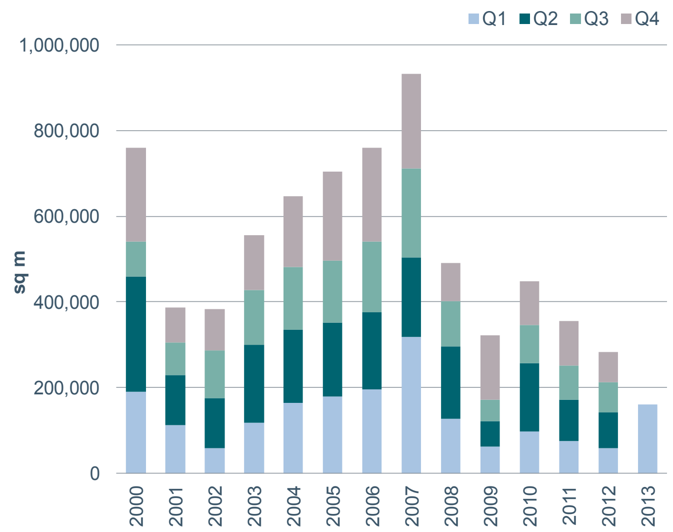
Market report
Madrid offices

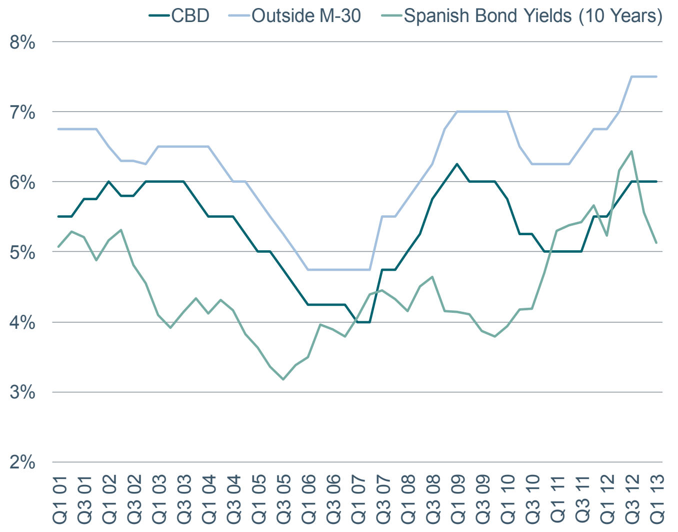
Q1 2013

GRAPH 1
Annual Take-up



Source: Savills

GRAPH 2
Prime yields vs Spanish bond yields



Source: Savills, INE

SUMMARY

Economic growth forecasts are being defered ever further off into the future

■ Take-up has been driven by the coincidental signing of several mega-deals. The 50,000 sqm deal of Vodafone which will bring all its offices under one roof was the largest on record.

■ As a result, the quarterly gross take-up volume exceeded the total H1 2012 figure. However, we remain cautious about the market outlook as these deals are considered exceptional.

■ Available supply continued to grow. At the end of March, supply stood at more than 1.7 m sq m. Hence the vacancy rate stood at above 13%, which is the highest seen since 2000.

■ The continued imbalance between supply and demand suggests that we are likely to see further downward rental adjustments. The strength of the CBD has allowed the achievable rental value to remain at €24.50 per sq m/ month, although there have been a few lettings signed above this figure.

■ After a spur of activity at the end of 2012, Madrid's office investment market has now slowed. However, although there has not been a large number of transactions, the key difference compared to one year ago is that prospective buyers are back in the market and intend to buy.

■ The sluggishness of the market has kept yields stable and for now we do not expect to see any changes.

Economic situation

Economic uncertainty is once again hanging over Europe, this time due to Cyprus. Although the Spanish banking sector exposure to Cyprus was only €36 m, and 'a priori' would therefore rule out any form of knock on effect, tension in the markets could hamper a recovery.

On the other hand, the low levels of growth and the high debt and deficit levels of peripheral European countries that caused GDP falls in Q4 2012 (1.9% for Spain and 2.5% for Italy), are bringing the European economy to a virtual standstill. According to Eurostat, in the last quarter of 2012, the economy dropped by one point.

Due to the high unemployment rate, the labour market continues to be in an extremely worrying situation. In Q4 2012 unemployment reached 26.02%, despite the measures adopted by the government in order to boost recruitment.

The positive results are coming from the trade balance, which has dropped by 70% since the top of the market in 2007, this is helping to boost the competitiveness of the Spanish economy, which since 2010 has continued to have to quickly adapt to the new circumstances. This process spans from structural reforms focused on reducing the deficit and creating jobs, right through to individuals and businesses attempting to be more competitive in order to foster more confidence in financial institutions.

All of this is attempting to being carried out when worldwide retail trade growth forecasts are looking anything but rosy, with the IMF (International Monetary Fund) estimating retail trade growth to be at 3.5% for the first quarter. We would also single out the Japanese economy, which has adopted the historic decision to double its monetary base in order to depreciate its currency and thereby boost exports.

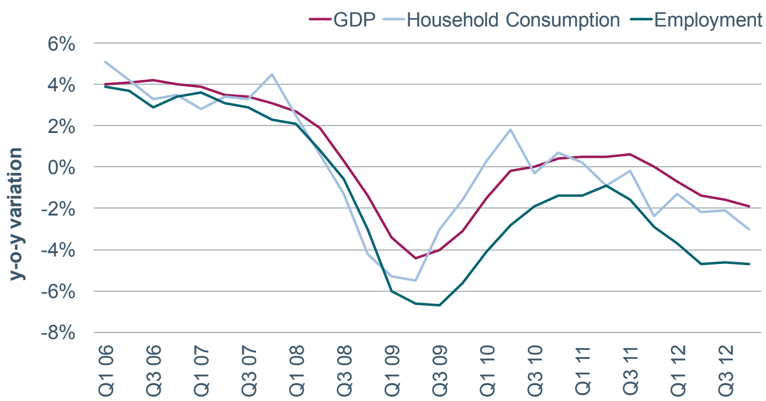
In terms of inflation, the latest data published by INE (Spanish National Statistics Institute) in March set inflation at 2.4%, four tenths of a percent below the same figure registered one month ago, but still above the European average of 1.9%, according to Eurostat.

The Spanish banking system is also pressing ahead with its restructuring process and everything currently suggests that there will be a very limited flow of credit in 2013. This in turn will curb consumption, business start-ups and job creation.

In conclusion, we are at a point in time where harsh austerity measures are leading to economic contraction and rising unemployment. Nevertheless, the falling inter annual deficit figure, which was at 6.98% in 2012, coupled with the alienation of the need for a bailout, mean that the forecast for the upcoming quarters could potentially suggest tentative and yet sustained economic improvement. This is then expected to stabilise in 2014 and show clear signs of growth from 2015 onwards.

GRAPH 4

GDP, consumption and employment



Source: INE

GRAPH 3

Retail sales and consumer confidence

Source: INE, CIS

TABLE 1

Economic indicators

Indicator	2011	2012	2013*	2014*	2015*
GDP	0.4%	-1.4%	-1.6%	0.3%	1.4%
Household consumption	-0.8%	-2.2%	-2.9%	-0.1%	1.2%
Unemployment	21.6%	25.0%	26.7%	26.6%	24.5%
CPI	3.1%	2.4%	1.9%	1.4%	1.5%

Source: Focus Economics (April 2013) / * forecasts

Take-up and demand

The first quarter of the year closed with the highest gross take-up volume registered since mid 2008. The close to 160,000 sq m of take-up, was almost three times higher than Q1 12 and was even 13% higher than the figure achieved in the first six months of 2012. However, we should point out that this only came about due to the coincidental conclusion of several mega-deals that drove the take-up figure to record highs.

Among the largest lettings, we would highlight the one that was not only the largest over the past quarter, but also the largest on record (from 2000 onwards). Vodafone will soon bring its Fuencarral and La Moraleja headquarters under one roof in Parque Empresarial Avenida de América 115 (50,000 sq m), on the A-2 axis. The aim of which is to optimise resources and increase efficiency.

Iberia comes second in this quarter's large transaction ranking. Having abandoned its plans to develop a corporate headquarters close to T-4, it will now be the new tenant of the old Philips headquarters, located on the first stretch of the A-2 (16,000 sq m).

The Agencia Efe came in third place having also opted to rent space rather than go ahead with the construction of its headquarters in Ensanche de Vallecas. It will now leave its long standing home on calle Espronceda to move to Edificio Génesis on Avenida de Burgos (12,000 sq m) in the Northern area.

These three deals alone accounted for close to 80,000 sq m, which makes up almost half of the quarterly total.

When it comes to the number of transactions, it is a whole different story. The 20% year-on-year decrease in the number of lettings is a clear indication of the fact that occupiers are continuing to avoid expansion due to the uncertain business climate.

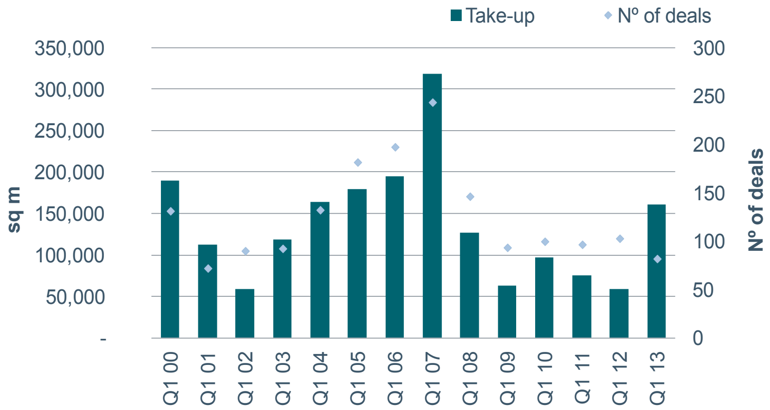
City centre vs periphery

The disproportionate increase in take-up over the first quarter and the fall in the number of lettings signed have meant that there has been a significant increase in the average size of office space taken. The market's overall quarterly level is now above 1,900 sq m, close to 2,800 sq m outside of the M-30 and 1,800 sq m in the city centre.

The unique nature of several of the lettings signed over the quarter has dramatically increased the amount of take-up outside of the M-30 ring road. Therefore the amount of office space taken in out-of-town areas in the first quarter reached 68%, whereas over the past four years the same figure was at between 50% and 55%. As it is becoming more and more the norm, the north eastern quadrant has seen the highest volume of office take-up, accounting for just over 80% of the total. Companies are primarily opting for the city's more consolidated office areas, but we should indicate that

GRAPH 5

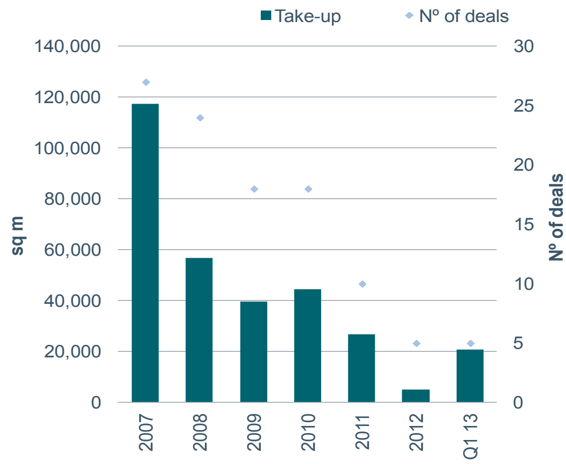
Historic trend in demand



Source: Savills

GRAPH 6

Public sector demand



Source: Savills

other areas are making a come back. Vallecas and Getafe accounted for close to 13% of space taken in out-of-town areas.

The CBD and the urban area also saw various lettings over 3,000 sq m, which helped to increase the average take-up volume. In terms of location, one letting that stands out from the rest is Abertis's new headquarters at 39 Paseo de la Castellana, which is currently being refurbished. In addition to this, various companies will move to Torre Cristal, which between January and March let close to 10,000 sq m.

Public sector

For the second quarter in a row and after almost one year of being out of the market, various institutions from the three public administrations came on to the scene again. Aside from the aforementioned Agencia EFE, CAM is continuing with its downsizing and cost reductions plan and will transfer the offices that the Treasury department occupied on Calle Principe de Vergara to the Julián Camarillo submarket in the Eastern area. Finally the FROB (Fund for Orderly Bank Restructuring) will occupy an office in AZCA, which is the same area that Sareb chose the quarter before.

Current availability

Over the first three months of the year office supply in Madrid continued to climb, reaching 1.7 m sq m of vacant space at the end of March. The vacancy rate also continued to rise and is now over 13%, which is a record high.

The CBD continues to have a healthy vacancy rate, well off this record high figure, but it has registered a slight increase compared to the previous quarter. The vacancy rate in the CBD reached 6.3%, primarily due to Paseo de la Castellana 7 coming back on to the market (9,000 sq m of speculative space is on the market, as two floors were let in Q4 2012).

Other recent completions

In the area around Plaza Cuzco the second phase of the Castellana 200 office complex was delivered. The shopping arcade will also be opened soon, which will have a diverse retail offering of services and leisure.

In total, close to 30,000 sq m came on to the market, but only two thirds of the new or refurbished space has increased the amount of available space, as some of the properties were already pre-let.

Future supply

Little more than 130,000 sq m is forecast to come on to the market over 2013. These figures are just estimates, as developments regularly continue to be delayed. In 2013, close to one third of all new space has been carried over from the year before.

One of the projects that has seen some of the most severe delays has been Torre Titania. In 2011 the retail area was opened as an extension of the Castellana Corte Inglés, with close to 15,000 sq m of office space pending delivery. Eight years after the Torre Windsor fire and six years after construction works started on the new development, it looks like 2013 will be the year when one of the Madrid skyline's most prestigious buildings will come back on to the market. At the moment, no-one has signed a lease agreement, but various of those companies looking for large amounts of office space have shown an interest in Isidoro Álvarez's crown jewel.

Refurbishment projects

Refurbishment projects are taking on more and more of a prominent role in the market. More than 50% of office space that is expected to come on to the market in 2013 is fully refurbished properties and of these, one third are already pre-let. The owners took advantage of old tenants vacating the properties in order to carry out refurbishment works and update facilities to be in line with existing regulations and current occupier requirements. In some cases projects are being carried out almost immediately after the tenants have vacated the buildings, particularly those properties located in the city centre, which are more likely to find a new tenant. In contrast, other landlords strategies are to wait for a potential tenant to show a firm commitment. The difficult market context still means that owners are not looking to speculatively start projects without a tenant in place.

Stock growth

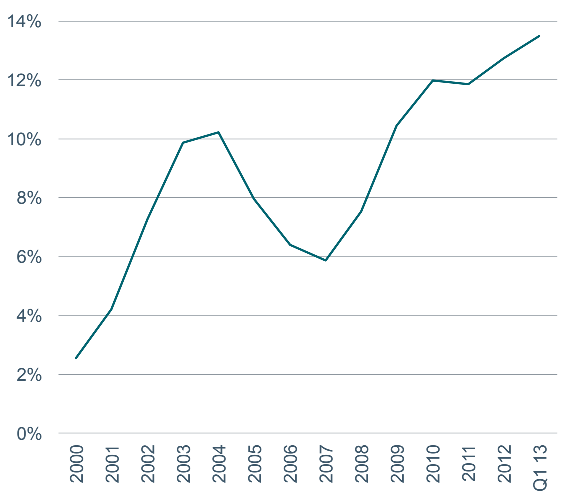
An increase in office stock is being constrained by refurbishment of existing stock and various office properties which are being taken off the market. As a result there has been a slight decrease in the market's total office stock. Some of the properties that have been taken off the market and caused this drop include the Canalejas Complex, and the Plaza de Espana buildings from the Copernico portfolio. The Canalejas Complex used to be Banco Santander's old headquarters. This property was purchased at the end of last year by Grupo Villar Mir and will be turned in to a mixed-use hotel, retail and residential development.

Just a few weeks ago, the VP hotel chain purchased one of the Plaza de España properties which was part of the Copérnico portfolio and which since December 2012 was owned by Anchorage and Värde.

This was not the only property to change from office to hotel use. Over the past few years various properties have also gone down the same route. The most recent was the old Data Protection Agency headquarters, which is now a youth hostel.

GRAPH 7

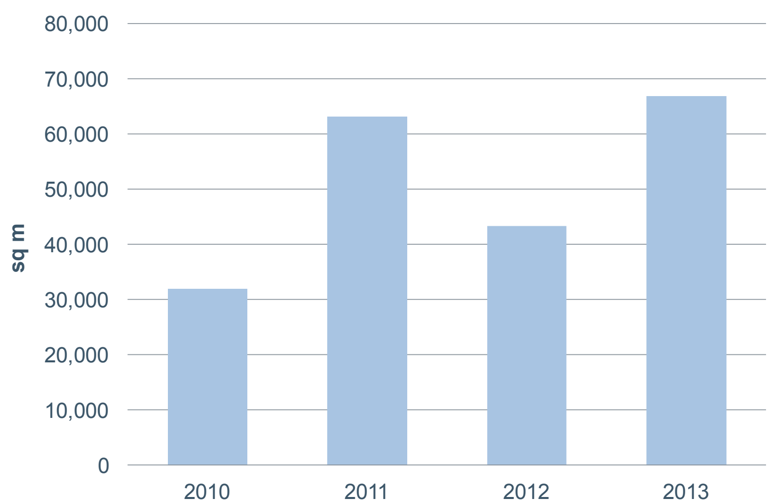
Vacancy rate



Source: Savills

GRAPH 8

Pipeline: refurbishment projects



Source: Savills

Rents are stable

Despite the excellent amount of take-up over the first quarter of the year, the lack of demand has not compensated for the large amount of oversupply on the market, therefore, we do not currently expect rental values to begin to recover.

Despite this, we have detected a slight increase compared to the closing rents signed last year in more consolidated areas and in very specific properties, therefore we could be seeing the bottom of the market and from now on see some form of tentative, if not stunted growth. In contrast, the areas located furthest from the city centre and which have a very large amount of oversupply, continue to see rents fall. And that is the best case scenario, as many out-of-town areas have not seen any interest from occupiers for some time now. It is evident that it has become a two-tier market.

The overall average rental value for business properties (exclusive office use and high tech) over the first quarter of 2013 was €14.30 per sq m/month, which is close to a 1% year-on-year change. It is the first positive entry since 2008.

The lowest rent registered last quarter was still €6 per sq m/month and the number of lettings signed below double digits has continued to rise. Between January and March, these accounted for close to 17% of all lettings and all of them were in out-of-town areas, but these are creeping ever closer to the natural borderline of the M-30 ring road.

«Rents will begin to recover as and when supply and demand balance out. Economic growth forecasts are being pushed ever further off into the future and this will be a key factor to overcome in order to drive the market forwards»

Gema de la Fuente, Savills Research

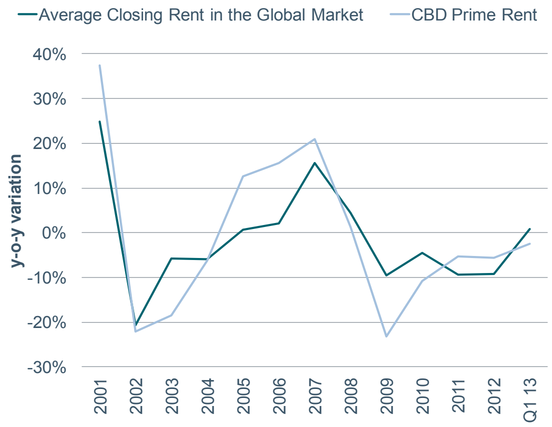
Prime rents

The CBD has seen closing rents remain unchanged compared to last year at €24.50 per sq m/month. Prime CBD achieved rents were 5% lower compared to Q1 2012 and 42% below the peak of the market. In some very exceptional cases, some lettings have been signed above this figure, but not for office spaces which were any larger than 400 sq m.

Overall, higher rental values can be achieved for renovated properties, as the majority of the stock along the main axes in Madrid's CBD is outdated.

GRAPH 9

Average closing rents vs CBD rents annual variation



Source: Savills

TABLE 2

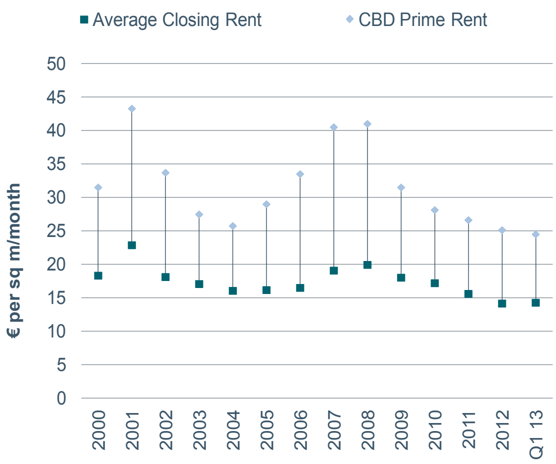
Main leasing Transactions - Q1 2013

Tenant	Zone	Floor area (sq m)	Activity sector
Vodafone	A-2	50,000	IT
Iberia	East	16,000	Air transport
Agencia EFE	Northh	12,000	Public administration
Amper	A-4	6,800	IT
CAM	East	6,500	Public administration

Source: Savills

GRAPH 10

Average closing rents vs CBD rents



Source: Savills

Investment market

After the investment bonanza at the end of 2012, the Madrid office investment market has returned to low levels of activity. The investment volume over the first three months of the year barely reached €50m and only comprised two deals. If we exclude a large mega-deal in Q1 12 (Torre Picasso), the investment activity in Q1 13 is similar to last year. The difference lies in the fact that there are more prospective buyers in the market, as investor sentiment improves.

Investor interest

The traditional investors that have been in the market over the past few years, primarily national investors, know the commercial property market like the back of their hand and continue to be interested in purchasing properties, as long as they are good quality products and are in line with their requirements.

International investors, mostly German ones, are reviewing their investment strategies, which include Spain being back on their radars. After a few years of inactivity this type of investors is actively searching for opportunities, keeping a close eye on the country's economy and property market.

On top of this, several other players came on to the playing field last year. International investors from South America, USA and Asia are positioning themselves so as not to miss out.

The harsh measures adopted by the government, the restructuring of the banking sector, the creation of the asset management company SAREB, as well as the alienation of the possibility of a bailout, have all helped investor sentiment to improve and Spain is now back on their radars.

In addition to this, prices per sq m are now at the lowest levels seen since 2000, which is an indication that the market is bottoming out.

Nevertheless the number of deals signed remains low. Why?

Lack of transactions

Mainly for two reasons. Firstly, a the scarcity of financing and strict terms and conditions accompanying it, remain a barrier to market entry. That said, some of the market players have the advantage that they are not dependent on financing, which gives them the upper hand when it comes to the competition.

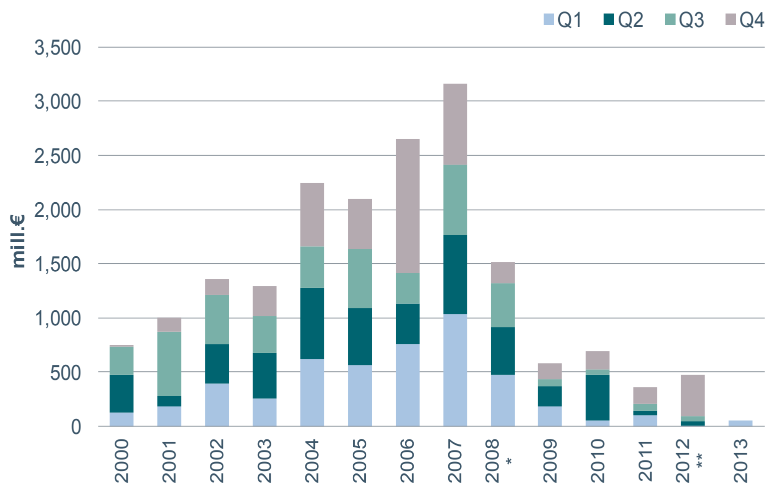
The second factor and the main cause of market inactivity is the lack of quality product on the market at realistic prices. Prospective buyers are analysing the opportunities based on existing rental values (which continue to fall) and yields, which therefore implies that prices per sq m are falling ever further. On the other hand, sellers do not want to bear the loss in real value of their property. As long as this standoff continues, we will only see deals being signed by sellers who are in need of liquidity or impulsive buyers, mostly privates, who pay over the odds compared to market indicators.

SAREB

The creation of the Management Company for Assets Arising from the Banking Sector Reorganisation (SAREB) has created a great deal of concern amongst investors - primarily international - in relation to the way this could affect the market in terms of pricing. Nevertheless, the majority of the portfolios that have been transferred at a significant discount to SAREB, are residential properties.

GRAPH 11

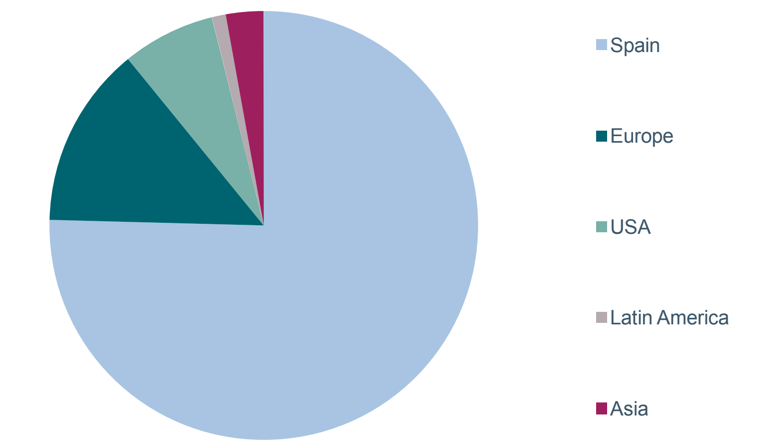
Investment volume



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

GRAPH 12

Investment volume by purchaser origin 2009-Q1 2013*



Source: Savills / * excluding Torre Picasso

«The scarcity and expense of financing continues to hamper investor activity, but the main hurdle is the lack of quality product at market prices» Pablo Pavía, Spain Investment

There is not a great deal of commercial property in the portfolios transferred and, in addition, many of these properties are occupied and are therefore income-producing properties, hence they are currently not a huge problem in comparison to the colossal volume of residential properties on SAREB's books.

Type of product

In terms of the wide spectrum of investment opportunities looked at by both national and international investors, offices have a dominant position. The CBD and most established submarkets of Madrid will be the ones seeing the most interest.

Despite the general pressing lack of product at all levels, prime assets will be the focus of prospective national and international investors. The key differentiating element will be the lot size that can be achieved. Private national investors will be limited to lot sizes of between €20-30m, whereas this would be the starting point for international investors. Sale & leaseback formats are an interesting alternative, both within the city and in out-of-town areas. The Deutsche Bank building on Paseo de la Castellana was sold at the beginning of April and we expect to see more of these types of deals being signed between now and the end of the year.

Yields

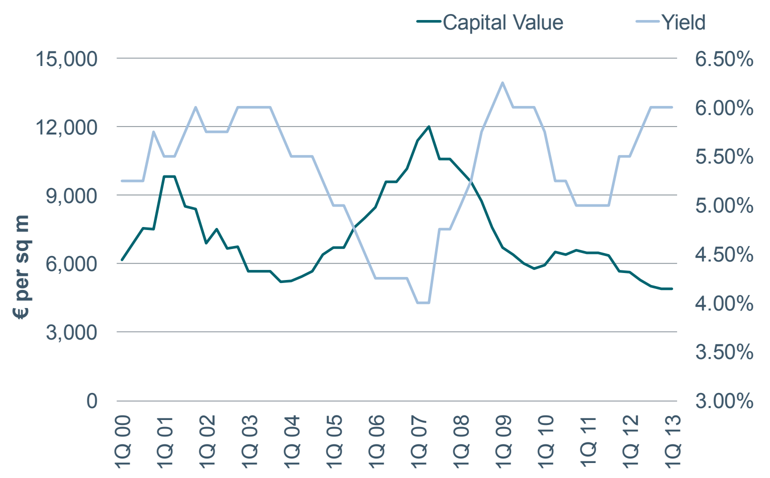
The lack of activity in the market is making it difficult to establish what trend yields will follow.

The CBD and prime areas of the market have remained stable compared to the previous quarter: around 6% on the Castellana and 7.5% in business hubs with a sound market can be achieved. Despite this, trophy assets could sign at lower than theoretical yields.

The Madrid office market could offer opportunities of diversification for international institutional funds, as long as macro indicators and economic forecasts show some form of sign of recovery in the short to medium term.

GRAPH 13

CBD indicators



Source: Savills

OUTLOOK

2013

■ Job creation will be the defining factor behind the business sector taking more office space. Forecasts for 2013 are not optimistic, but despite this and as happened in the first quarter of the year, various large office space requests, which have been in the process of being negotiated for months, will contribute to bulking out the level of take-up.

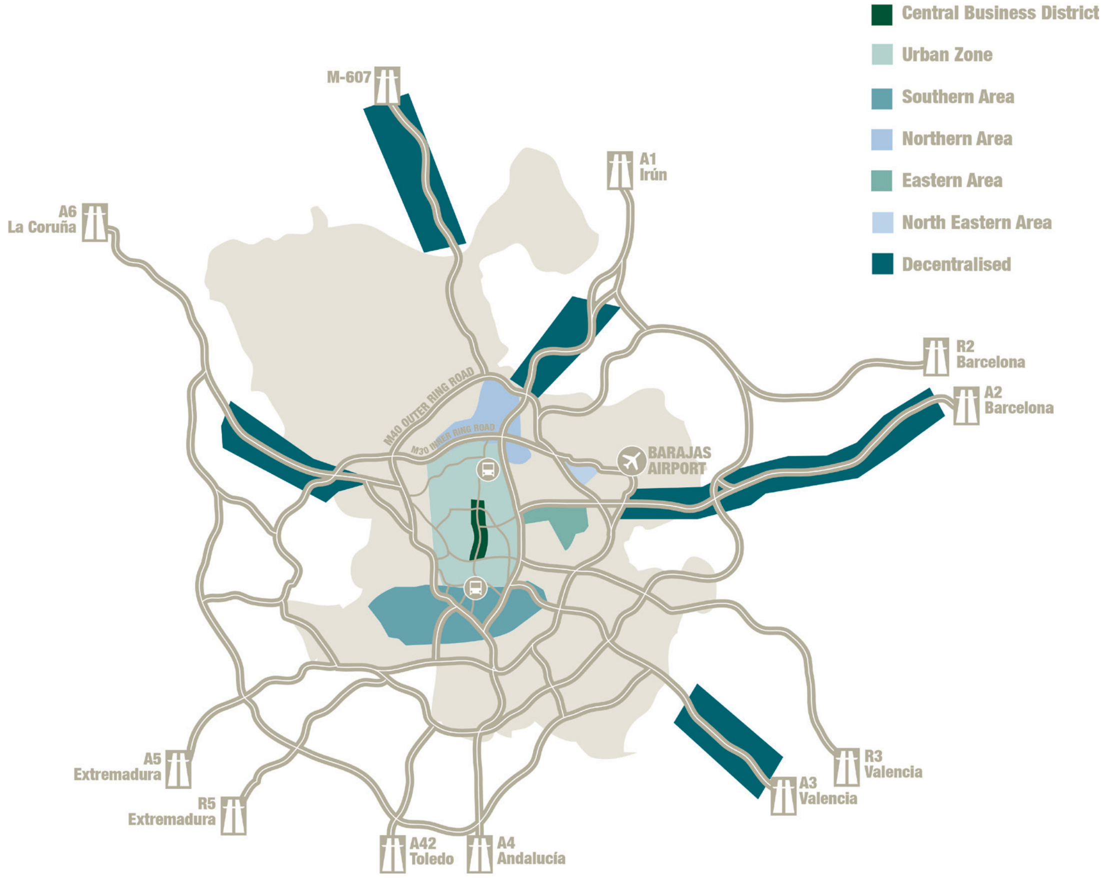
■ Refurbishment projects will alleviate the large volume of obsolete properties in the market without increasing the total volume of stock. Some of these refurbishments are being carried out once the property is vacated, others join the long queue of new developments and turn-key projects that are waiting for an interested tenant in order to start construction..

■ The continuous imbalance between supply and demand would suggest that there will be further rental value adjustments, although some transactions have been carried out above achievable levels.

■ The investment market will continue to be marked by an extreme lack of transactions due to the lack of financing and the shortage of quality product at 'saleable' prices. There is investor demand and interest in buying, but at the moment the gap between buyer and seller value expectations will prevent deals from being signed. The sluggishness of the market is keeping yields stable and for now no changes are expected.

MAP 1

Madrid office market



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