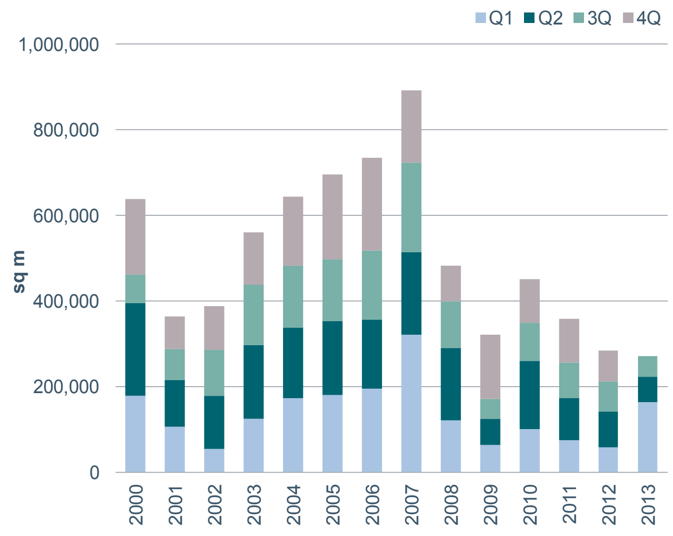
Market report
Madrid Offices

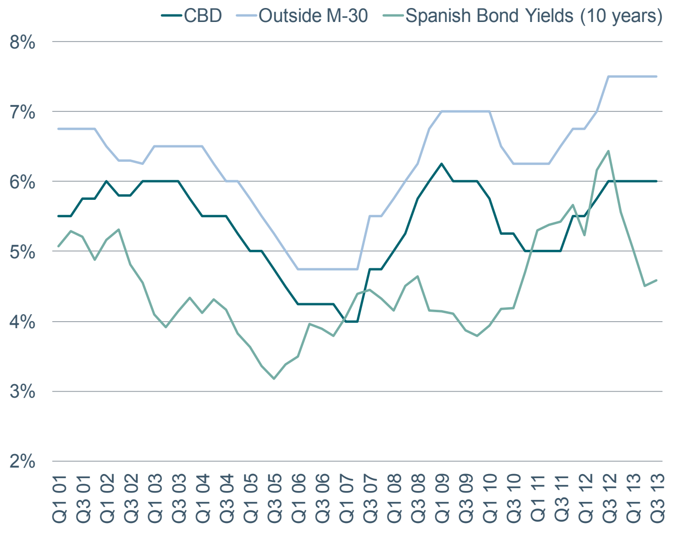
Q3 2013

GRAPH 1
Annual take-up



Source: Savills

GRAPH 2
Prime yields vs Spanish bonds yields



Source: Savills, INE

SUMMARY

There is ever more interest in the Spanish market

■ Take-up between January and September increased by 27% year-on-year to almost 270,000 sq m; however this figure is heavily distorted by several mega deals that were signed in the first quarter of the year, which accounted for almost a third of the total.

■ Subdued demand, which is a far cry from the high amounts of take-up actually registered, is still waiting to see clear signs of economic recovery and growth.

■ The vacancy rate now stands at over 14%, which equates to more than 1.8 million sq m of vacant space. New office developments in the pipeline in Madrid are still few and far between, particularly if they are speculative projects, which are virtually non-existent in the market. 75% of speculative space in the pipeline between 2013 and 2014 relates to refurbishment projects.

■ The achievable rental price in the CBD remains unchanged for the fourth consecutive quarter, given the lack of quality space in prime areas of the city, and recurring demand in the area.

■ On the one hand, the current investment market is marked by the arrival of a large number of different types of investors, with significant amounts of capital behind them, who are very interested in analysing purchasing options and closing deals, and on the other hand by the lack of product in the market.

■ This imbalance between supply and demand would suggest that yields should harden in prime locations. However, as of today, the lack of comparable deals has led us to leave the theoretical yield at 6%.

Economic situation

The decline in GDP is gradually edging off. According to the latest Q2 2013 data published by INE, the decline in the Spanish economy is gradually slowing, with a 0.1% decline compared to the previous quarter, which is three tenths of a percent below the figure achieved in Q1. The current data available confirms that economic activity could be stabilising, or could even increase marginally in the short-term; however forecasts for the year as a whole remain negative.

It would therefore appear that we are starting to see the initial benefits of the reforms implemented by the Government.

In terms of the job market, data from the EPA for Q2 indicates that the unemployment rate currently stands at 26.26%, which is a slight decline quarter-on-quarter. This is particularly significant if we consider that this is the first drop in unemployment we have seen since we entered the double dip recession in Q3 2011. Monthly figures published by SEPE would suggest that there has been a slight upswing, however a large part of the jobs created were seasonal summer jobs.

The summer was the bearer of more good news, such as the record number of international tourists that visited the country in August, which was 7.1% up on July's figure, which was already a record high figure.

The arrival of such a large number of tourists, came on top of a 12% increase in consumption.

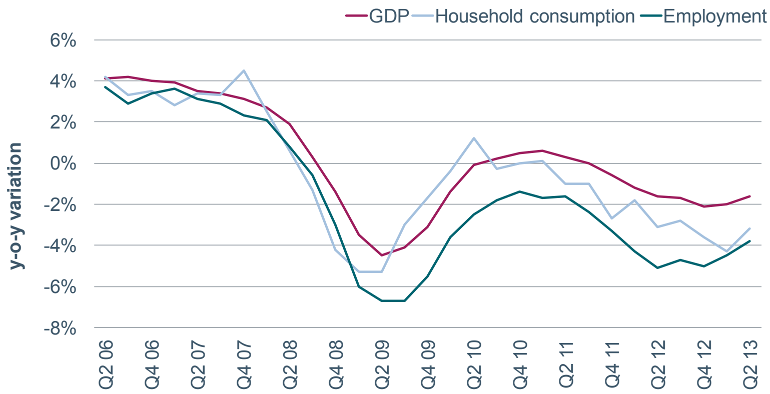
On the other hand, the foreign trade sector remains strong, which is compensating for the shortcomings in other sectors, which continue to be burdened by the fall in consumption and weak business activity. Between January and July, Spanish exports grew by 7% year-on-year. Despite the difficulties in accessing finance, the business sector is making a huge effort to increase its presence abroad, as they are absolutely convinced that it is a good alternative to increase business. In this regard, the rise in productivity and a decline in labour costs have made Spain more competitive internationally, which has helped exports grow.

It should also be noted that the increase in export trade volumes has been accompanied by a reduction in the number of imports, which has enabled the country to reduce its trade deficit by almost 70% year-on-year.

From an EU perspective, Europe has emerged from a long recession thanks to Germany and France, which is positive for the Spanish economy, as these two countries are its two main trade partners (effectively, exports to Germany account for 16% of total foreign exports, and exports to France, 10.7%, therefore both countries are important for the Spanish economy).

GRAPH 4

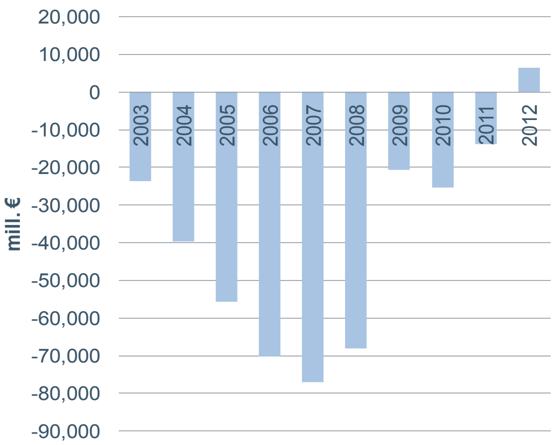
GDP, consumption and employment



Source: INE

GRAPH 3

Balance of payments: goods & services



Source: INE, ICEX, Banco de España

TABLE 1

Economic indicators

Indicator	2011	2012	2013*	2014*	2015*
GDP	0.1%	-1.6%	-1.4%	0.5%	1.2%
Household consumption	-1.2%	-2.8%	-2.6%	-0.0%	0.8%
Unemployment	21.6%	25.0%	26.5%	26.4%	25.3%
CPI	3.1%	2.4%	1.7%	1.2%	1.4%

Source: Focus Economics (October 2013) / * forecasts

Take-up and demand

The summer break has left its mark on the capital's office market. The quarterly figure between June and September barely amounted to 48,000 sq m, which is slightly above the Q3 all-time low, which dates back to 2009.

Take-up has fallen by 31% year-on-year, which has increased the number of transactions by up to 29%. This demonstrates how weak demand currently is.

However, it is a very different story when we look at the gross take-up figure since January. Take-up grew by 27% year-on-year to around 270,000 sq m; however we must remember that this figure is heavily distorted by several mega deals that were signed in Q1, which amounted to 30% of the total take-up figure.

City centre vs out-of-town

Occupiers and buyers continue to show a clear preference for central locations compared to out-of-town areas. Since 2009, there has always been a greater preference for offices in the CBD compared to those located around the M-30 ring road, with over 50% of deals signed in the former. The increase in vacant space in the urban area and the continued drop in rental prices have enabled many companies that had to leave the city last year to return to the centre.

In Q3, 56% of deals were signed for space located within the M-30. We should highlight that the least developed areas and those furthest from the central core were off many occupiers' and investors' radars.

One of the greatest issues with Madrid's office stock was that many properties were outdated and this was primarily the case for buildings in central locations. Subdued activity in the market in recent years has meant that there has been a rise in comprehensive refurbishment projects or minor works that have enabled owners to modernise their facilities and spaces, up to the standards that occupiers currently require.

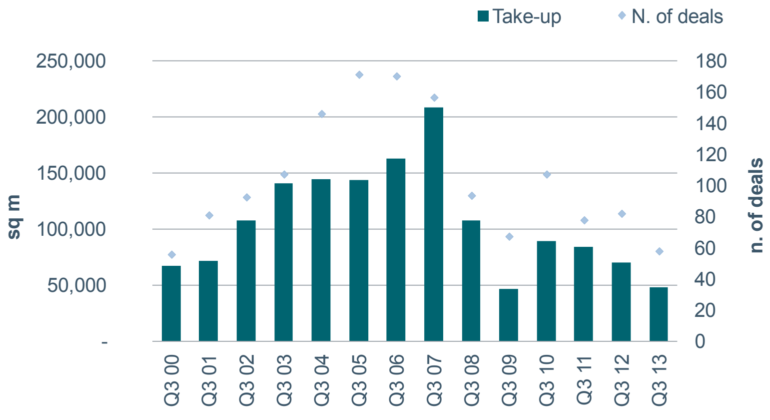
Companies have responded positively to opportunities to relocate their headquarters, and this is reflected in the high occupancy rates in buildings where some degree of refurbishment has taken place. The latest significant deal in this regard was the legal firm Hogan Lovells' move from its headquarters on Paseo de la Castellana, 51 to Intereconomía's old offices on Paseo de la Castellana, 36-38.

End of year forecasts

Based on the figures achieved up until September, it was more than likely that take-up would exceed 2012's figure (285,000 sq m); however the recent news that Cepsa is moving to Torre Foster changes things. This will be another one-off transaction that will push up the total annual take-up figure well over previous expectations, potentially up to 350,000 sq m. The high volume of take-up is not in line with reality in the vast majority of the business sector. In most cases users remain cautious and are still waiting to see clear signs of recovery and economic growth, as the need to expand to a larger office will very much depend on how their businesses grow and to what extent they expand their workforce. Everything would indicate that the total number of transactions for the year will come in lower than the figure achieved last year; however this may be the last year of the recessionary phase. The creditworthiness of the Euro and the decline in international firms' perception of Spain's country risk has increased foreign investor confidence in Spain, which will encourage many players to actively participate in the economy in the short to medium-term.

GRAPH 5

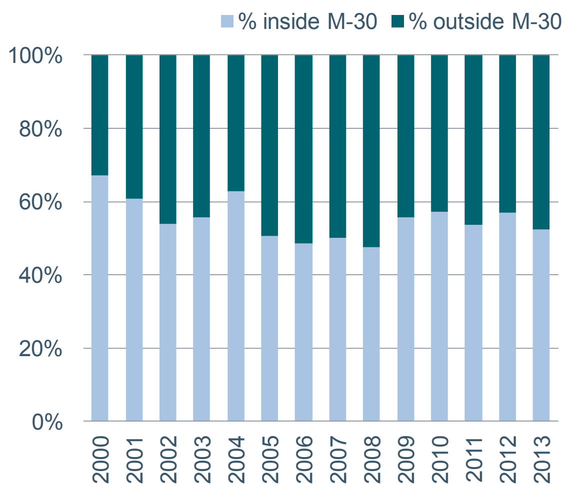
Historic demand trends



Source: Savills

GRAPH 6

Deals with regards to the M-30 road



Source: Savills

Other markets (non-residential)

Large deals have not been restricted to the office market. Several companies that operate in the education sector have taken whole buildings, which have been excluded from the overall take-up figure, as they are not office use properties. Ferraz 21, one of Universidad Pontificia de Comillas' headquarters, will be occupied by Universidad Camilo José Cela and a building located in the Salamanca district has been let to be used as student halls.

Current availability

The Madrid office market vacancy rate now stands at over 14%, which equates to more than 1.8m sq m of vacant space. In Q2, the figure increased by 4%, which was mainly due to second-hand supply coming onto the market, as well as Torre Titania entering the market. Eight years after the fire that destroyed Edificio Windsor and two years after the retail area of the new building was officially opened, around 20,000 sq m of office space has come onto the market.

This new space has barely had an effect on the overall market; however AZCA's vacancy rate has increased from 9% (as at June 2013) to 12% in just three months. The challenge will now be to find occupiers for the city skyline's new building. Its fantastic location in the financial heart of the city, flexible design and the fact that the space can easily be adapted to occupiers' current technical and technological requirements, and easy access to the building via different methods of public transport, as well as a wide range of services within reach that complement the business sector, will attract many different occupiers, and the rental price will provide a solid base with which to start negotiations.

The vacancy rate in the CBD remains slightly above 7%, due to Paseo de la Castellana 7 coming back onto the market at the beginning of the year. This building has been refurbished, and to date only has one tenant.

Stock growth

New developments coming onto the Madrid office market are still few and far between, particularly for speculative projects, such as Torre Titania, where the handover date was pushed back on several occasions. With regard to new space, we should also highlight the first of the buildings in BBVA's new headquarters, in the north of the city. 200 employees have already relocated there and a further 1,800 employees will have relocated there by December. In total, the first phase amounts to just over 30,000 sq m of new office space coming on to the market.

On the other hand, the total amount of stock has also reduced due to some buildings undergoing a change of use, which has meant that total stock growth has been close to zero.

Future supply

The development of new speculative space is now somewhat of a rarity. Developers are being cautious in response to the current market situation, which is not currently showing clear signs of economic recovery. This means that new developments are mainly owner-occupied headquarters (such as the Repsol Campus or BBVA's headquarters). Hence, barely 145,000 sq m is in the pipeline for 2013 and 2014, of which just 16% will come onto the market.

Refurbishment projects

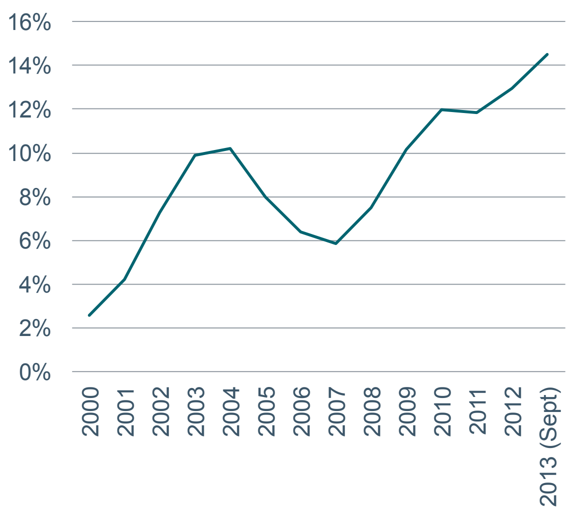
The majority of speculative space is associated with refurbishment projects, which account for 75% of space in the pipeline between 2013-2014. The number of outdated buildings being refurbished continues to rise, particularly in the city centre.

In any event, there are a large number of projects that are currently at various different stages of refurbishment, in the hope that the market shows signs of recovery, or that a user with a real interest in the property comes up, at which point the landlord will start work on the property.

These buildings that are 'on-hold' are not included in the available space figure, nor are the buildings relating to many of the most recent mega deals, which remain occupied, which would significantly push up the vacancy rate in the short to medium-term.

GRAPH 7

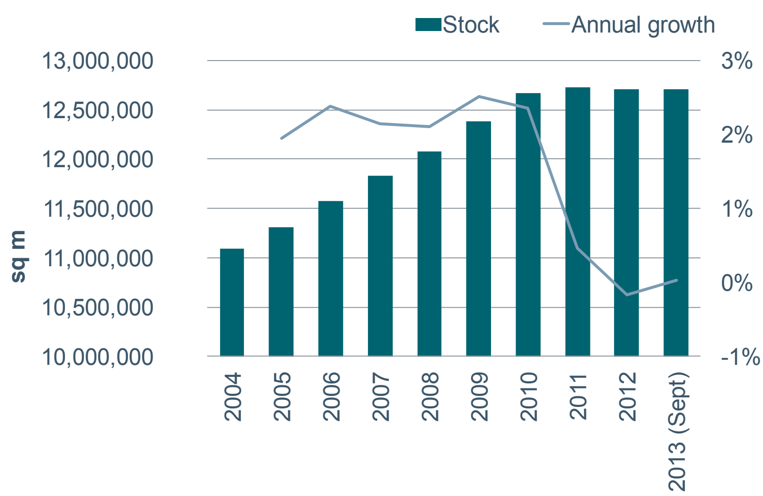
Vacancy rate



Source: Savills

GRAPH 8

Stock evolution



Source: Savills

Stability in the CBD

The achievable rental price in the CBD remains at €24.50 per sq m/month for the fourth consecutive quarter; however we should highlight that on some occasions, in very specific properties, rental prices have exceeded the achievable value. It therefore seems that rents in certain areas or properties have already bottomed out, and are currently stable. If history repeats itself and we once again find ourselves in the same position as in the mid-1990s, the transition period would last eight months, after which the market would gradually grow over the next two and a half years.

Overall rents adjust even further

The overall market still remains immersed in a downward rental spiral; although it is true that rental adjustments are less marked than before. The average figure of all the rents agreed for commercial properties (sole use and high-tech) since January reached €13.30 per sq m/month, which is a 6.5% decline year-on-year. Limiting our study to sole office use buildings, the figure stands in the region of €14.20 per sq m/month, which is a 4% year-on-year decline.

We should highlight that, although the order of the day is a reduction in rents, the strength and consolidation of some areas, with healthy vacancy rates and recurring demand, has meant that rents have remained relatively stable.

"The achievable rental price in the CBD remains unchanged for the fourth consecutive quarter, due to the lack of quality space in prime areas of the city, and recurring demand in the area".
Gema de la Fuente, Savills Research

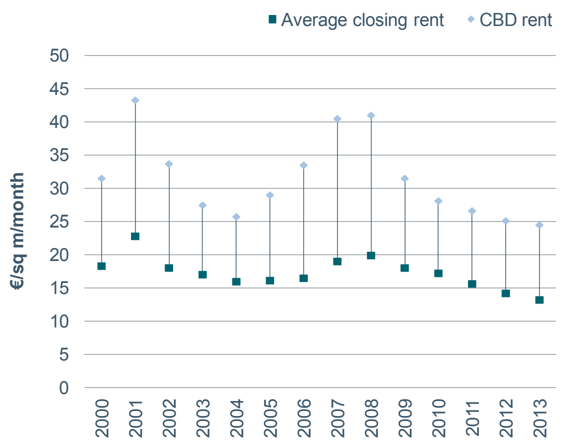
City centre vs out-of-town

In any event, recovery in the market will have a ripple effect, starting in the CBD and slowly moving out to out-of-town areas, which will continue to suffer from more widespread reduced rents. The lowest rental values remain at levels similar to values for logistics properties, and single digit deals have increased at an exponential rate since 2008, and are even being seen in some properties in the inner suburbs.

However, it is also worth highlighting that the difference between values in the city centre and areas outside of the M-30 have gradually moved closer in recent years, which will continue to attract users and investors to the urban area.

GRAPH 9

Average closing rents vs CBD prime rents



Source: Savills

TABLE 2

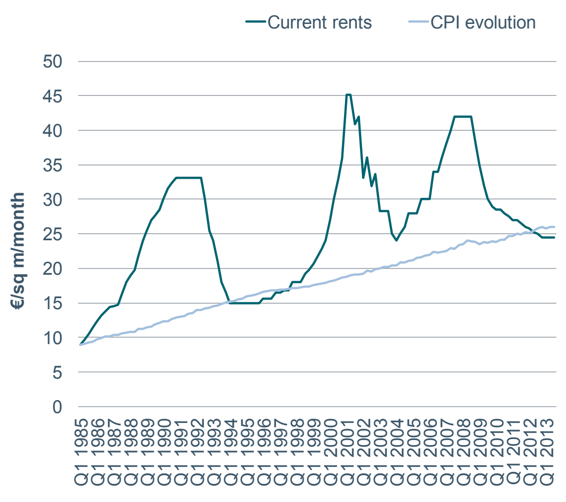
Main deals - Occupiers market - Q3 2013

User	Zone	Floor area (sq m)	Activity sector
Ferrovial Servicios	North	6,000	Business services
Hogan Lovells	CBD	4,600	Business services
Grupo Once	East	4,000	Business services
Arvato	East	3,900	Business services
Grupo Planeta	East	3,200	Business services

Source: Savills

GRAPH 10

CBD rental level



Source: Savills / INE

Investment market

The Madrid office investment market is starting to heat up. The figure registered in the summer months (close to €70m) is a far cry from the €155m registered in Q2; however it is a 42% increase compared to the same figure registered the year before. If we compare the cumulative data since January, the figure for 2013 amounts to just over €275m, which is almost triple the figure for the first nine months of 2012, this figure obviously excludes the Torre Picasso deal.

The number of deals, although still small, has been slowly increasing each quarter, from two in the first quarter of the year, to six between June and September. There has been a 71% year-on-year rise in the number of deals signed up to September this year.

Little by little, we are starting to see increased investor activity in the largest office area in Spain. We should point out that in recent months, Barcelona has shared the limelight with Madrid, where to date, 45% of deals signed in the office market in Spain took place. Having said that, 75% of the total for Barcelona relates to a portfolio of 13 Generalitat buildings that were purchased by AXA Reim.

Main players

The market continues to be dominated by national investors, which accounted for 57% of all investment, but this is well off the 75% mark achieved in previous years. In addition, foreign capital used for deals that have been completed originates from players who to date have been unknown in the market (both European and American) but who are beginning to take positions in Spain. Institutional funds, who were familiar faces in the market a few years ago, have turned their sights back on to the Spanish market, by investing in office buildings in Barcelona and other segments of the commercial property sector (retail units and hotels).

In addition to the players that are already on the scene, there are several different investors who are very interested in actively participating in the Madrid office market. Some of them are urgent to carry out purchases before the end of the year. The problem is matching demand with supply.

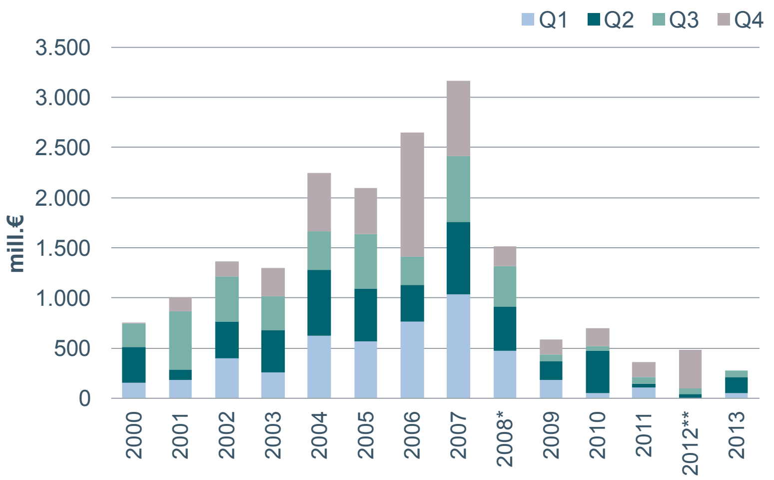
Supply in the market

Aside from attaining financing, one of the main problems, is the lack of available supply in the market (there are barely four sales mandates out in the market). However, the reality is that although owners are not openly advertising their properties as being for sale, they are always open to considering proposals. The difficulty therefore arises in the complex exercise of balancing price expectations between buyers and sellers, as if they do not need to disinvest, sellers are not ready to accept the discounts that are currently in the market, which are 60% lower than prices achieved at the top of the market.

To date, the marked difference in the market had meant that part of the market was deserted. National investors (primarily private investors and family offices) have sought refuge in prime properties located in the CBD, and opportunistic funds have renewed their interest in the residential sector, as properties in the office market are not as distressed as they had hoped. The intermediate market has been untouched, and new investors could well fill this gap.

GRAPH 11

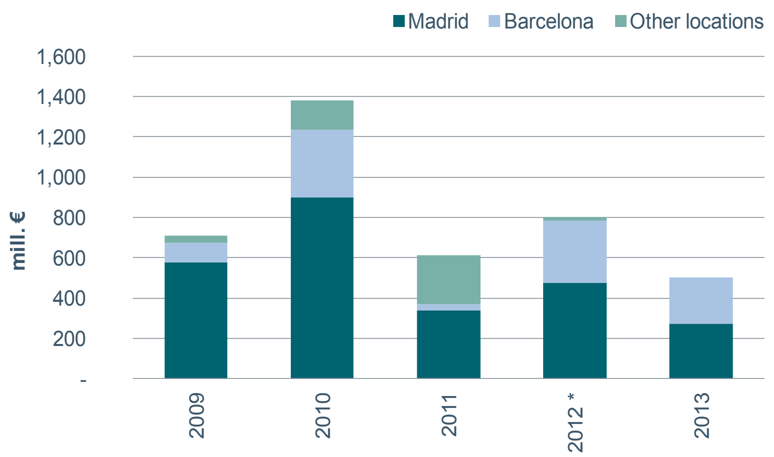
Investment volume



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

GRAPH 12

Investment volume by location (Spanish office market)

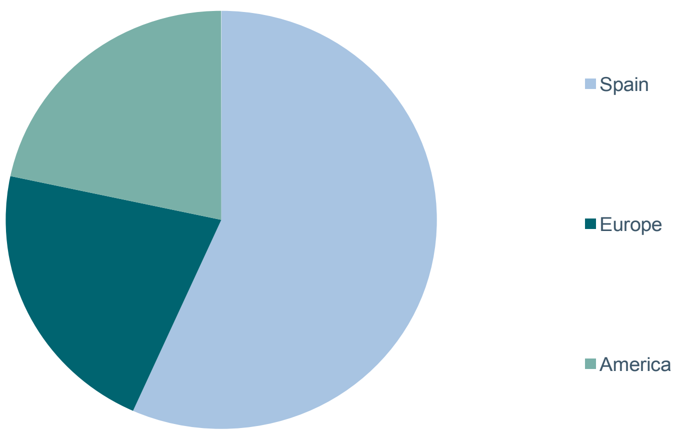


Source: Savills / *excluding Torre Picasso

«The marked difference in the market between private national investors and opportunistic international investors has been one of the reasons for the lack of deals in recent years. We believe that the arrival of new investors to the market may well fill that gap» Pablo Pavía, Spain investment

GRAPH 14

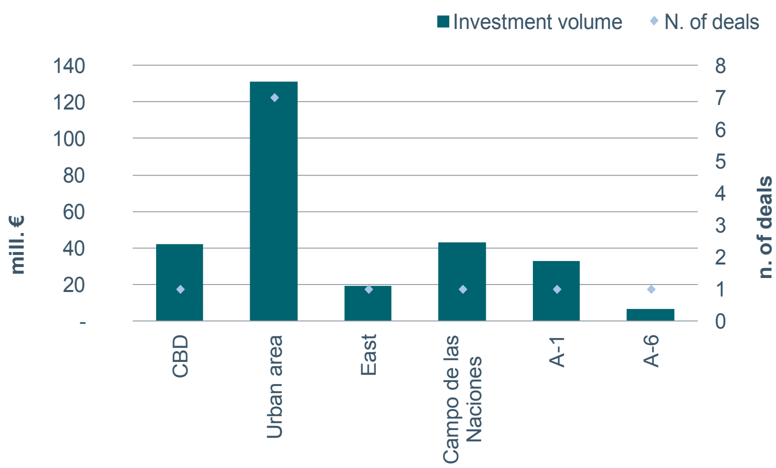
Investment volume by purchaser nationality (Madrid office market - accumulated 2013)



Source: Savills

GRAPH 13

Investment volume by market zones (Madrid office market - accumulated 2013)



Source: Savills

Key transactions

Amongst the latest deals, we would highlight IVG's disposal of the Crisalis building, on the first stretch of the A-2, to a private investor from Latin America. This was not the first, nor the only investor from the area that is searching the market for opportunities. These investors are making the most of the language and cultural similarities in order to expand their business into Spain.

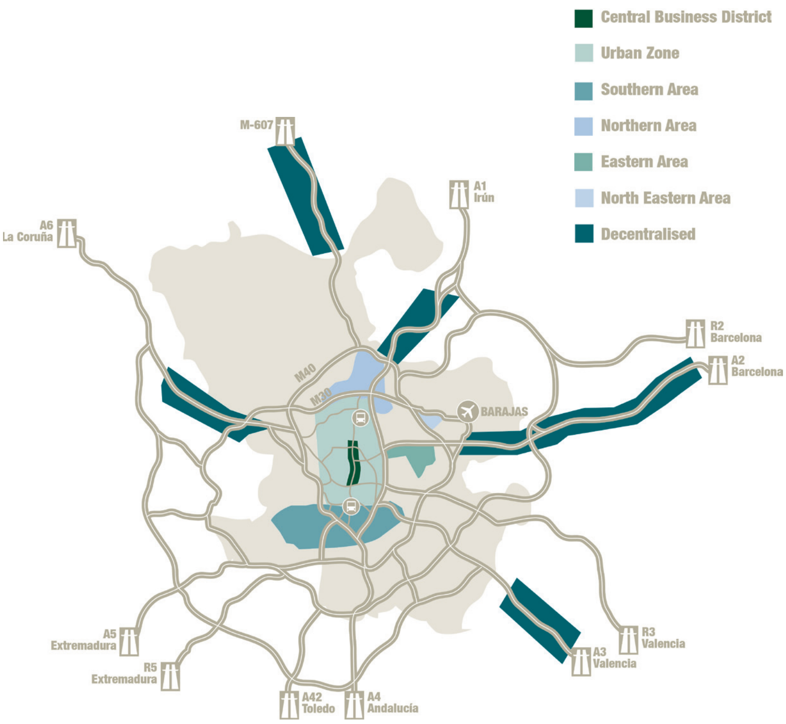
We should also mention that there continue to be sale & leaseback deals out there. Over the past quarter two companies opted for this formula in order to attain liquidity. Out of the total figure, sale and leaseback deals amounted to just over a third of the total, including the sale of Tinsa's headquarters in the Las Rozas Business Park.

In addition, acquisitions of office buildings in order to change their use have been increasing in popularity since last year. The two deals registered in 2013 were signed last quarter. One of which was in the Salamanca District (Serrano, 85) and the other was in the Paseo de Prado area (old Grupo Bergé headquarters).

Yields

The lack of supply and increased buyer interest should have translated into yields hardening in the best locations, however the lack of properties on the market that fit very specific investor criteria in terms of location, the quality of the property, the tenant, etc. has led us to leave the achievable yield in the CBD at 6%. Trophy assets with lots sizes of less than €30m could achieve lower yields.

MAP 1
Madrid office market



OUTLOOK

2013

■ The annual take-up volume could reach 350,000 sq m, which would be almost a 25% increase on last year's figure. The lack of demand is in direct contrast to a strong increase in lettings, due to mega deals carried out by Vodafone, Iberia and Agencia EFE in Q1 and Cepsa in Q4 (the total sum of the four agreements amounts to a third of the total take-up volume). Excluding the space relating to the four one-off lettings, take-up remains in the region of 250,000 sq m, which is an all-time low. Growth in the office market will go hand in hand with economic recovery, and according to forecasts, the Madrid region is expected to expand.

■ The companies that have been involved in the aforementioned mega deals vacating their office space, as well as BBVA moving several of its headquarters to its new financial city, will increase office availability in the medium-term.

■ The lack of quality supply in the CBD and recurring demand in the area has meant that the theoretical rental price has remained stable, and no further sharp adjustments are expected.

■ The Madrid office market is slowly starting to see a pick up in investor activity. There is ever more interest in investing in Spain, both in terms of national and international investors, however the signing of deals has been slow, amongst other factors, due to the lack of financing, the difference in investor profiles and the lack of product.

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