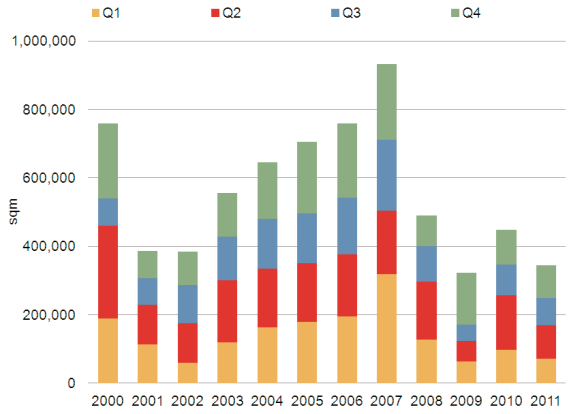
Madrid office market

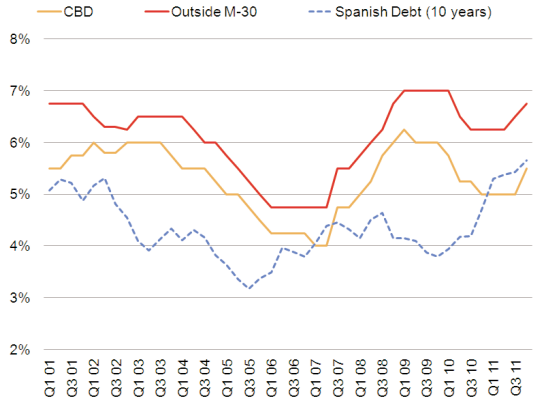
Q4 2011

Annual take-up



Source: Savills Research

Prime yields vs Spanish Bond yield



Source: Savills Research, INE

"The decreasing levels of demand for office space in 2011 coincided with deteriorating economic sentiment. Only significant rental adjustments and incentives were involved in large scale lettings; we have seen 2012 begin stronger than the previous year".

Ana Zavala - Head of Office Agency

- A dismal year for the Madrid office market. Gross take-up for 2011 amounted to just over 340,000 m², which is slightly above the record low for the decade (registered in 2009), but this is 23% below the 2010 figure. Demand is sluggish and potential occupiers are waiting for the economy to improve, which would then allow them to consider thinking about growing again.

- Most of the companies that decide to relocate their headquarters are choosing to downsize and this is the main reason for the increase in available space on the market, as new developments remain few and far between. Office stock in December 2011 only grew by 0.3% year-on-year. At year-end, the vacancy rate was at around 11.8%.

- Constrained demand activity and the gap between supply and demand continue to push rental prices down. The adjustment in rental prices has affected the whole market - the CBD, the city centre and periphery areas, although decreases have been less marked in the most consolidated submarkets.

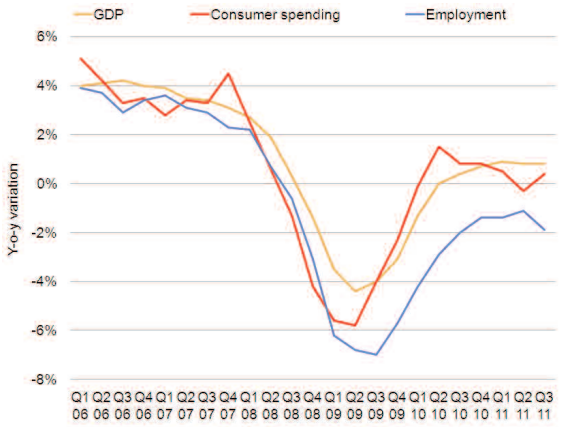
- An unbeatable start to 2012. The €400 million sale of Torre Picasso amounts to 10% more than the total invested in the whole of 2011. International investors are wary of the Spanish market and financing is hard to come by and is becoming ever more expensive. This has paved the way for private Spanish firms that have liquidity, but they are only able to make smaller investments (lot sizes of around €30 - 50 million). Mr. Amancio Ortega is obviously an exception to this rule.

Economy

Spanish economic situation

After a 2009 in which macroeconomic figures revealed the very worst effects of the crisis in Spain, 2010 marked the light at the end of the tunnel; GDP was on the up again and demand and consumer confidence started to improve. However, in addition to being subdued, this recovery was threatened by several factors in an unstable economic climate (uncertainty in the banking sector, lack of improvement in the job market, weaknesses in different productive sectors of the economy, the property sector being slow to adjust to the crisis...). Finally, the real obstacle to consolidating economic growth reared its head in 2011, in the form of a sovereign debt crisis, which affected several countries in the European Union and was particularly hard on Spain.

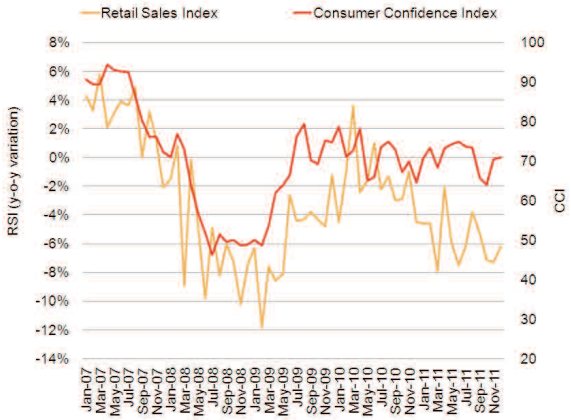
GDP, consumption and employment in Spain



Source: INE

In addition to the immediate consequences of the constraints and the increased cost of financing, the financial crisis has resulted in a political crisis in the EU. Several countries, including Spain, have been obliged to commit to austerity measures (reducing public spending, tax increases...), which are bound to have a negative impact on the economy. Activity slowed in the second half of 2011 and the job market gradually deteriorated even further. Household consumption declined yet again (despite an increase in consumer confidence right at the end of the year), leaving the foreign sector as the only bastion of Spanish economic activity. At any rate, GDP growth for the final quarter of the year is expected to be meagre or almost zero.

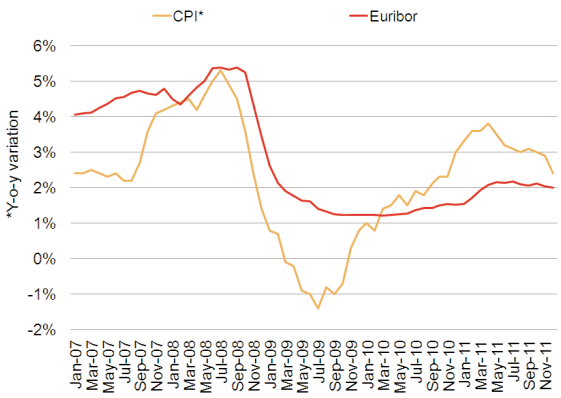
Retail sales and consumers' confidence



Source: INE, European Commission

This recent stagnation has affected an already seriously damaged job market, which has seen unemployment increase, whilst National Insurance scheme contributions have decreased and this trend is not expected to change over the coming few months. The uncertainty linked to this scenario and the forecasts for 2012 mean that we cannot be optimistic in the short-term, especially considering that the risk of recession in 2012 extends to a good deal of European countries, which will result in a negative effect on the Spanish foreign balance of trade. At any rate, and depending on how quickly European institutions agree on measures or treaties that will restore confidence at the heart of the EU, growth in both Spain and the continent will remain muted until 2013.

CPI and Euribor



Source: INE

Demand

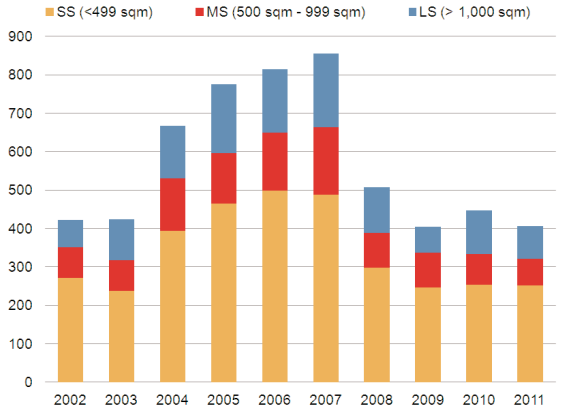
Demand

Office demand in slow motion

Business confidence is currently not going through the best of times. According to the latest data published by the Chamber of Commerce's Superior Council, there was a clear decline in the Business Confidence Index in the third quarter, after reaching its highest level in three years in July. When we look at the Present Situation Index and the Expectations Index, the short-term outlook is not looking promising.

The slowdown in business activity has had a direct effect on the decline in activity in Madrid's office market, with little more than 80,000 sqm of office space taken in the fourth quarter. The year-on year quarterly take-up figures and the accumulated half yearly figures are negative for the fifth consecutive quarter (-6% and -9% respectively). Total take-up for the year was around 340,000 sqm, which is 23% less than in 2010.

Transactions by size



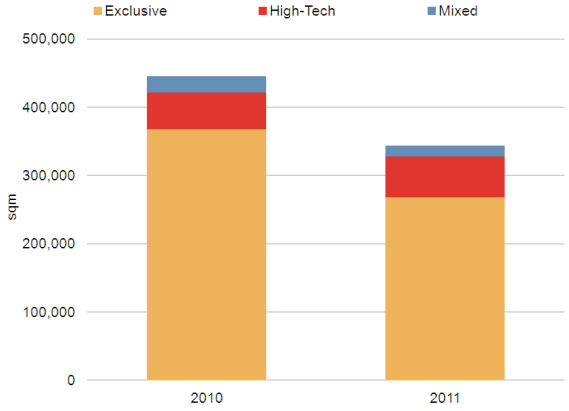
Source: Savills Research

Companies continue to cut costs and resources and the main reasons for moving offices are still cost savings, either by combining several headquarters into one sole head office, downsizing or simply taking space with a lower rent.

This would explain why the small office space category (up to 500 sqm) has remained stable over recent years, to the detriment of large and very large office space. In addition, both the number of transactions and the average size of space taken in the >10,000 sqm category have also gradually declined.

But the austerity measures and cuts are not just affecting business in the region, as public administrations have also gradually become less active since 2007. They are currently in the midst of analysing space requirements, in order to optimise and streamline the space they own and let, which has caused a marked fall in activity in 2011. The three public administrations (local, autonomous and central) have taken part in hardly 1% of all of the transactions completed and the corresponding volume of take-up amounts to 7% of total space signed.

Take-up 2010 vs 2011 (by type of building)



Source: Savills Research

However, although rental price adjustments have generally affected the whole market, price falls have been more evident in the periphery areas of the city. Companies have therefore taken this into account when searching for and moving headquarters, as the amount of transactions completed outside the M-30 ring road have continued to grow since summer 2010.

This would be related to the increasing interest in semi-industrial properties, which are mainly located in periphery areas and which have interesting price to quality ratios. 17% of take-up in the fourth quarter was for space located in the Julián Camarillo area and two thirds of lettings were for properties that are less than two years old.

Several areas which saw almost no demand activity have come back onto the radar (such as Rivas Vaciamadrid or Alcorcón) and new business areas are emerging in new urban developments that are located further from the traditional tertiary sector areas. Grupo Ortiz has a complex comprised of three properties in the Ensanche de Vallecas, one of which was let to Securitas in the fourth quarter. It was the largest letting in the fourth quarter by volume and one of the eleven largest transactions of the year (>5,000 sqm).

Supply

Supply

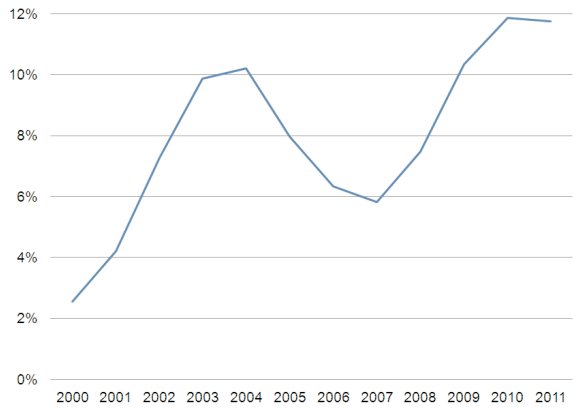
Net take-up causes the vacancy rate to rise

It is relatively normal to see delayed construction works. Almost 25% of office space in the pipeline at the beginning of 2011 has been delayed to 2012. In the end, just over 120,000 sqm of space was delivered, of which over a third was pre-let in previous years (Peugeot's new headquarters in Las Tablas, Strike Ibérica's new head offices in Alcobendas and AENA's new headquarters in Pegaso City) or came from other more recent contracts.

On the other hand, building refurbishments are becoming increasingly common. We would point out that in 2011 the amount of refurbished space exceeded that of new space (53% compared to 47% respectively). And although up until a few years ago, these types of projects were usually located in the city centre, owners now understand that a complete refurbishment is the best way to adapt outdated properties to current occupier requirements, thus increasing the competitiveness of the properties. In turn, occupiers are clearly more interested in refurbished properties, as demonstrated by the fact that many of these properties have come back onto the market fully let. An example of this is BBVA's new headquarters on Isabel Colbrand, or properties with high occupancy rates, such as Albasanz 14, in the Julián Camarillo area, or Paseo de la Castellana 79, in AZCA.

Refurbishments have also halted the uncontrollable increase in office stock. At the end of 2011 stock in the Madrid office market amounted to just over 12.8 million sqm, a mere 0.5% more than the same figure in December 2010.

Availability rate

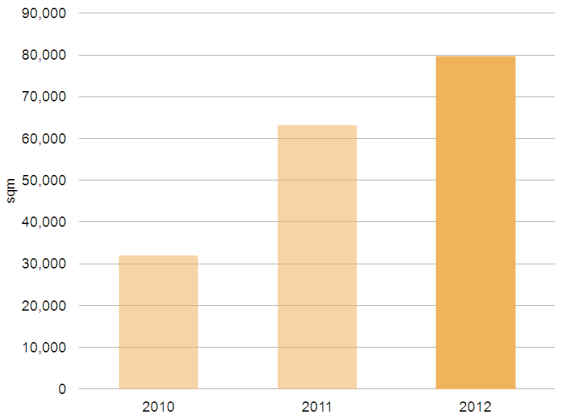


Source: Savills Research

In terms of available supply, the gradual completion of new or refurbished space has meant that the vacancy rate has only increased very slightly, reaching around 11.8% in Q4, which is just a few tenths of a percent above the figure for the previous quarter.

Thus the main reason for this increase in available space is the net take-up figure, as most companies that decide to move their headquarters are downsizing.

New projects and refurbishments



Source: Savills Research

Around 300,000 sqm is in the pipeline for 2012, although as has been the case in recent years, this figure will vary as the year goes on, as the pace of work depends on the rate at which marketing are made and developers having access to finance.

In any event, over 40% of the total will be owner-occupied, such as Repsol's new headquarters on Méndez Álvaro, or will be pre-let space, such as the new head offices of the law firm Cuatrecasas on Calle Almagro. Abengoa recently signed a pre-let agreement for a property on Paseo de la Castellana, which will be refurbished before it is expected to come back onto the market in 2012.

However, when these very large firms move headquarters, this means that their current headquarters will be left vacant. The largest project in terms of volume is the introduction of over 4,000 Repsol employees into its ca. 60,000 sqm campus, which will mean that a considerable amount of space will be freed up. Amongst others, the two properties located at the end of Paseo de la Castellana were both built at the beginning of the 1990s and will both undergo a comprehensive refurbishment and modernisation process.

From 2012 onwards the outlook for future supply is plagued with uncertainty. Few new build projects are expected to come onto the market in 2013, although the accumulated delays from 2012 will increase the volume of projects to be delivered. At the moment most

Rents and transactions

of the space in the pipeline corresponds to refurbishment projects or properties that will be vacated. There is a large pool of projects, whose viability depends on re-establishing credit flows and a market recovery.

Rental prices continue to fall

The lack of demand and the gap between supply and demand continue to push rental prices down. The adjustment in rental prices has affected the whole market - the CBD, the city centre and periphery areas, although declines have been less marked in the most consolidated submarkets.

The theoretical closing rent in the CBD in Q4 was around €26/sqm/month, which represents a 2% fall compared to the previous quarter and a 5.5% decrease year-on-year. The figure achieved at the top of the market seems to be but a blip on the horizon, as by the end of 2011 this figure had fallen by 38%.

Rental prices in prime areas outside the M-30 are very similar to those in the CBD when you compare these to rental prices registered in Q3 2011, Q4 2010 and the top of the market. At year-end, the theoretical rental price was around €16/sqm/month.

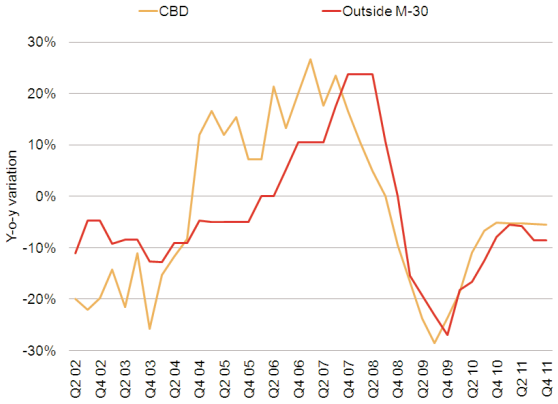
The difference between the maximum and minimum prices in the second half of the year was over €20/sqm/month. The highest value in the market, €28.50/sqm/month was registered on Paseo de la Castellana, although this is an isolated case and it should not be considered as a sign of recovery or a growth trend, as muted growth and new space coming back onto the market such as Torre Titania, or refurbished space, such as Catalana Occidente's previous headquarters, will contribute to weakening rents over the coming few quarters.

The lowest rental price registered was in San Sebastián de los Reyes, at €6/sqm/month. Rental prices in areas furthest from the periphery have declined sharply, mainly as a result of over supply. In the case of San Sebastián de los Reyes, there is a 50% difference between the lettings closed now and those closed in 2007.

When you study the transactions completed for sole office use properties in 2011, there has been an 8% year-on-year decline, which is almost over 2% more than the year-on-year figure for 2010.

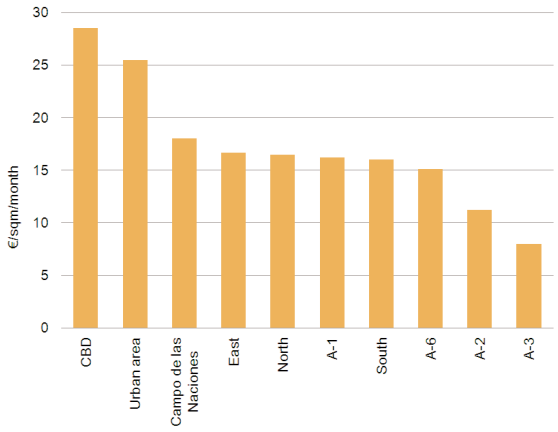
Rents for semi-industrial properties fell by 15%. On the one hand, transactions have increased for this type of property, and on the other, the fall in rental prices has seriously affected outdated properties in areas furthest from the city centre. Whilst in 2010 only 18% of transactions registered for these types of properties were below €10/sqm/month, in 2011 30% of contracts were signed for one digit rents.

Prime rents growth



Source: Savills Research

Maximum rents - exclusive office buildings - Q4 2011



Source: Savills Research

Main letting transactions - Q4 2011

Tenant	Area	Surface (sqm)	Activity
Securitas	South	6,300	Services
Interxion *	East	6,000	Services
Zurich	Urban	4,600	Insurances
Beam Global	Campo de las Naciones	6,000	Industry
Vector Software	A-6	3,800	IT
Holcim	East	2,900	Industry

Source: Savills Research / *Advised by Savills

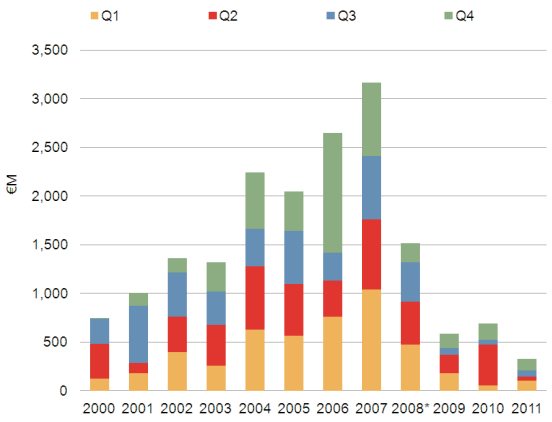
Investment and yields

Investment

Record low investment volumes

The "annus horribilis" for investment in the Madrid office market, has finally come to an end. The total for the year marks a record low since 2000, with around €365 million, which is a 47% year-on-year decline compared to the previous year. Investor activity has also dropped considerably, as the 19 transactions registered, amount to a 30% decline compared to 2010 figures. The average investment lot size has also fallen by 25% compared to last year to €19 million, which is the first time in 10 years that it has been below €20 million.

Investment volume



Source: Savills Research / *Ciudad Financiera del Santander excluded

This general sluggishness can be directly linked to two factors. On the one hand, international investors have less and less confidence in the Spain market. This, amongst other factors, is primarily due to the collateral damage that turbulence in the international financial markets had on Spain and this has made the country less attractive in the eyes of investors. On the other hand, there is also a scarcity, for want of not saying absence, of financing (which is perhaps the most important factor).

It is becoming increasingly difficult to enter the market, as demands are ever stricter and having access to equity is essential. When you look at buyer profiles, family offices and private investors clearly dominate the market. They know the market and its characteristics inside out and they have liquidity to be able to buy comfortably, but always at market values, as the expectations of sellers and investors are much further apart from each other than one would expect.

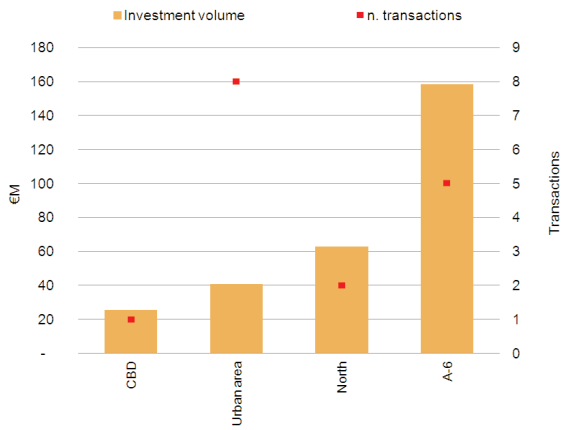
International investors have not been as active in the market and have only carried out three transactions, which amounted to 25% of the total investment volume. However when you study the sellers, it shows that certain foreign funds have considered that now is the right time to rotate their assets. Having quality supply in the market is a distinct advantage.

In terms of volume, the largest transactions of the year on the seller side were carried out by international funds.

The sale of the second phase of the complex that Hines developed in the Las Rozas Business Park, was comprised of buildings B and C, which were sold to a private investor for an estimated €50 million. The tower, which is occupied by ADIF in the Méndez Álvaro area was acquired by Invesco for a total of around €40 million.

The city's secondary market and the consolidated areas in the periphery are an interesting alternative, as there are opportunities in modern, quality properties with good tenants, long-term contracts and market rents.

Geographical distribution - 2011



Source: Savills Research

Yields have moved out slightly

Yields have moved out further due to weak investor demand and an increase in supply. In the CBD investor offers place the yield at between 5.25% and 5.50%.

Transactions completed over the year in the Las Rozas Business Park have enabled us to monitor the development of yields for completed transactions, indicating an increase of between 75 and 100 basis points from January to December.

Outlook

Outlook

Economic forecasts

Until around summer 2011, top economic and financial institutions estimated that the Spanish economy would grow by no less than 1.2%. However, expectations have fallen considerably since then, and at the end of the year this figure was touching on negative. Despite the fact that the Spanish sovereign debt spread compared to German sovereign debt spread has fallen gradually, it remains high. The inevitable austerity measures and the persistent imbalances in the Spanish economy will affect the performance of these spreads in 2012, as well as substantial growth after the period of static economic growth or recession.

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

	2009	2010	2011	2012	2013	2014
GDP	-3.7%	-0.1%	0.7%	-0.3%	1.0%	1.6%
Consumption	-4.4%	0.7%	0.2%	-0.1%	0.8%	1.4%
CPI	-0.2%	2.0%	3.1%	1.5%	1.5%	1.5%

Source: Focus Economics Forecasts (January)

Market forecasts

Confidence and financing are the two fundamental areas that hold the key to a recovery in the office market. Hopes are pinned on the structural reforms that the new government has implemented and will continue to implement. But the outcome of the proposed changes will not be immediate and for the time being, forecasts for the main economic indicators are looking worrying.

The office market did not reach the huge scale of residential stock, which will at least enable us to see the light at the end of the tunnel, although there is still a good way to go yet.

We are a far cry from the time when occupiers of commercial space moved offices in a bid to improve their image or because the workforce had expanded and we are also a far cry from the time when there was barely any space that was not in line with occupier requirements. Companies are currently focusing on their core business, which is not say they are undervaluing the effort, drive and dedication of previous years, but nowadays companies only change offices if it is absolutely essential or if there is a very attractive offer which would provide a clear benefit for the company, such as combining several headquarters into a sole head office. Rental renegotiations with landlords will continue to be the main alternative to adjust costs, despite the fact that most new contracts include appealing incentives. On top of rent-free periods or including service charges or parking spaces in the agreement, contributing to fit-out costs is also becoming increasingly common. And the fact is, that when supply far exceeds demand, anything that attracts the eye of potential occupiers is fair game.

The balance between supply and demand will slow the continuous fall in rental prices, but forecasts for 2012 suggest that take-up figures will be similar to those of 2011 and that there will be an increase in the vacancy rate, which means that there will be consecutive declines over the four quarters of the year.

The investment market scoreboard will open with the €400 million for Torre Picasso. This single transaction already amounts to 10% more than the total investment volume in 2011. But despite this great start, the indices do not bode well for the rest of the year. Despite the fact that there is supply in the market, not all of the properties are sellable because there are a lack of properties that meet all investment requirements.

Location, higher than market rents, short contracts, with future rent reviews, old properties that need additional investment to bring them up to current market occupier requirements etc. are some of the aspects which would be even more penalised by yields moving out further, which is something that sellers cannot accept.

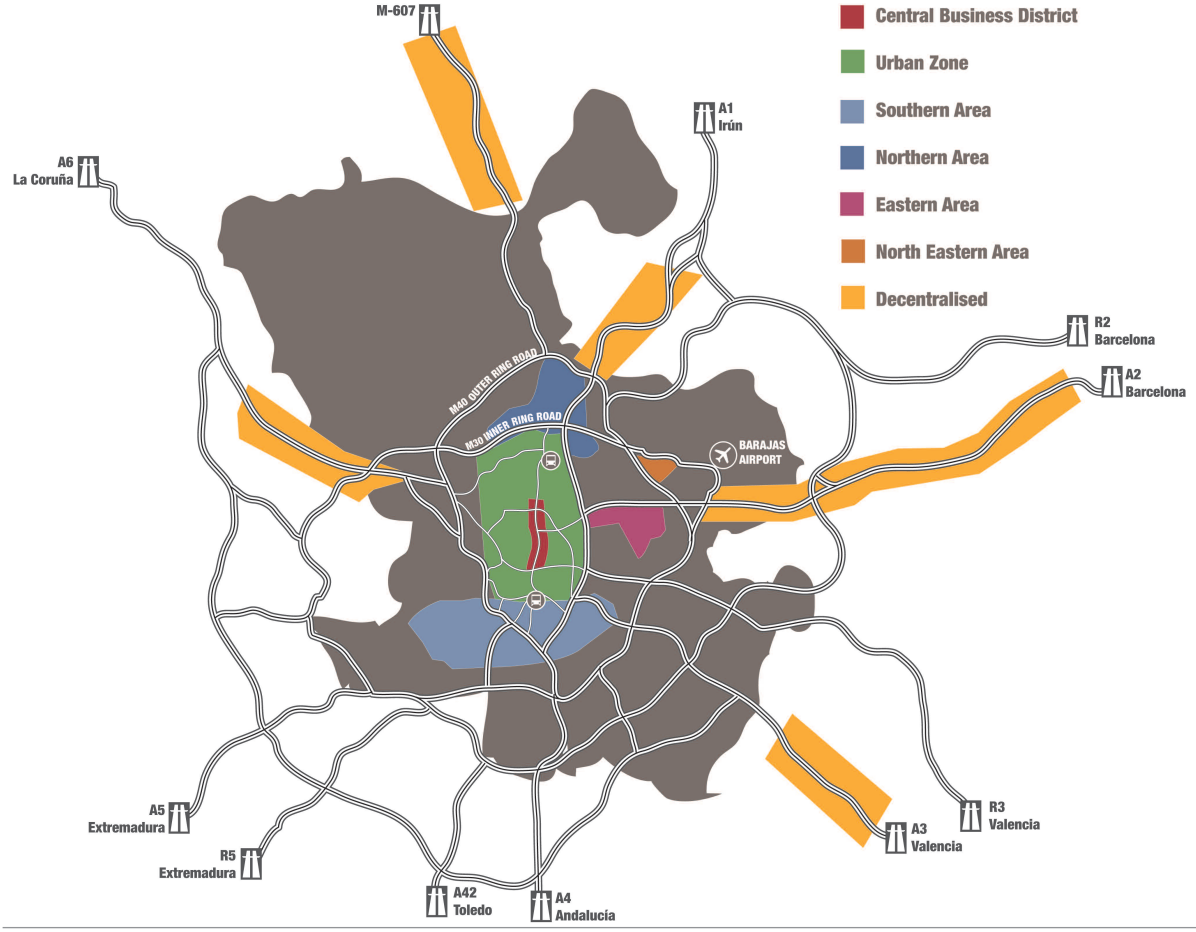
Sale & leaseback transactions were not as evident in 2011 and this is not expected to improve in 2012 (we are referring to the office market, given that in the bank branch segment small lots are still being sold). Properties which could be interesting for buyers were acquired at the top of the market and as such there would be a considerable difference between their current price and the price they were purchased for.

However, access to finance will be the key factor which will enable investor activity to increase in the market, because there are some players who are interested in jumping onto the bandwagon. Properties that have fallen into the hands of banks may come onto the market, and in these cases these institutions themselves would offer financing.

Spanish private investors will mainly set the pace in the market. The interest of international firms in Spain will be focused on other tertiary sectors, mainly retail, although opportunistic funds are aware of the opportunities that are arising for distressed assets.

Madrid office market

Survey map



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