm, which is 25% below the take-up figure over the same period last year and reaching the level recorded in Q1 2009.
- The overall market vacancy rate fell by a few tenths of a percentage point, reaching around 11.5%. This modest decline was mainly due to a reduction in the amount of newly completed space being marketed and also because several companies that have completed large transactions in recent years have still not moved to their new premises.
- Rents in the office market are moving at different speeds. Whilst rental declines in the CBD and prime areas outside of the M-30 are reducing, rents continue to fall significantly in areas furthest from the centre in a bid to attract occupiers.
- International investors are getting involved in the office sector once again. RREEF (Deutsch Bank's real estate investment fund) and CPI (Continental Property Investments) were involved in transactions in 2010 and have reappeared in the market. Yields remained stable mainly because of a lack of activity in the market.

Economy

Economic situation

The Spanish economy is recovering slowly. We are in a period of intense uncertainty both domestically and abroad and although the global economy is expected to grow, several recent factors will affect recovery: an increase in the price of raw materials, social and political instability in oil exporting countries, the natural disaster in Japan (the third largest economy in the world), the collapse of outlying European countries (Ireland and Greece and now Portugal) and the need to bail them out, the ECB increasing interest rates to combat increasing inflation in Europe. This is making us more cautious when assessing the future development of the economy and it puts a question mark over expectations for exponential growth in the short-term (at least for the moment).

GDP, consumption and employment in Spain

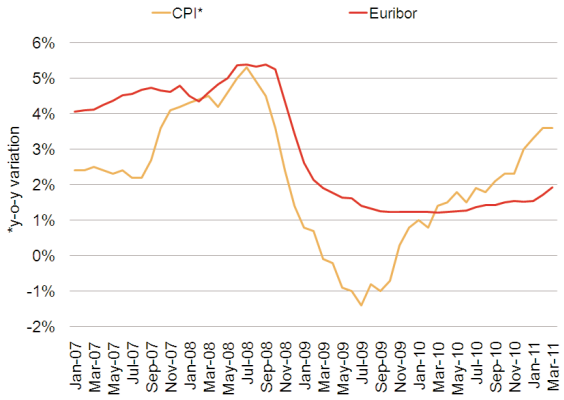
Source: INE

Spain's economy grew by 0.6% in the last quarter of 2010 and its average year-on-year GDP for 2010 was -0.6%. Most of the indicators improved slightly in recent quarters, but some of the factors highlighted previously (increase in interest rates and prices, together with the continued deterioration of the job market) point towards weak consumption and national demand in general and this may mean that the Spanish economy will remain sluggish over the next few months. However, there are some positive aspects, which are encouraging a certain degree of optimism: the measures taken to control the deficit have meant that Spain is rated higher abroad. The country does not currently fall under the criteria for economic intervention. In addition, variables such as investment in capital goods or exports are performing well, and foreign tourism is expected to recover in 2011.

It is widely recognised that the Spanish real estate market played a significant role in the origins of the crisis in Spain, especially in terms of its different characteristics compared to other countries, as well as changes in the sector. Focusing on the Madrid office market in particular, there has been a significant correlation between take-up or investment activity and macroeconomic development, particularly GDP and employment since the beginning of the crisis. We must highlight the differences (in this case positive differences) between Madrid and Spain as a whole: the unemployment rate in the Community of Madrid is significantly lower than the rate for Spain overall (15.75% compared to 20.33%) and it has improved in recent quarters. Considering the relationship between the office market and employment in the services sector particularly, the percentage of employees out of the total in Madrid has increased from 77.7% to 83% in the last 3 years (in Spain the current figure is 72.8%).

Taking this into account together with the demand for office buildings, economic activity and the job market and considering that these variables will remain similar, presumably the market will recover in the medium term and will return to average levels seen in the past. General economic growth may enable the job market to recover (reaching levels seen in recent decades around 1.2% or 1.3% for net employment creation) although the situation is still not good (over 20% national unemployment).

Spanish CPI and Euribor



Source: INE

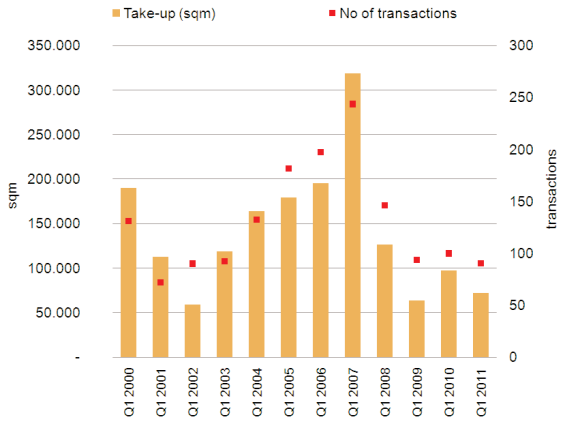
Take-up and demand

Demand

Expansion plans postponed with no fixed date to restart

Over the first few months of 2011, the general trend as regards the development of the economic climate was still one of mistrust. Take-up was around 73,000 sqm which is around 25% less than the same period last year. There has not really been a difference in the number of transactions, which have fallen by 8%. Demand has been cautious over the first quarter.

Take-up and number of transactions



Source: Savills Research

There is a 50% difference (approx.) between quarterly take-up and average take-up figures for the past five and ten years.

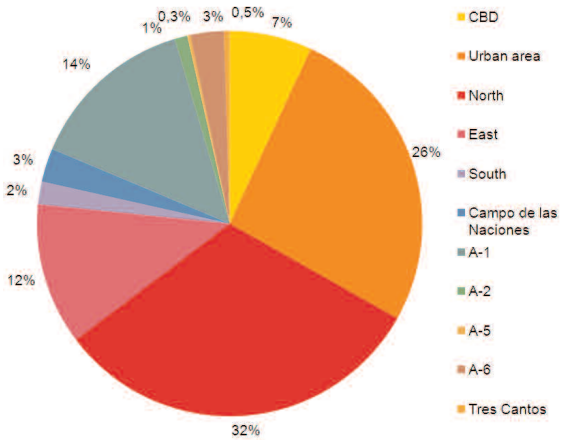
Last year, large transactions pushed take-up levels up slightly and they have had a modest presence over the first quarter. The number of transactions in this range is similar to previous quarters, but take-up for large areas (> 1,000 sqm) is 65%, whilst in 2010 it was 73%, so this means that smaller areas were taken. Only five transactions over 3,000 sqm were completed and these are all in the north of Madrid. Three of them are in the periphery areas closer to the centre, one in Alcobendas and another in San Sebastián de los Reyes.

The largest transaction was for a property that was recently renovated near the old Fuencarral-Alcobendas motorway. BBVA let around 9,000 sqm in an area where in 2007 it let around 24,000 sqm. The proximity to its future financial city and the low rental level are causing several divisions to congregate in the area. But BBVA is not only located here – the bank also took a considerable amount of space in Manoteras few years ago, a submarket also very close to its future headquarters.

Although 70% of the transactions over 1,000 sqm were completed outside the M-30, some noteworthy transactions were completed in the urban area. The headquarters of the Universidad de Deusto will be located in a small palace in the Salamanca neighbourhood of Madrid, and the building which Telefónica occupied in Paseo de Recoletos is slowly starting to be occupied. The pharmaceutical company Celgene will share its headquarters with Banca Cívica and the legal firm Jones Day Reavis & Pogue, located in Paseo de Recoletos, 37-41.

The lack of presence of local, regional and central public administrations was apparent. The municipal and autonomous elections that will take place in the end of May could be holding relocation plans back or regroupings of some organisations or institutions that depend on the Town Hall and the Community. Given that general elections are set to take place in 2012, the central government is expected to carry out some transactions this year, although this is directly linked to the decision-making period. Since last year there have been rumours that government bodies such as ICEX (Instituto Español de Comercio Exterior) and the CNMV(Comisión Nacional del Mercado de Valores) have been looking to relocate their headquarters to new properties and the press has published potential properties that could be of interest, however, as of now we are not aware of any contracts having been signed.

Geographical distribution of the take-up



Source: Savills Research

The sales market doesn't have a good time. The economic climate is still dominated by uncertainty, access to finance is not as easy as it used to be and interest rates are increasing. These factors are pushing occupiers towards the letting option.

Supply

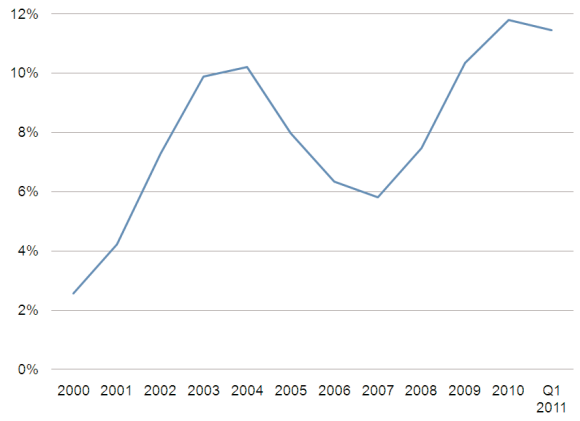
Supply

Change in trend? No yet

After thirteen consecutive quarters of growth, the vacancy rate has provided some respite in the Madrid office market with vacant space now at less than 1.5 million sqm. The difference in the vacancy rate compared to the end of 2010 is barely three tenths of a percentage point and several factors have influenced this. On the one hand, only 3,500 sqm of new space have come onto the market and on the other hand, several companies that completed large transactions in 2010 (AENA or PwC) have still not left their existing headquarters.

The average overall vacancy rate for Madrid is 11.5%, although some areas are still far away from this. The vacancy rate in the CBD is at around 5%, whilst several areas in the periphery are at double or triple the market average.

Availability rate



Source: Savills Research

With regards to projects that are expected to be completed over the next two years, the initial figure of around 350,000 sqm is slightly above the figure for 2010, although we must remember that almost 45% of the total for last year included several developments whose completion dates had been delayed over the previous two years. But not even the overall excess of supply or the overall situation in the market will ensure that the space will be completed as expected, so it is very likely that there will be delays when completing various developments, which are currently being constructed.

Not all the space that we expect to be completed in 2011 will be marketed, because around 40,000 sqm is already pre-let. AENA and Peugeot for example will open their headquarters after the summer.

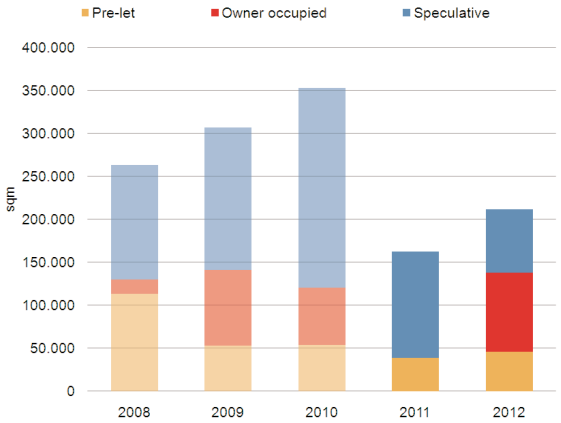
Out of the developments that are expected to be completed, the 50,000 sqm Reyal Urbis business complex stands out. It has been built at the junction between the A-2 and the M-40 on a plot that used to house Casbega's old bottling plant. Solvia (the real estate subsidiary of Banco Sabadell) has been responsible for the project since last year, after the refinancing process.

26% of the total amount of space coming onto the market in the CBD and its surroundings will be new or renovated office space and this increases to 33% if we only consider the space that will be marketed.

Despite the decline in new developments coming onto the market, second hand properties coming onto the market will increase the vacancy rate. Several properties will be vacated over the year as their current users move their headquarters to new properties. On the other hand there has been a lot of large-volume demand in the market for a while and firms could start making decisions about properties that adapt to their requirements, which would increase the vacancy rate further. Properties that remain vacant will have to undergo refurbishment works in the short or medium term to refresh their image and to adapt the space to technical requirements and current technologies. The owner will decide whether to start works quickly or wait to see if the general market situation improves, which will bring forward or delay the availability of space, but in a year to eighteen months the market will have over 100,000 sqm of extra supply.

This and other ambiguities will become clear as the year goes on.

Pipeline: new developments and refurbishments



Source: Savills Research

Rents and transactions

Rents and transactions

Rents ease briefly

Rents in the office market are moving at different speeds and there are two very different realities in this respect. Although year-on-year variations remain negative, the strength of the CBD and prime areas of the periphery areas is causing the pace of decline to slow for the sixth consecutive quarter. Conversely, in the areas furthest from the centre where the excess in supply exceeds “healthy” levels, price becomes the main incentive to attract occupiers.

Rents in the CBD remained stable compared to the previous quarter – between €27 /sqm/month and €28/sqm/month which is -3.5% year-on-year.

With regards to rents for properties for exclusive office use, 60% of transactions were between €25/sqm/month and €30/msq/month in the first quarter, amounting to an average of just over €25/sqm/month.

In the urban area there is a wider spread in rental prices, but 38% of transactions were for rents between €18/sqm/month and €20/sqm/month.

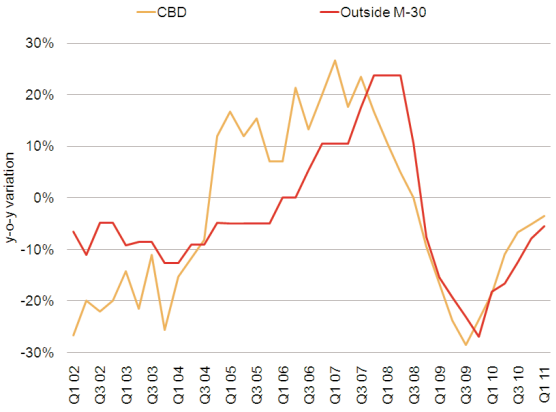
Outside the M-30, rental prices are linked to the conditions in the specific submarkets. In the first stretch of the main access points to the city, maximum rents are between €16/sqm/month and €17/sqm/month, whilst in the business centres of the municipalities further out, vary between €7/sqm/month and €9/sqm/month.

Generally speaking, rents in the Madrid market decreased by 10% compared to the same period last year. If you look at quarter-on-quarter figures they are stabilising at around -2%.

Incentives and temporary rental discounts continue to be the order of the day. All manner of ways of attracting tenants are being employed, including long rent free periods, scaled rents, contributions to fit-out works, contributions to removal costs, parking spaces included in the total etc. But this formula is not accepted by all owners: some have faith in the fact that their properties are different and they are not currently accepting excessive discounts despite the fact that this can push demand towards competitors’ properties (which are sometimes located just a few metres away).

Therefore, asking prices have generally decreased slightly, which still allows for a wide negotiating margin.

Prime rental growth



Source: Savills Research

Main leasing transactions - Q1 2011

Tenant	Area	Surface (sqm)	Activity
BBVA	North	8,900	Bank
Confidential	North	3,800	IT
OGOZA	A-1	3,700	Distribution
Bombardier	A-1	3,500	Industry
Técnicas Reunidas	North	3,400	Professional services
Richemont	Urban area	2,600	Industry
Renault Trucks	Este	2,500	Industry

Source: Savills Research

Main investment transactions - Q1 2011

Purchaser	Area	€M	Address
RREEF	A-6	28.00	Dia HQ
Private investor	CBD	25.50 *	Pº de Recoletos, 17
CPI	Urban area	22.00 *	Serrano, 240
Private investor	A-6	20.00 *	ONO HQ

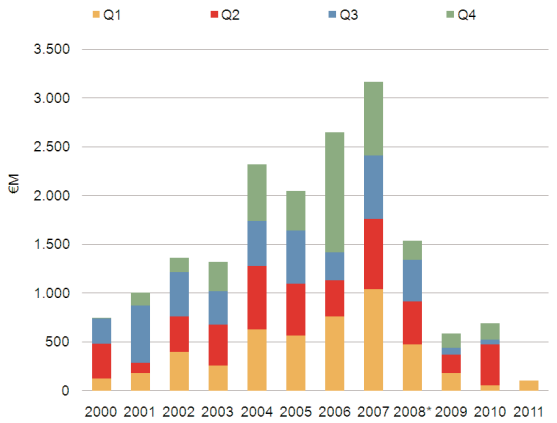
Source: Savills Research / *estimated volume

Investment market

Investment market

Investment market in slow motion

Over the first three months of this year, the investment market slightly exceeded €100 million. Although this figure is double that of the first quarter the year before, it is not very encouraging if one takes into consideration that it was the lowest figure for the last decade.



Investment volume

Source: Savills Research

The marker opened in January with an operation carried out from investment activity in 2010.. The current headquarters of Grupo Dia in Spain is located in one of the three buildings in the Tripark complex that Hines developed in the Las Rozas Business Park increased RREEF's asset portfolio.

As we indicated in our previous report, one of the most positive aspects of the market is that international investors are slowly getting involved in the office market again. As we just mentioned RREEF, Deutsche Bank's real estate investment fund joined the French company CPI (Continental Property Investments) in the market. Both were involved in transactions in 2010 and they reappeared in the market as buyers. At the moment the distribution of transactions has been 50:50 – 50% for national investors and 50% for international investors; but in terms of investment volume, international investors have a slight advantage with 53% of the total over the quarter.

National companies are leading the sales market, despite the presence of Hines with the sale of the Tripark building.

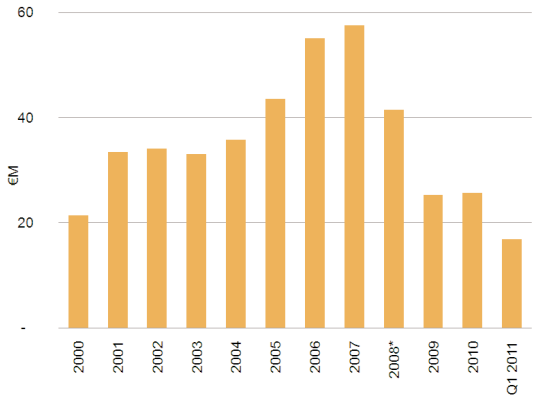
This was not the only transaction that took place around the A-6. It is one of the most consolidated markets in the periphery and it attracts both national and international investors. A Galician family office bought ONO's headquarters in Pozuelo on a sale & leaseback transaction.

In the city centre, the CBD continues to stir interest amongst local and foreign investors. Just like last year, the lack of properties for sale and the large amount of demand caused yields to decrease in order to make offers more competitive.

Up until now the aggressiveness of national players has stopped international players from entering the market, but at the end of last year a German fund managed to join the select club of owners in the main area of Madrid by purchasing a property that did not come to market. The yield was around 5% but we should see this as an exceptional case - several factors benefited the transaction, as it was a sale & leaseback transaction for a single property located in the first stretch of Paseo de Recoletos.

International companies will not be interested in properties with yields under 5.5% to 6%, so they will have to go to secondary markets in the urban area or to business areas in the periphery outside of the M-30 ring road.

Average investment volume



Source: Savills Research/ *excluding Ciudad Financiera del Santander

Yields stabilise

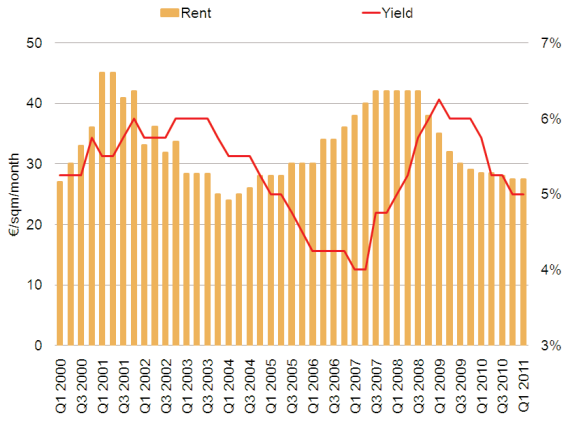
Stability has come about primarily due to the lack of activity in the market. In our opinion the yields in the CBD are the same as the previous quarter – between 5% and 5.25% but if there was a property for sale that fulfilled all investment requirements (quality building in a good location with a solvent tenant and long-term contracts) the demand from national investors would put pressure on yields.

Yields and forecasts

The situation is quite the opposite in the secondary centre of the urban area. There is supply but it does not adapt to buyers requirements, which has slightly increased yields to 6.5% to 6.75%.

International investors could find yields that are in line with the requirements in the prime areas outside of the M-30, so they may look to these areas.

Rents and yield in CBD



Source: Savills Research

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

	2009	2010	2011	2012	2013	2014
GDP	-3.7%	-0.1%	0.6%	1.3%	1.7%	1.9%
Consumption	-4.3%	1.3%	0.3%	0.9%	1.3%	1.6%
IPC	-0.2%	1.8%	2.5%	1.6%	1.6%	1.6%

Source: Focus Economics (April)

Economic forecast

Spain will continue to recover, but the recovery may be sluggish over the next few months as the increase in prices causes consumption to fall. Consumption is already weak due to a decline in household spending power and the continued (albeit to a lesser extent) increase in unemployment.

This year GDP figures will be positive, and they will increase in the years to come. In the same way, most supply and demand variables in the medium and long term will recover lost ground, and Spain will be on the path to economic growth. Nevertheless, in order to deal with Spain's biggest issue, unemployment, economic recovery must not be delayed. Spain will probably not start generating net employment again until 2012 and it will be even longer until it returns to acceptable levels.

Market forecasts

Everything points towards 2011 being a year of transition. Growth plans will be delayed in most of the business sectors due to economic uncertainty and as a result, take-up levels will be similar to those in 2010.

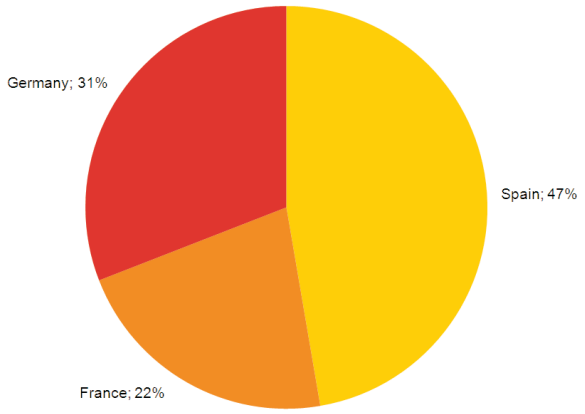
In terms of supply, after the delay of new developments coming onto the market for several years, which distorted their caution and prudence attitude, the volume expected for the next few months will finally adapt to the situation of excess supply that continues to dominate the market. Despite all of this, some projects could delay their completion dates further. As in the past, the amount of new space will continue to change over the year.

In addition to new or renovated space that will come on to or re-enter the market, second hand supply will significantly increase the vacancy rate of specific areas of Madrid.Consequently, rents will continue to fall.

With regards to the investment market, it is still too early to gauge the estimated investment volume for the year, but it is expected at least to reach levels seen over the past two years. International investors will return to the Madrid office market and this will probably increase the average transaction volume. International investors will be able to access products that national investors cannot.

With regards to yields, the fact that the ECB has increased interest rates could imply the demand of higher yields on the part of potential investors, in contrast to the current downward trend.

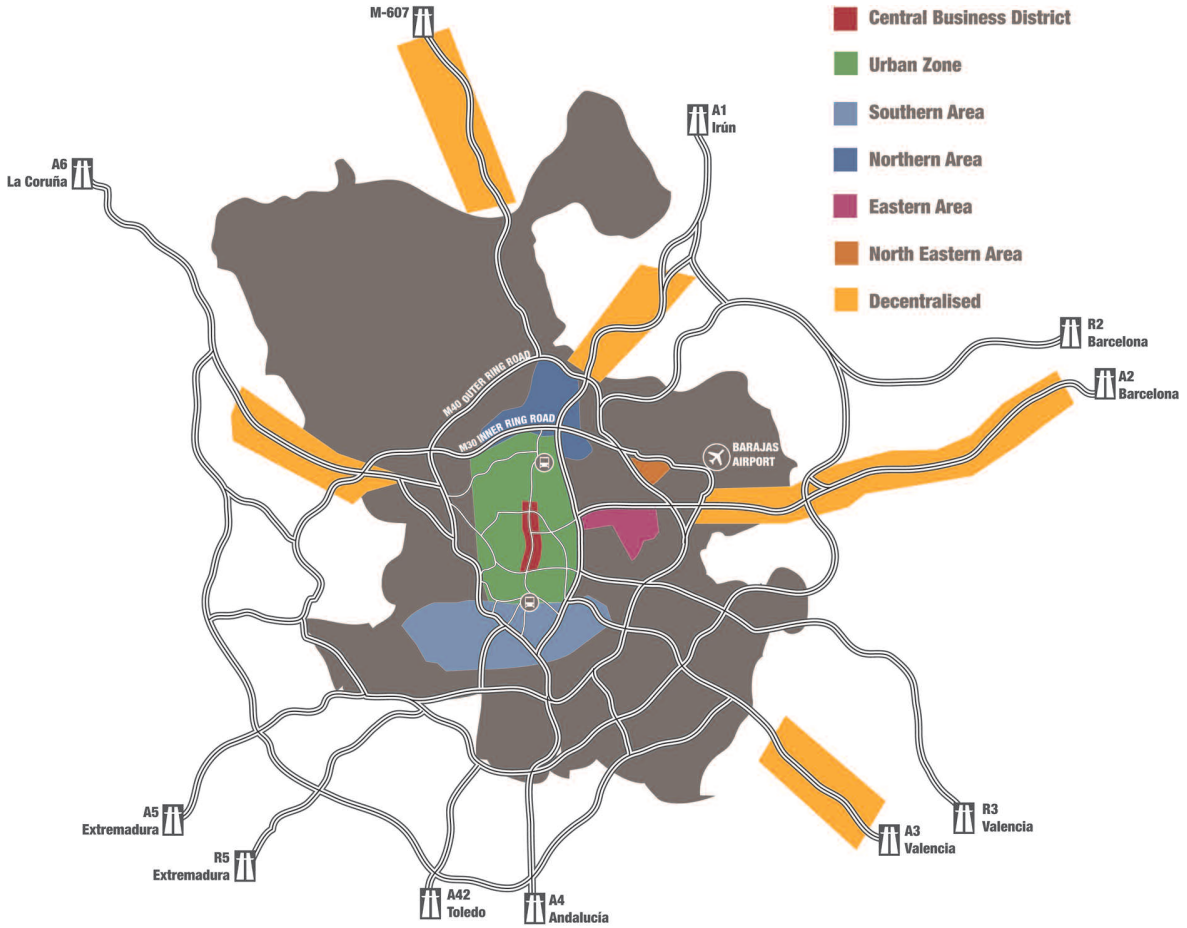
Investment volume by purchaser nationality



Source: Savills Research

Madrid office market

Survey map



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