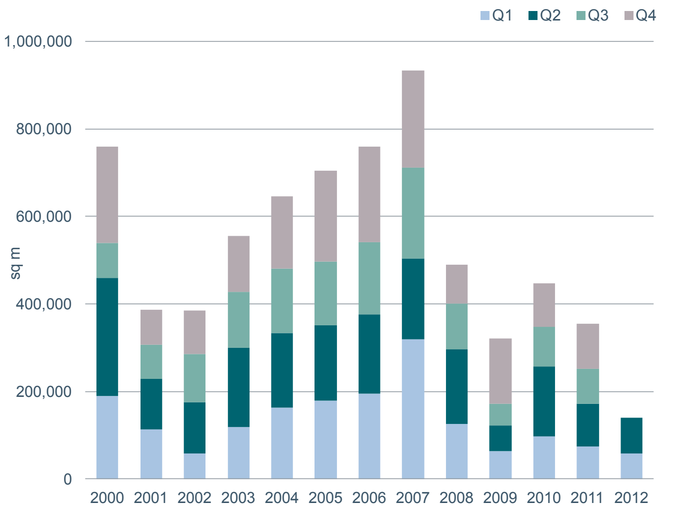
Market report
Madrid Offices

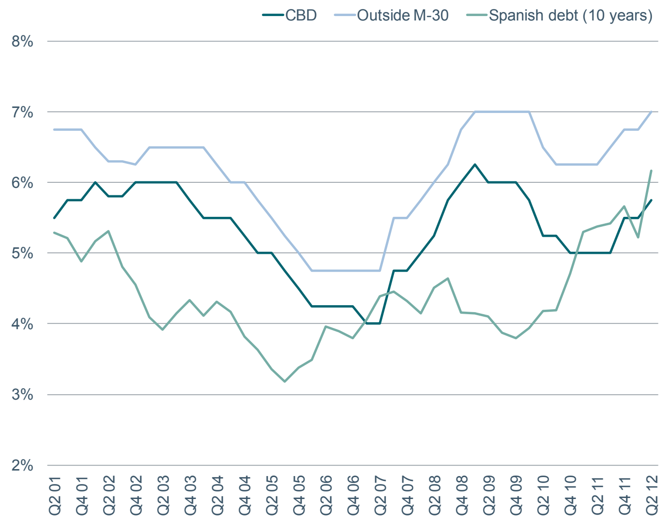
Q2 2012

GRAPH 1
Take-up



Source: Savills

GRAPH 2
Prime yields vs Spanish debt



Source: Savills

SUMMARY

Overview

■ The uncertainty in the Madrid market hasn't brought little respite to the capital's office market. Gross take-up to June was in the region of 140,000 sq m, which is a 19% year-on-year decline.

■ Government bodies are engaged in space optimisation plans and as such remain out of the market.

■ Just over 1.5 million sq m of vacant space has meant that once again, the vacancy rate has reached around 12%. Properties that have been delivered in recent months are either owner occupied, or occupied by a tenant that had signed a pre-let contract years ago. However, these moves will take place gradually, which, for the moment, will curb the amount of supply in the market.

■ An ever increasingly weak demand is incapable of taking the excess supply in the market. The economic climate is not favouring a recovery, and rental prices will continue to fall until the two balance out.

■ The investment market has almost come to a standstill. Excluding the sale of Torre Picasso, the figure for the first half of the year barely reached €50m, which is 69% less than the volume achieved in the first half of last year.

■ After several months with no transactions in the CBD, a property was finally sold in the area surrounding the CBD in May.

■ The prime yield in the CBD is in the region of 5.75%.

Spanish economy

The Spanish economy continues to worsen in 2012, in the midst of an economic slowdown in Europe. The majority of economic indicators (supply and demand aggregates, business and consumer confidence indicators, job market figures...) are a clear indication of this. GDP growth in the first quarter is therefore expected to decline slightly (four tenths of a percent year-on-year), and economic forecasts for the year are expected to be downgraded.

Nevertheless, attention has turned to the higher cost of financing Spanish debt, which has reached record highs since Spain joined the single currency, and to structural issues (banking crisis, difficulties of achieving deficit targets...) which in the first instance and in general, is affecting Spain at the heart of the European Union, and as a result the stability in the EU as a whole. At the beginning of June, Spain requested a loan of up to €100 billion in order to recapitalise the banking sector, which was originally going to be via the Spanish FROB (Fund for Orderly Bank Restructuring) and would consequently be calculated as public debt (and the interest as a deficit). However, this did not alleviate debt interest tension. Currently (at the beginning of July), the terms of this loan are being negotiated, and the Spanish Government is attempting to recapitalise the banking sector directly from Europe.

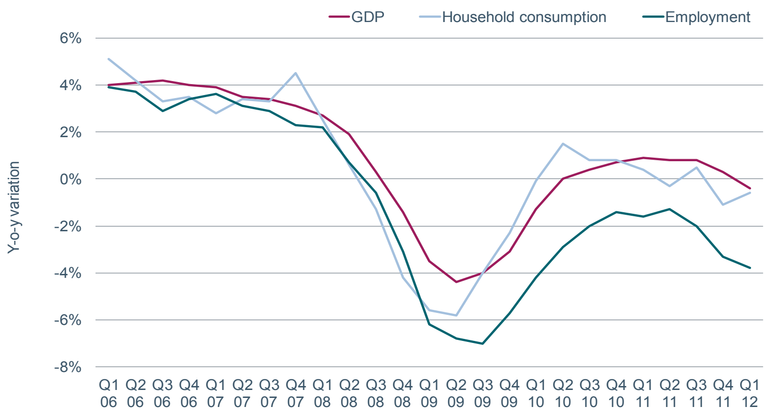
In short, the economy will not recover until the political situation in Europe stabilises and international financial markets' perceptions of Spain return back to normal. The need to curb public spending and reorganise Public Administration is also having a negative effect on domestic demand. Hopes are set on the external sector (exports have fallen slightly recently, however so have imports) and tourism performing acceptably in the near future.

"The economy will not recover until public debt financing conditions stabilise" Rafael Gil, Savills Research

Consequently, an improvement in market players' perceptions and an upswing in the manufacturing industries and the job market remain in stasis. Further cuts, as well as fiscal changes are also expected. The next cycle of economic growth will depend on the responses from the European Union as a whole, with regard to the aforementioned issues and clear support with regard to strengthening the Eurozone and the Euro (greater financial, fiscal and budgetary integration).

GRAPH 3

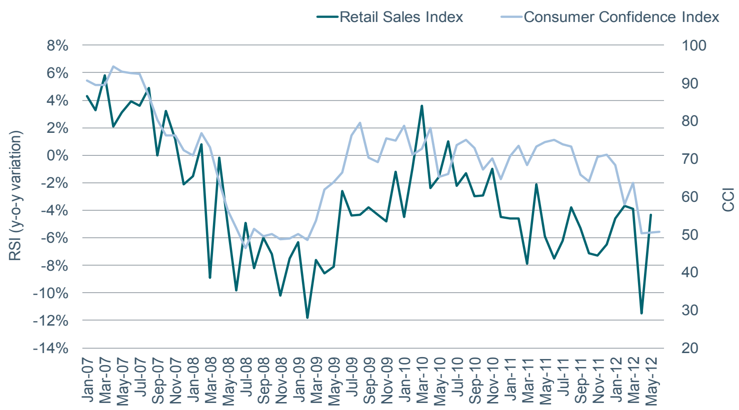
GDP, consumption and employment (Spain)



Source: INE

GRAPH 4

Retail sales and consumer confidence



Source: INE, CIS

Take-up and demand

Uncertainty prevails in the capital's business sector. Take-up between April and June amounted to just over 80,000 sq m, which is 17% below the figure registered in Q2 2011. Figures for the first half of the year are similar, amounting to around 140,000 sq m, which is a 19% year-on-year decline. The quarter-on-quarter and year-on-year figures for transactions signed do not indicate that the market is recovering - both figures are negative.

On the other hand, the seasonality of the quarters leads us to compare data from the same periods. Generally speaking, the results of the second and fourth quarters, exceed those of the first and third quarters, although on this occasion, as was expected, take-up was 38% above the figure for Q1 and the number of transactions fell by just over 7%. This would once again indicate that demand is waiting for the economy to show clear signs of recovery.

The increase in take-up compared to the previous quarter was a result of larger transactions in the market (over 1,000 sq m), which increased from 11% in the previous quarter, to almost 22% in the second quarter. In addition, whereas only one transaction of over 3,000 sq m was registered in the first quarter, six transactions were completed between April and June. Three of these transactions stand out. Técnicas Reunidas was the largest letting signed in the Madrid office market so far this year. Técnicas Reunidas took more space in the Adequa Business Park, by taking 8,200 sq m in Building 6, which was delivered a few months ago. Secondly, Indra, a Spanish multinational technology firm, will occupy one of the buildings in the San Fernando Business Park, which is owned by the Goodman Group. Indra will take a further 4,700 sq m out of a total of around 20,000 sq m that they have let, which was split into three lettings that have been signed over the last nine months. Finally, the office section of the Castellana 200 complex now has its first tenant. Schweppes will occupy 3,600 sq m of Building 2.

As has become customary, the professional services sector accounted for a third of the total take-up figure for the quarter. The most significant increase has been amongst energy firms, thanks to Técnicas Reunidas coming onto the scene.

Once again, government bodies were nowhere to be found. After several years of gradually reducing their presence in the market, they have currently not taken anymore space.

To date, local and autonomous corporations in Madrid are in the process of relocating several of their departments in a bid to optimise space. At the same time, they are putting several properties up for sale in order to obtain liquidity. Some transactions may be carried out on a sale & leaseback basis and other properties will be sold with vacant possession.

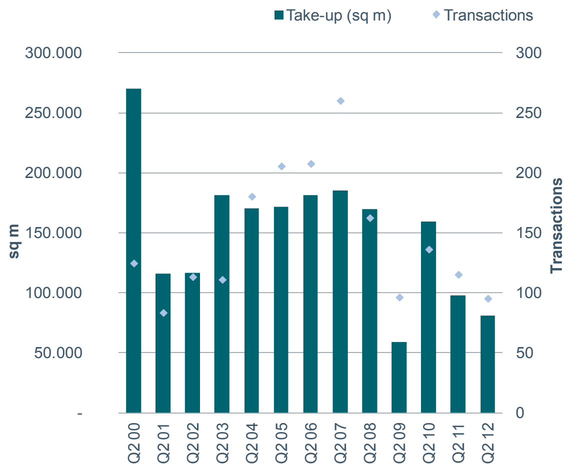
The central government now has a report on the status of its Rationalisation Plan for the use of government-owned buildings. These different activities are already bearing fruit, and a 20% saving on the exisiting rental costs is expected to be achieved. 61 contracts had been terminated by 2nd July, and rents for 58 contracts had been negotiated downwards. According to the report, the ministries with the most changes in contracts (contract terminations and rental renegotiations) were the ministries of Justice, Education, Culture and Sport, and Industry, Energy and Tourism.

Are occupiers letting or selling?

Letting is currently far more popular than selling. The sharp decline in prices could make one think that now is a good time to make the most of opportunities, but the lack of financing and high credit prices are some of the obstacles that are delaying or causing transactions to grind to a halt. Only those who have sufficient liquidity can obtain a mortgage loan. In the second quarter, one of the properties that stood out was the sale of a semi-industrial building in the Cardenal Herrera Oria Industrial Estate. The building in question is Grupo Eulen's old headquarters on Calle Lezama, which has been sold to a Pan-European telecommunications operator, Interoute. Interoute will move its offices there after the property has been fully refurbished.

GRAPH 5

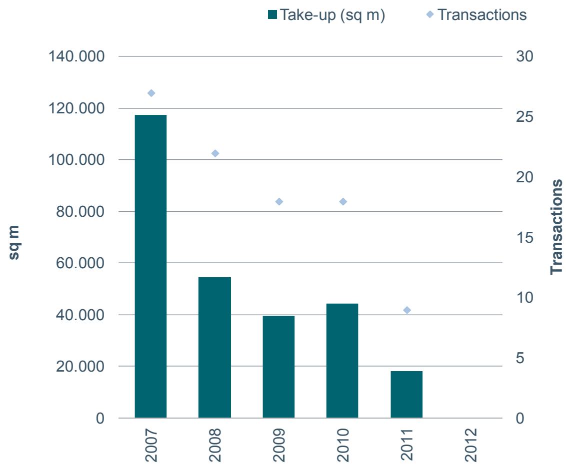
Second quarters



Source: Savills

GRAPH 6

Public Administration



Source: Savills

Current availability

Hardly anything has changed in terms of available supply. Vacant space remains above 1.5 million sq m and the level of office stock has barely increased. Properties that have been handed over in recent months and come onto the market are either owner occupied, such as the Repsol Campus, or have already been pre-let after having signed a pre-let contract years ago, such as Cuatrecasas's headquarters. Both firms will gradually relocate to their new premises, which means that not even the oil company or the legal firm are entirely free from the space they occupy to date. This in turn has curbed the growth in supply. In addition, many of the headquarters will need more than just a lick of paint given the length of time their tenants have been in the properties, which would delay some properties becoming available even longer; however, the properties will benefit from being refurbished, as it will make them more competitive.

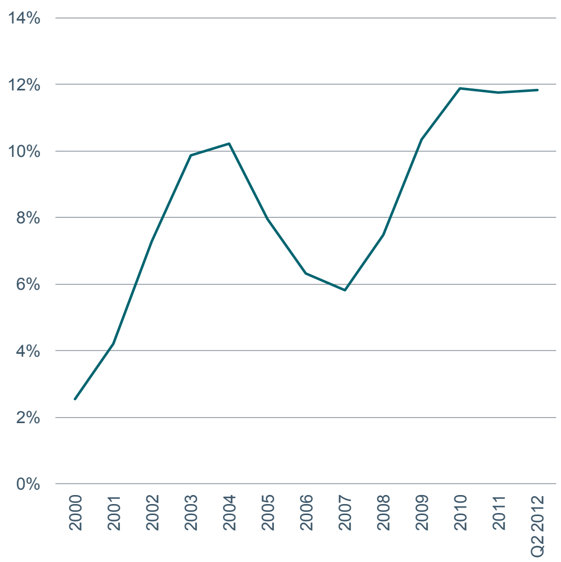
While, once again, the vacancy rate is at around 12%.

Supply in the CBD

There has been a slight decline in the amount of vacant space in the CBD micromarket, which meant that the vacancy rate in June 2012 was below 4.5%. Despite this decline, asking prices have adjusted slightly.

GRAPH 7

Vacancy rate



Source: Savills

In the next few months, 50,000 sq m will either come onto or come back onto the market in the CBD, which will undoubtedly push prices down. It seems that some owners may have anticipated this situation in order to compete in terms of price with new (or refurbished) properties. It is clear that setting a high asking price, despite this price being subject to negotiation, puts some occupiers off.

New space in 2012

The amount of new and refurbished space in the pipeline for 2012 continues to be in the region of 300,000 sq m, 40% of which has already been delivered in the first six months of the year. It is worth remembering that this figure includes both new developments, that will increase the level of stock, as well as comprehensive refurbishment projects, which amount to around 55,000 sq m.

In addition, just 51% of the total figure for the year will be marketed, as 49% of the remaining space will be occupied by either the owner or a tenant.

In a best-case scenario, the current market situation will cause a slowdown in construction works. Consequently, 33% of space in the pipeline for 2012 was as a result of delays last year. On the other hand, almost 70,000 sq m of space does not have a set delivery date. Therefore, as we reach the end of the year, we will have more of an idea as to the amount of space that will be delivered in 2013, instead of 2012.

Key projects

The four largest projects in the pipeline for 2012 will amount to 54% of the total figure for this year.

Repsol's new headquarters is believed to be the largest project of the year, comprising close to 60,000 sq m. According to sources in the sector, the Asset Management department has already moved into the complex to familiarise itself with the space and to help the almost 4,000 employees, who will gradually move to the complex before the end of the year.

The 50,000 sq m business park which is located on the old Casabega bottling plant became part of 2012 forecasts due to a delay in it being handed over in 2011. It appears that works could be completed over the summer.

Banco Popular is putting the finishing touches to a building located close to the A-2 and Campo de las Naciones. The company's DPC (data processing centre) will comprise 22,000 sq m.

Finally, FCC may also open a new headquarters in the next few months. It will let a 21,000 sq m project that it sold to Gorbea back at the end of 2010.

Sustainability

At a time when sustainability and energy saving policies and respect for the environment are clearly on the up, owners are increasingly supporting green values in their buildings, with internationally recognised 'green certificates'.

Developments in the pipeline for 2012 include the Belgian firm CODIC's first BREEAM certified building in Spain (Julián Camarillo 36), and two schemes registered to get a LEED certification (the Banco Popular's new headquarters on Calle Abelias and the recently delivered Repsol Campus in the Southern area).

Two projects that have also decided to go for LEED certification will come onto the market in 2013 - BBVA's new financial city and Torre Rioja's refurbishment of Telefónica's old R&D headquarters.

The advantages of having an efficient building include considerable cost savings, as a result of reductions in energy use, water, regenerating waste or CO2 emissions. It also adds value to the property, placing it at the forefront of the market.

More rental adjustments

An ever increasingly weak demand is incapable of taking the excess supply in the office market. We seem to be well off there being a balance between the two, and until this happens, we will continue to see more rental adjustments.

"The economic situation is not favouring a recovery in demand. Rents will continue to spiral downwards until they are in line with supply". Gema de la Fuente, Savills Research

Generally speaking, rents continue to fall in all submarkets. Rental prices in the CBD and some highly consolidated areas, with recurring demand and quality supply are not falling as much as in areas located further from the city centre. Vacancy rates are impossible to gauge in the short to medium-term, where office rents are edging ever closer to the rents of some industrial properties.

The average of all rents registered for transactions signed in buildings for office use in the second quarter of the year was just over €14 per sq m/month, which is a 15% year-on-year decline.

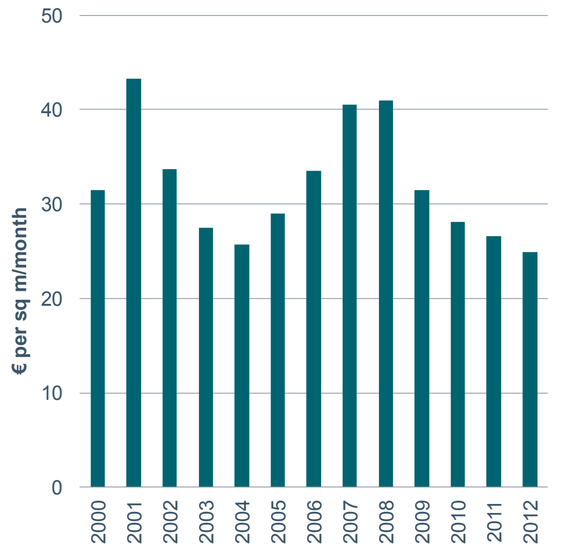
Prime rents

The CBD is no exception to the downward spiral in prices. At the end of the second quarter, the theoretical closing rent reached €25.50 per sq m/month, however in the last three months no transactions have been completed for any prime building in the CBD. The highest rent in the market was under €23 per sq m/month. The average rent in the CBD was around €20 per sq m/month, but it is important to highlight that 90% of transactions took place in AZCA, where rents are lower, with the exception of Torre Picasso. This is one of the most emblematic buildings in the city and the market, and is rapidly reaching 100% occupancy. This is despite the fact that rental prices are generally higher than other properties, however this is due to the fact it is in the financial heart of both the city and the country, and this comes at a price.

Rental prices in the CBD have fallen by 5.5% year-on-year and by 39% compared to the top of the market.

GRAPH 8

Prime CBD rents



Source: Savills

TABLE 1

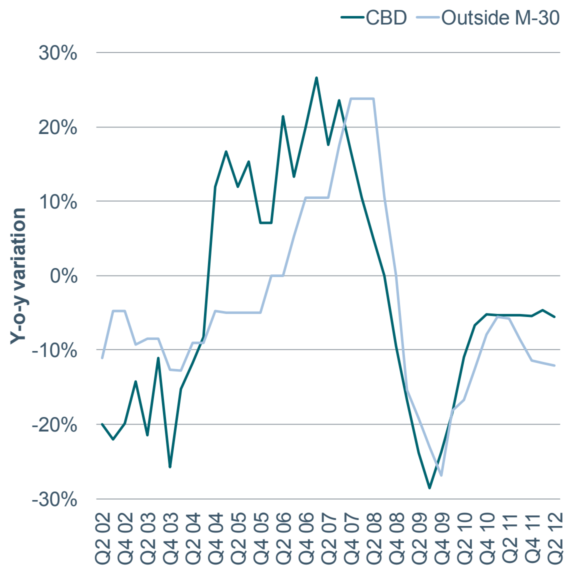
Main letting transactions - Q2 2012

User	Zone	Area (sq m)	Activity
Técnicas Reunidas	Norte	8,200	Energy
Indra	A-2	4,700	IT
Schweppes	Urban area	3,500	Industry
Interoute	Norte	3,500	IT
Confidential	A-1	3,300	Real Estate
Miele	A-1	3,200	Industry

Source: Savills

GRAPH 9

Prime rental growth



Source: Savills

Investment market

Spain's critical economic situation has meant that the downturn in the office investment market is getting closer to a standstill. Excluding the €400m paid for Torre Picasso, the figure for the first half of the year barely reached €50m, which is a 69% year-on-year decline.

And the uniqueness of the acquisition of one of the most emblematic buildings in the Madrid office market should not be considered as a milestone. Pontegadea made the most of several unexpectedly favourable circumstances, but this is in no way a true reflection of the market.

The lack of quality product at a price that investors are willing to pay, difficulties in acquiring financing and the increase in the cost of debt are still the main hurdles to overcome. On top of this, one has to add an increase in country risk perceived by international investors, which has meant that they are currently out of the picture at the moment.

In recent months, the only transaction a foreign investor has been involved in has been the office area of a mixed complex (retail+offices) in the La Moraleja area, although the main component of this complex is retail. The rest of the deals have been headed up by private national investors.

The high level of liquidity they have, means it is much easier and quicker for them to get involved in deals, and the aggressive yields that they usually had to offer in order to compete with international funds, have now given way to them being much more demanding and offering higher yields. With foreign investors out of the market, private national investors' requirements continue to be a quality building in a good location, a solvent tenant with a long-term contract at market rents etc., however, they are looking for higher yields.

Consequently, several processes that were active a few months ago did not come to fruition, due to the buyers and vendors differing on their price expectations. Some of them received over ten proposals, but none of the offers were in line with the owners' objectives, therefore they have been taken off the market. A clear example of this situation was Paseo de Castellana, 89.

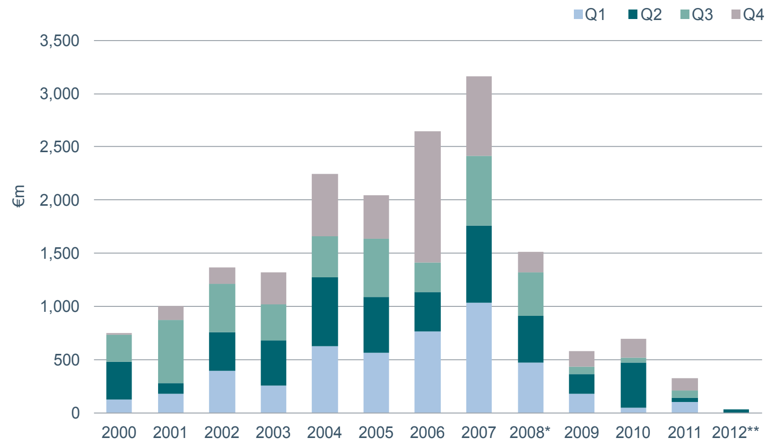
Profile of properties for sale

Prime properties in prime locations are still the most in-demand product, but it is precisely because of this, that there are less of these types of properties available. In any event, there are investment opportunities very close to the CBD which have been well-received by investors, but in some cases, properties have certain bureaucratic limitations that should have a negative effect on prices. However, once again, vendors have not entirely adapted the asking price to market reality, thus there is a considerable difference between buyers and vendors' opinions of value. Other properties which have had a 'for sale' sign up for over a year may become more attractive in the near future, as they are at a turning point, as they are about to renegotiate several of their tenants' contracts. Adapting rental prices to market rents may be enough to make the property more appealing to buyers.

The Madrid City Hall and the autonomous government have opted to sell properties as a means of reducing their respective deficits. CAM has recently announced its asset optimisation plan, via which it will auction its properties in two phases. The first lot comprises twelve buildings and retail units with residential use classifications, although they can

GRAPH 10

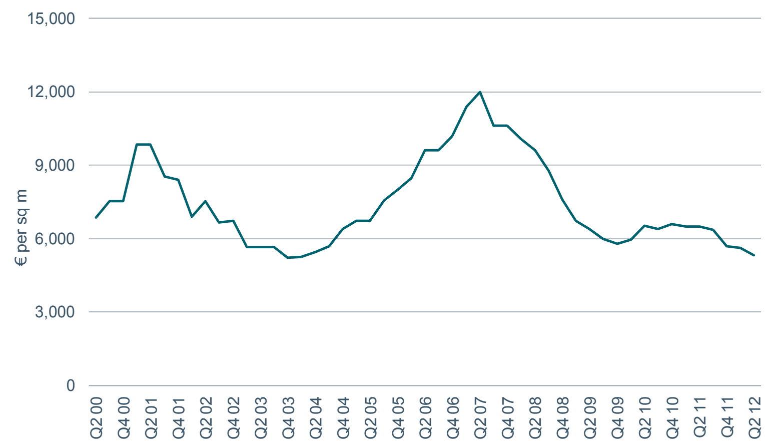
Investment volume



Source: Savills / *Ciudad Financiera Santander excluded / **Torre Picasso excluded

GRAPH 11

Prime CBD capital values



Source: Savills

"A panorama of widespread economic instability is forcing international investors to continue to be wary of the Spanish Market. National investors are more active, however much of the available product will continue to be illiquid due to landlords´ continued failure to adapt to the demand"
Luis Espadas, Capital Markets

also be used for retail, hospitality, restaurant and office uses. A second package would include buildings that are currently occupied by different regional government departments. The Community of Madrid hopes to receive around €60m, but one has to take into consideration that it will be the market that determines the final price.

In terms of the Madrid City Hall, on 11th July, the Tax and Public Administration Department announced that they were going to sell Paseo de Recoletos, 12 (the current headquarters of the Environment, Security and Mobility Department) via auction. Offers can be submitted up until mid-September.

Active demand

Generally speaking, available supply would best fit the investment capacity of national investors, who are much more limited in terms of lot size compared to large funds. The range of investment volumes they have access to is between €15m and €30m, which is reflected in the average investment lot size for the first half of the year, which is around €20m. Once again, Torre Picasso has been excluded from this analysis.

The most active investors are also looking for properties under a sale & leaseback format, with long contracts (over 10 years) and properties with added value in urban areas. The price will be the determining factor when it comes to carrying out any transaction. In fact, some investors already have a set yield in mind that they consider to be suitable for this type of transaction, regardless of where the property is located.

There is also supply that far exceeds the 'reduced' scope of private sector investment, and given the lack of interest from international investors, the alternative to cross-border capital will be mutual and insurance companies.

Forecast

Uncertainty in the market is making it difficult to predict the expected volume of investment for the second half of the year. Taking into consideration the sales processes currently underway and the likelihood of success for each, we estimate that it could reach €150m, but there are many factors and setbacks that could cause this figure to change.

Several market sources suggest that another of the City Hall's commercial properties, the APOT building, has already been sold, but at the moment it is still registered as being owned by the City Hall.

Yields

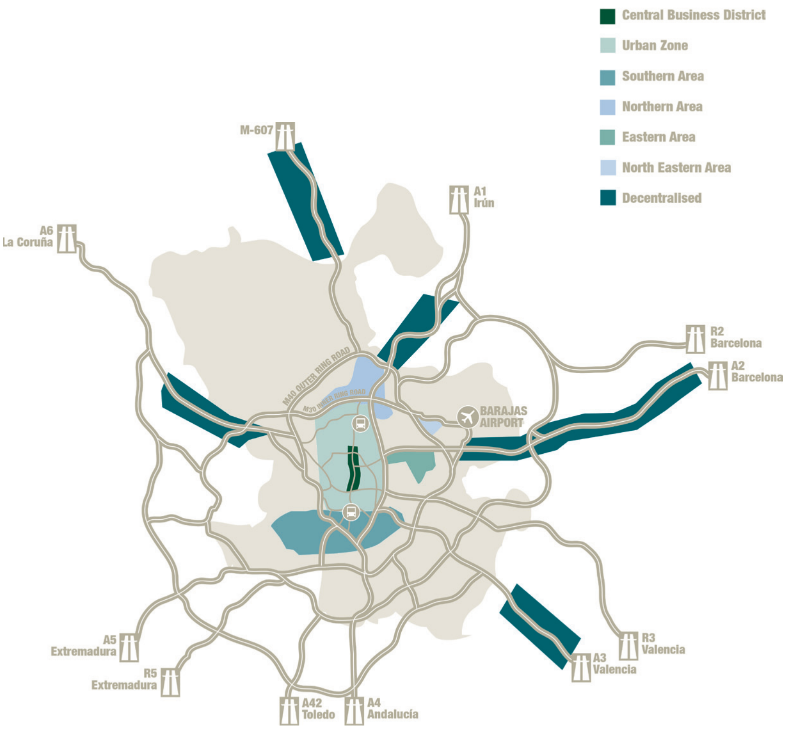
The overall increase in economic indicators has had a direct effect on yields in the capital's office market. If, amongst other factors, we add the increase in country risk to this - which has resulted in uncertainty amongst international investors, causing them to flee the Spanish market - the difficulties in acquiring finance which are now commonplace, and increasingly strict requirements when it comes to acquiring credit, the result is an ever more unstable market.
Yields in the CBD would remain in the region of 5.75% and prime properties in consolidated locations outside of the M-30 would achieve 7%.

After several months with no transactions registered in Madrid's CBD, which could be said to be a sign of the yields based on market sentiment, a property in the area surrounding the CBD was finally sold in May. Yields in prime areas outside of the M-30 are still currently only opinions of value.

GRAPH 12
Prime CBD yield

Source: Savills

MAP 1
Madrid Office Market



Outlook

2012

■ Demand is waiting to show clear signs of recovery. The economic climate is continuing to favour rent reviews and renegotiations, compared to relocations.

■ The volume of supply will continue to grow, and if all delivery dates are met for projects under construction, the vacancy rate could reach 13%.

■ However, delays in construction works remain the order of the day, and we already know that it is highly likely that some projects will come on to the market later than expected.

■ Rental prices continue to spiral downwards. On the other hand, incentives and temporary rental discounts are playing a bigger part in negotiations.

■ There is latent demand in the investment market, which is led by national investors, who are waiting for good opportunities. They have a high level of liquidity, which means that to a large extent, they do not have to depend on financing. Price will be a determining factor and they are more focused on capital values compared to yields. However, their investment capacity is much more limited (limited to a lot size of around €30m). The investment volume could reach €150m in the second half of the year, but given the volatility in the market, many factors could cause this figure to change.

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