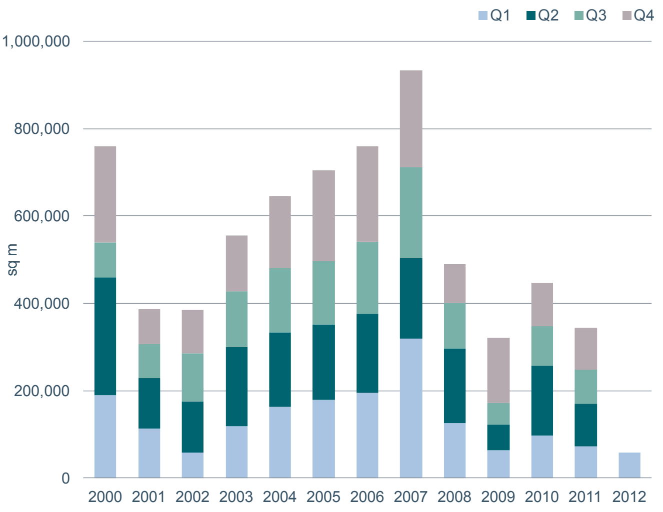
Savills Research
Spain Offices

Market report
Madrid Offices

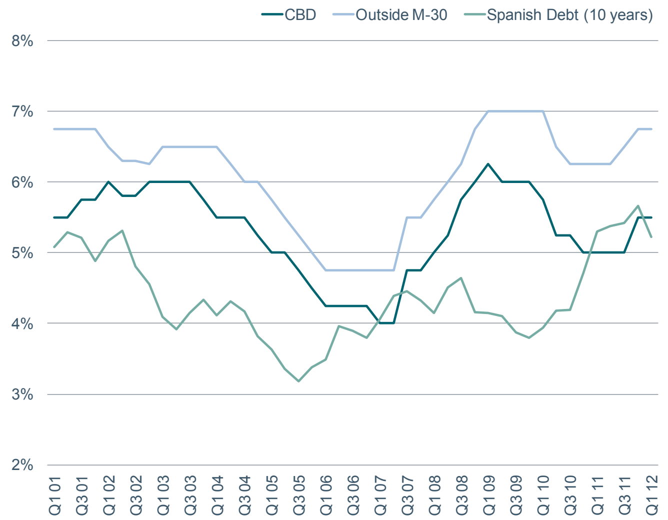
Q1 2012

GRAPH 1
Take-up



Source: Savills

GRAPH 2
Prime yields vs Spanish debt



Source: Savills

SUMMARY

Overview

■ The Madrid office market remains subdued and companies that are opting to relocate their headquarters are continuing to downsize.

■ Gross take-up for Q1 was close to 60,000 sq m, which is a 20% year-on-year decline.

■ Vacant space remains above the 1.5m sq m mark, which means that the overall market vacancy rate is heading for 12%. The area with the least vacant space is the CBD (under 5%), whereas at the other end of the spectrum, in some of the submarkets located further away from the city centre, the vacancy rate is well beyond 50%.

■ Ailing demand and an excess of supply are causing rental prices to fall and these declines are continuing to affect all submarkets.

■ The CBD is more resistant to price adjustments; however new renovated space which will come onto the market over the next few months, could cause rental prices to fall further.

■ Just the one sale of Torre Picasso at the beginning of the year outstripped the total sales volume figure for the whole of 2011. The lack of transactions does not represent a fair reflection of the amount of activity in the market, as there are several sales transactions in the pipeline and various bidders for each transaction. The difference between the buyer and vendor opinion of value, the negative sentiment in terms of the economic outlook and access to finance are still the main hurdles when it comes to completing any deal.

Economic background

The Spanish economy is currently (April 2012) at a crucial point. As is the case in almost all European countries, as was expected, the first few months of 2012 were sluggish, due to the decline in business activity in the last quarter of 2011.

Nevertheless, some macroeconomic indicators (particularly supply aggregates) and composite activity indicators are indicating that the economy is recovering faster than was expected. Despite this, once again Spain has had to deal with serious tensions in the debt markets, after the risk premium and spread versus the German yield increased to similar crisis levels seen mid last year, which may jeopardise any attempt to bring about economic recovery.

The national accounting data currently available (Q4 2011) confirms the slowdown in the national economy: there was a slight quarter-on-quarter decline in GDP growth, with zero year-on-year growth, and a drop in other demand aggregates (consumption, investment and foreign trade). However, the trade balance continues to improve and is still the main driver of the Spanish economy: after good recent export performance, the recent stagnant growth has been offset by an even greater decline in imports, which will continue to help reduce the trade deficit.

In addition, the increase in exports might explain why supply aggregates have been performing better (electricity consumption, industrial manufacturing...) compared to domestic demand (apart from the aforementioned, recent figures concerning consumer confidence have been very low).

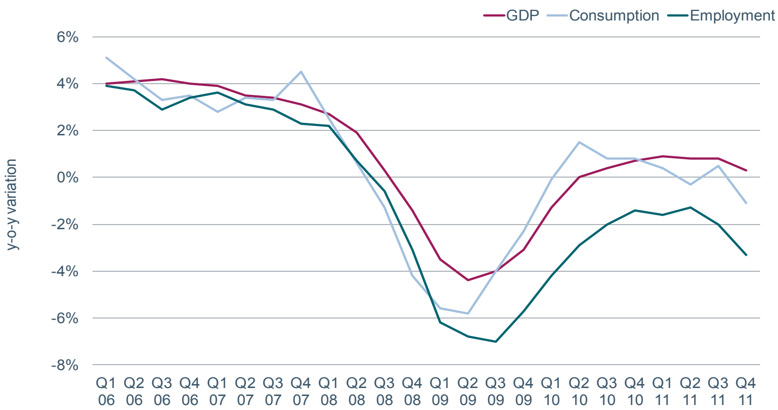
In turn, inflation stands at around 2% per year. Despite weak domestic demand, this may have been sustained by the price of crude oil and the increase in electricity tariffs in Spain. In terms of unemployment, we will still have to wait a little longer to see the effects of the Government's recent labour reform policy, although a significant upswing in employment is not likely to happen until economic growth is over 1% of GDP.

"If Spain overcomes the new international investor crisis over Spanish debt, the economy will get on the road to economic recovery in 2012"

As we indicated at the start of this section, all expectations with regard to the development of the main economic aggregates point toward a slight recovery, but this will very much depend on the threat of uncertainty among international investors and the consequent price hikes and difficulties in refinancing Spanish debt, which is currently making the situation reach critical levels. Moving away from this threat (it is fairly likely that the causes of this are not entirely related to the economic climate and the Spanish budgetary situation), as happened a year ago, Spain is likely to recover slightly over the next few months.

GRAPH 3

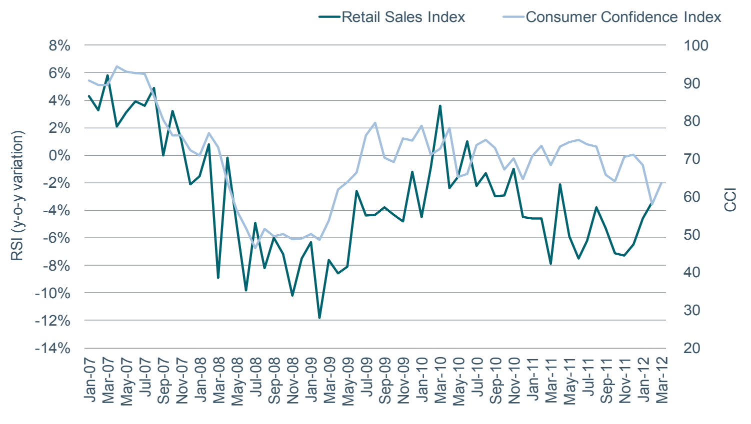
Macroeconomic figures



Source: INE

GRAPH 4

Retail sales and consumer confidence



Source: INE, CIS

Take-up

Business confidence is failing to show clear signs of recovery. At least this is the evidence provided from the latest figures published by INE (Institute of National Statistics - Instituto Nacional de Estadística), where for both the last quarter and this quarter less than 10% of companies interviewed considered that the progress of their business had been and will be favourable, whereas around 50% felt they were in the very opposite position.

On a more positive note, we must highlight that the latest INE Regional Accounts data indicate that the GDP figures for eight autonomous communities (including Madrid) are above the national average.

Despite this, Madrid's office market has also been affected by the uncertainty prevailing in both the domestic economy, as well as in other neighbouring countries.

Quarterly take-up volumes stood at close to 60,000 sq m, which is a 20% year-on-year decline. On the other hand, the number of transactions has increased slightly (+6%) compared to figures from Q1 2011. Therefore, the immediate effect of this has been a sharp decline (23%) in average take-up compared to the previous quarter, and a 24% year-on-year decline. This is the case for transactions signed in both the urban centre and peripheral areas.

Downsizing

The Madrid office market is subdued and companies that decide to relocate their headquarters are continuing to downsize - in other words, they are taking less space than what they are leaving behind in their previous premises. 80% of total transactions completed were for office space under 1,000 sq m; however it is important to note that almost a third of the total relates to the range of average space between 500 sq m and 999 sq m. This is an all-time high since 2000, and in addition to this, the number of transactions completed for spaces of over 1,000 sq m has hit an all-time low (just over 10% of the total).

However, there has not just been a significant drop in terms of the large-scale space range - the amount of space taken in this segment has also shown signs of fatigue. There has been a clear drop in the quarter-on-quarter and year-on-year average take-up figures - in other words, not only have there been few large-scale transactions, but the size of large spaces has also fallen. Few companies are showing clear signs of expansion. However, a Spanish technology firm has led the way with the largest letting of the quarter, by taking almost 5,000 sq m in the Julian Camarillo area. This is unique because after the summer of 2011 they signed for another entire building in the same area.

Activity by sector

The lack of public administration activity in the Madrid office market has been more than apparent for several quarters. Several public organisations' moving plans have been delayed as they look at how much space they really require and as they optimise their own resources and those of third parties.

The professional services sector continues to lead the market, both in terms of transactions and take-up; however the reduction of space has also affected this group.

On the other hand, there has been a notable increase in activity within the manufacturing industry sector - 20% of transactions between January to March and 30% of space taken relate to firms in this sector, whilst the averages over past few years were 14% and 13% respectively.

One should also highlight the fact that more new technology and telecommunications firms are taking space - jumping from an average of 15% in 2007 to almost 30% in Q1 2012.

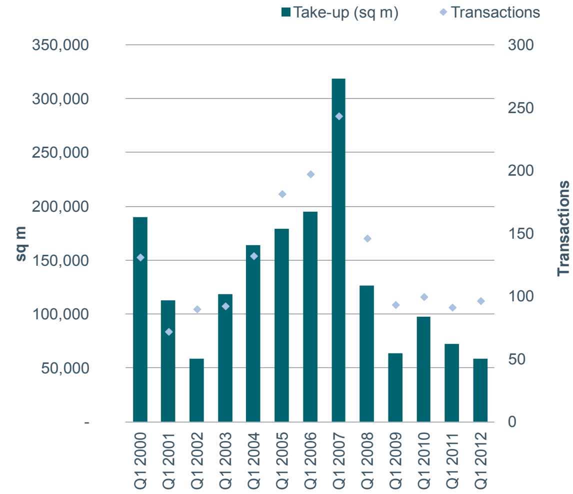
For sale or to let?

The sales market for owner-occupiers remains in a critical condition. There is lack of liquidity, access to finance is challenging and once financing has been secured (which is increasingly more expensive) this is invested directly into the business.

Despite the fact that the market climate does not appear to be very favourable, the largest tobacco company in the world has just acquired Soluziona's old headquarters on Paseo de la Habana.

GRAPH 5

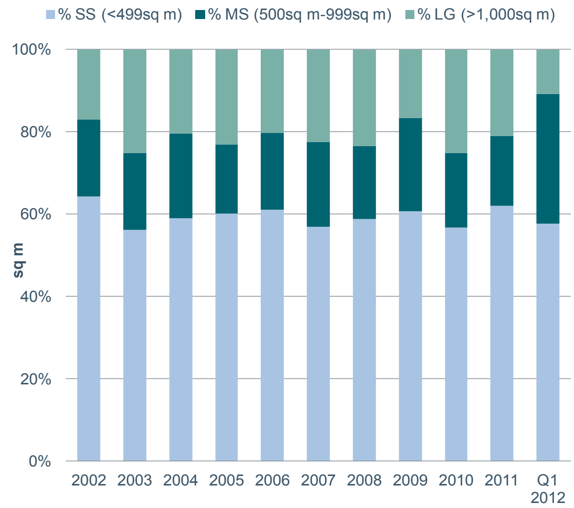
Demand in the first quarters



Source: Savills

GRAPH 6

Transactions per size



Source: Savills

Current availability

Vacant space in the Madrid market remains above 1.5m sq m, which puts the vacancy rate at around 12%. However, vacancy rates are below average for the overall market in the CBD and well-consolidated submarkets, such as Campo de las Naciones, La Moraleja or Las Rozas, as well as others that are still in the process of consolidating, such as Manoteras.

On the other hand, the inflated vacancy rate could become a concern, but we should point out that close to 10% of the total should be considered as long-term supply (as it has been on the market for over 5 years). In some cases, the age of the property and the fact that the facilities are dated, may be the main obstacles when it comes to attracting potential occupiers, and in other cases, the distance of the property from the city centre, the property being located in a less-consolidated area, an asking price which is not at market price, or bureaucratic or administrative issues that need to be resolved, may be the main reasons why properties are remaining vacant for long periods of time. Clearly this does not make excess availability in the market any less important, but it would reduce the figure for the amount of actually marketable space.

Compared to the previous quarter, stock has barely grown by 0.30%, and this once again highlights the fact that new projects coming onto the market are few and far between.

Codic's new development in the Julian Camarillo area stands out from the rest of the new additions to the market, as it is the first office building with BREEAM certification in the Madrid office market.

New supply in 2012

Forecasts for new space in 2012 remain in the region of 300,000 sq m, of which just over a third are projects which were meant to come on to the market in 2011 and were delayed. Everything points to the likelihood that this will continue to be the trend as time goes on, therefore the total figure for office space coming onto the market in 2012 could change as the year progresses. The overall market situation, the sales rate, which is directly linked to demand, and financing dynamics, will determine whether construction work schedules will be delayed or if projects will be completed on time.

In any event, to date, a meagre 180,000 sq m of space would be available to market, as several companies will be moving to new headquarters over the year, some of which will be owner-occupied and others will be leased. In terms of volume, we would highlight the Repsol Campus (60,000 sq m) in the Mendez Alvaro area, which will house 4,000 of its employees. In 2007, the oil company agreed to purchase a 30,000 sq m plot of land from its subsidiary CLH (Compañía Logística de Hidrocarburos) and after several years of pushing the moving date back, they will finally move in before the end of the year.

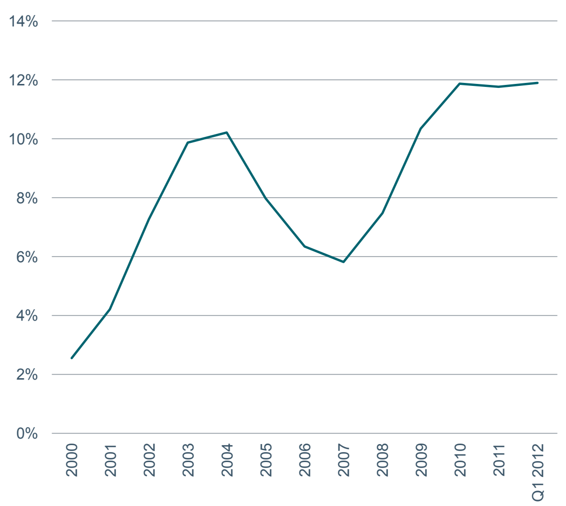
In addition, there seem to be advanced negotiations for around 50,000 sq m of the total speculative space in the pipeline for 2012, which would reduce the total figure for new supply being marketed to 43% of the currently forecasted figure.

More refurbishments

In similar fashion to recent years, the properties that have had one company occupy the premises for a long period of time that then vacates, tend to proceed to carry out a complete refurb of the facilities in order to adapt the space to current demand requirements, the result of which will be more competitive space in the capital's office market.

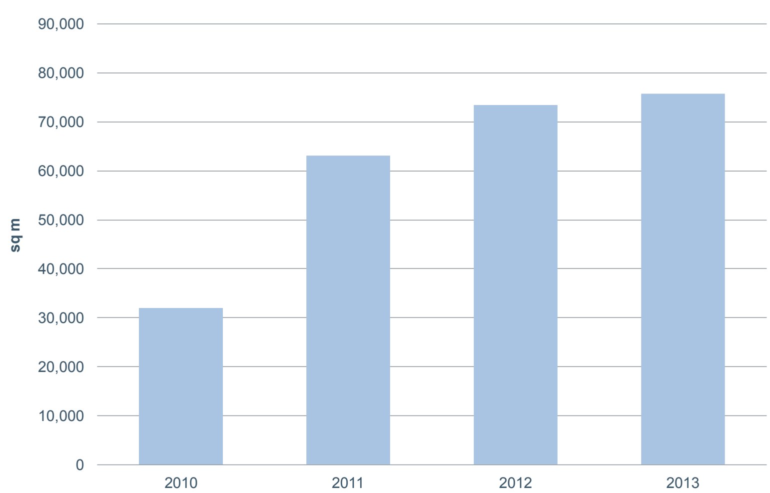
This will be the order of the day over the next few years, as, in addition to Repsol, other firms will open new head offices in 2012, such as Banco Popular, Cuatrecasas and FCC, and it appears that in 2013 the first phase of a new financial city that BBVA is developing in Las Tablas will be available, and this will continue to increase the amount of refurbished space in the market.

GRAPH 7
Availability rate



Source: Savills

GRAPH 8
Refurbished area



Source: Savills

More rental adjustments

Ailing demand and excess supply are causing rental prices to drop significantly, and these declines are continuing to affect all submarkets,

The CBD and those areas where the vacancy rate is lower than the overall market vacancy rate are being less affected in terms of rental adjustments, but in any event, it seems that for now we will definitely continue to see a fall in rents over the next few quarters. The closing rent for Q1 2012 in the business district stood at between €25.50 and €26 per sq m/month, which amounts to just a 5% year-on-year decrease. When compared to the previous quarter, the decline in the theoretical closing rent did not even reach 1%, but when compared with the top of the market, it has fallen by around 39%.

Comparing rental cycles

To date, rental prices in real terms (constant prices) are slightly above the lows seen in 1995, but less than the lows in 2004.

Current figures indicate a 44% decline in real terms compared to the top of the market in 2007 and 57% with regard to the top of the market in 2001. The difference between the current downward cycle and the previous cycle (the so called “dotcom” crisis at the beginning of the last decade) is particularly interesting - whereas in the current cycle the fall of 44% has been registered over a period of 18 quarters, in the cycle between 2001 and the beginning of 2004 a correction of 51% was registered in just 12 quarters.

"Current demand is unable to lighten the burden of excess vacancy, which continues to grow both due to second hand properties coming back on to the market, as well as the delivery of new projects. This results in further declines in rental prices" Gema de la Fuente, Savills Research

Rents in Europe

The maturity and flexibility of other European markets such as London, enabled prices to fall by almost 40% in less than a year, whereas the rigidity of Spanish markets has meant that similar declines have been achieved after more than four years. Consequently, the London office markets have already started on the road to growth, whereas prices continue to fall gradually in Spain's main markets.

TABLE 1

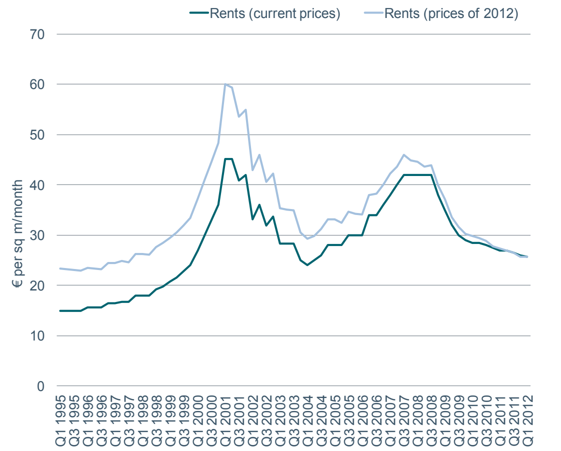
Main letting transactions - Q1 12

User	Zone	Area (sq m)	Activity
Iberia Express	A-2	1,900	Transports
Philip Morris	Urban area	2,400	Industry
Emerson	A-6	2,600	Industry
SFK	A-1	4,000	Industry
Confidencial	East	5,700	IT

Fuente: Savills

GRAPH 9

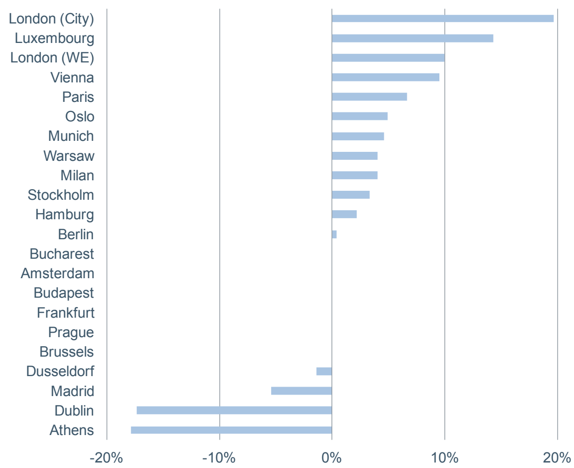
Prime rents in CBD



Source: Savills

GRAPH 10

Prime rental growth in Europe



Source: Savills

Investment market

After 2011 ended with the record lowest level of investment since 2000, 2012 began with one of the largest transactions in the market in recent years. Pontegadea, Inditex Group's real estate vehicle, acquired Torre Picasso, one of the most emblematic properties in the Madrid office market, for €400m, which amounts to 10% more than 2011's annual investment figure.

We should point out that this is an isolated case and it should not be considered as a sign of the market recovering. In this case, Pontegadea identified a good opportunity and despite the competition, it succesfully concluded the deal as it had the competitive advantage of access to finance. To date, acquiring finance and meeting financing conditions, (due to financing becoming ever more expensive) acts as a filter when it comes to starting negotiations and successfully completing a deal.

Despite the absence of completed transactions, the investment market is not at a complete standstill. Supply and demand are relatively dynamic, with new properties coming up for sale. Demand, which has been led by national investors in recent years, is mainly focused on quality properties in the Recoletos-Castellana area and in the city centre, but the lot size tends to be limited of between €30m and €50m.

International investors are studying properties once again, both within and outside of the M-30 ring road, as long as the properties are located in consolidated markets.

New properties have come onto the market in recent months. Current supply can cater for all types of requirements, in terms of lot size, location, quality of the property, contract term, etc.

Clearly any aspect of the property that strays away from investment fundamentals will see its yield penalised; therefore opportunistic funds focusing on distressed products are also amongst the international investors.

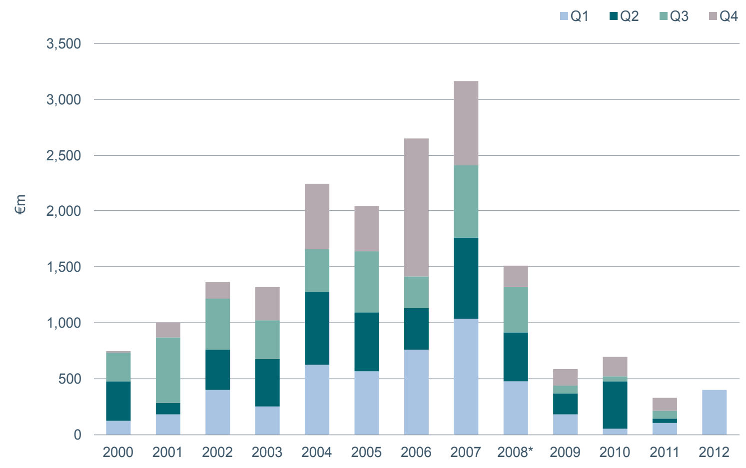
We should also point out that although it is not official, almost every owner out there is open to offers for properties in their portfolios.

There are currently several open sales processes in the market, and if all of these result in a sale, investment turnover could reach €450m by the end of the year (excluding the Torre Picasso transaction). Having said this, one of the obstacles to overcome, is the difference that still exists between the buyer and vendor price expectations, as well as undoubtedly the most complex obstacle to overcome: acquiring financing.

One of the ongoing sales that has attracted the most interest has been Ahorro Corporación's headquarters on Paseo de la Castellana, 89, which is very close to Torre Picasso, in the heart of the city's financial district. This could be the second largest transaction of the year in terms of volume, as the asking price stands at over €100m. Given the number of investors contending for the property, at the moment it seems to be the most attractive property on the market.

GRAPH 11

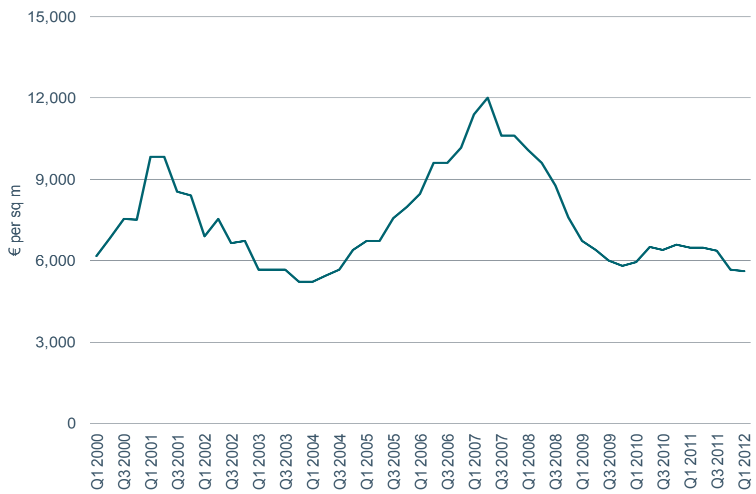
Investment volume



Source: Savills / *Ciudad Financiera Santander excluded

GRAPH 12

Prime CBD capital values



Source: Savills

"The lack of activity in the market is a result of restricted financing and mixed views on prices, but demand is high for a property that meets the main investment criteria and is at an attractive price" Luis Espadas, Capital Markets

The large lot size has meant that more offers have been received from international investors, however, we should point out that several national investors are involved in the sales process.

The estimated final sales price is expected to be in the region of €100m, as there is still a considerable difference between the vendor and bidders' opinions of its value. As we pointed out previously, acquiring finance will be the key to success.

However, the Madrid City Hall has decided to put some of its properties up for sale in order to pay off some of its debt. These properties, amongst others include the Apot building, in Campo de las Naciones and Montera, 25-27, which it acquired in 2007 with the aim of turning it into a five star hotel, or the Town Planning Department headquarters on Calle Guatemala, which could potentially be able to be changed to hotel or residential use. According to data that has recently been published in the press, the Council is currently reaching the final stages of closing the sale of the Apot building, although the identity of the buyer has not been revealed.

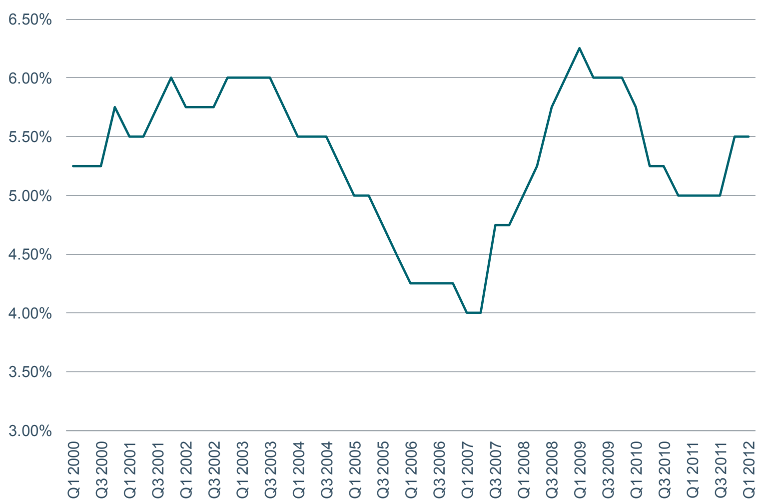
Yields

Hardly anything has changed in terms of yields. Due to the lack of transactions, the initial yield remains at the same level as the previous quarter.

Yields for the CBD remain at between 5.25% and 5.50%, as long as they are prime properties in excellent locations with a solvent tenant, long-term contracts and are at market rents. Outside of the M-30, the yield would reach 6.75%. Current yields in secondary markets could increase slightly (both in the urban area, as well as in periphery areas), due to an increase in supply and the fact that properties are less attractive to buyers and the increase in financing costs, together with the forecast that rental prices are expected to fall further.

GRAPH 13

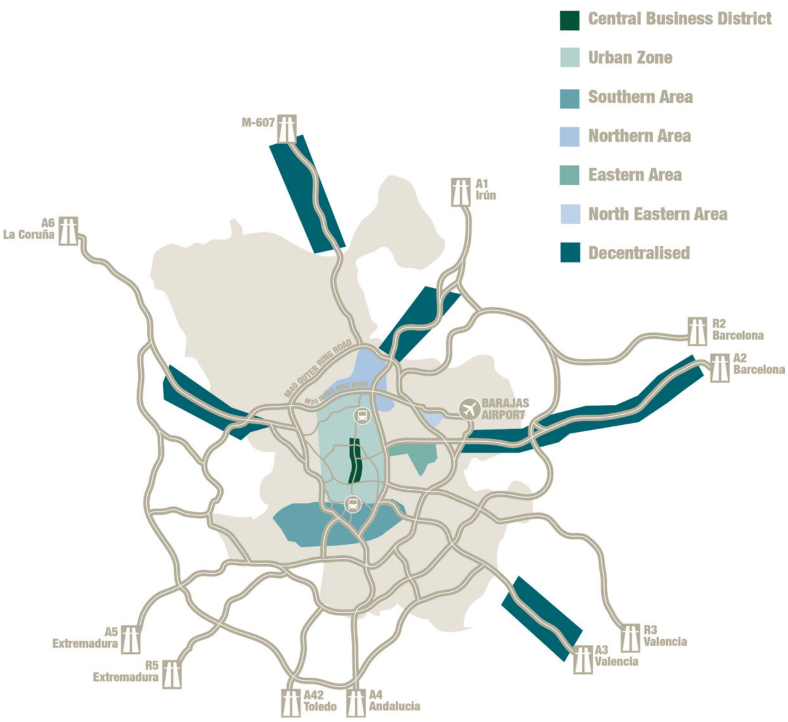
Prime CBD yields



Source: Savills

MAP 1

Madrid Office Market



OUTLOOK

2012

■ The second quarter will set the pace for the occupier market performance in 2012, as according to the long term average represents a third of the annual take-up. However the economic climate in Spain and in neighbouring countries does not instil much optimism for the letting activity.

■ In this gloomy climate, net absorption is unlikely to be positive by the end of the year.

■ Rents and incentives will continue to play a key role in negotiations for office space. Occupiers that are looking for office space are aware of their negotiation power, given the large number of alternatives open to them.

■ Investors gaining access to finance will be one of the determining factors when it comes to stimulating and breathing new life in to the market. The alternative to financing that has traditionally come from banks, could be finance coming from other types of companies, such as fund managers or insurance companies, which are already providing finance in other European markets.

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