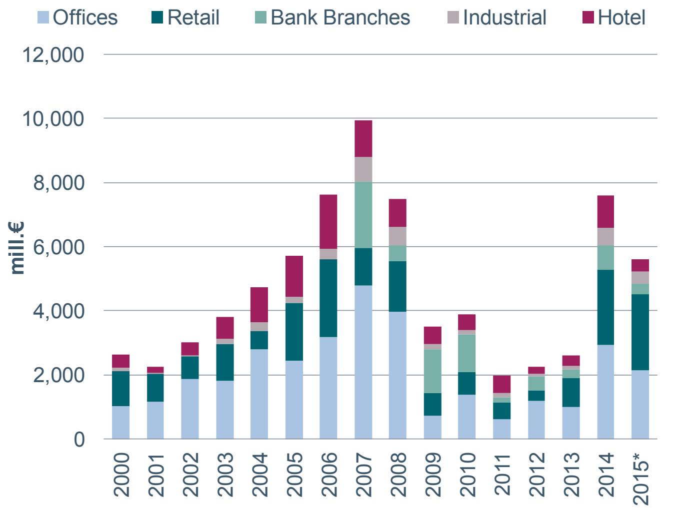
Market Report
Spain Investment

September 2015

GRAPH 1

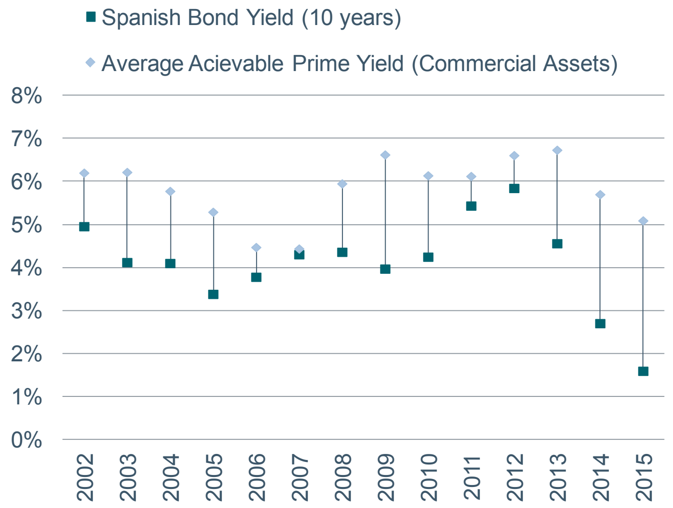
Investment Volume by Sector



Source: Savills /* until September

GRAPH 2

Spanish Bond Yields vs Average Prime Yields



Source: Savills

SUMMARY

The intensive investment activity could lead to all-time high number of deals

■ Commercial property investment volume between January and September 2015 reached 75% of the 2014 annual total.

■ Intense investment activity means the year will end with a similar amount of investment as in 2014, or potentially even higher if one of the megadeals currently under negotiation is completed, such as Torre Espacio.

■ Overseas capital continues to be heavily focused on the commercial property sector, although the upcoming general elections could put the brakes on decisions being made on some deals.

■ Expected rental growth, which has already been noted in prime properties for some specific property sectors, coupled with continued low prices per sqm, have captured investors' attention.

■ Based on the past, we are now moving towards a period of more stable prime yields, while secondary and decentralised property yields will harden further.

■ Commercial property has become a solid investment alternative.

"A similar investment volume to 2014 is expected and perhaps even higher if one of the megadeals currently under negotiation is closed." Luis Espadas. Capital Markets

■ The spread between achievable yields and 10-year bond prices is at a record high (more than 350 basis points).

Economic Outlook

Each time economic figures are released, the recession appears to be ever more a thing of the past. According to the latest figures published by Eurostat, in Q2 2015 the economy registered the highest growth in eight years (3.1%). Spain came in fourth place in the Eurozone, only behind Ireland (6.7%), Luxembourg (4.9%) and Malta (4.8%) and was well above the Eurozone average (1.5%).

Domestic demand continued to be one of the main growth drivers. Final household consumption began to rise at the start of 2014 and over H1 2015 registered the highest increase since the start of the crisis, 3.35%. This figure is intrinsically linked to consumer confidence. Indicators published by CIS are now above the psychological '100' barrier, which suggests that consumers are now more positive about the economy.

It also looks like the job market is on the mend. According to the latest data from EPA, the unemployment rate in Q2 stood at 22.4% and employment grew by 2.9% y-o-y. Despite this figure still being high, it is the lowest figure registered over the past four years. In terms of the quality of jobs created, full-time contracts are on the up and the number of part-time contracts are down, with a y-o-y change of 3.7% and -0.9% respectively.

Finally, China's dominance on the world stage is ebbing. The imbalances that are now affecting the Chinese economy, suggest that required growth rates will not be achieved. It would also appear that various large raw material exporters could be affected by this downturn. This downturn in the international markets should not adversely affect Spain in terms of its short-term growth prospects, as the external imbalances will be offset by domestic demand, due to the drop in petrol prices and the decrease in personal income tax expected in 2016. Nevertheless, we expect to see a slight slowdown in H2 2015 compared to the growth seen in H1 2015.

Market Recovery

The recovery in investment activity in the commercial property market in 2014 has carried over and continued so far in 2015, reaching close to €6,000m up to September, which is 74% of the total transacted in 2014.

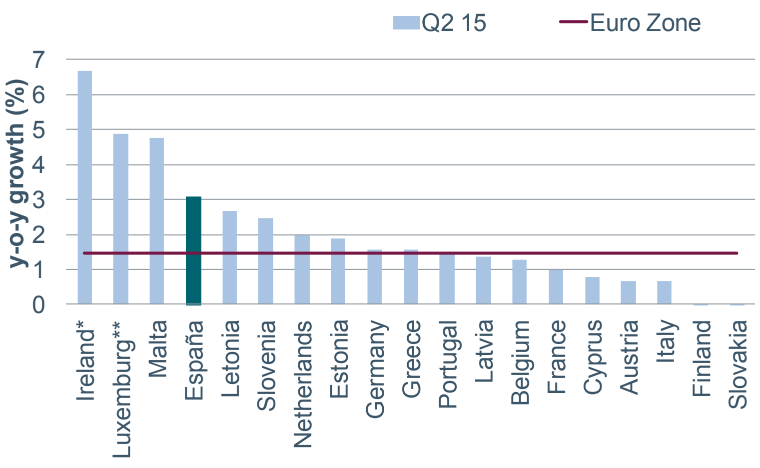
However, investors are buying based on expectations, as the occupier market results for each segment are moving slower than the investment markets.

The recovery of the main economic indicators, as well as growth forecasts for the coming years, have been highly appealing to various international players and have contributed to them regaining confidence in Spain.

During 2014, rents in the best properties in the best locations also rose, ushering in a change in achievable rents since the end of 2013. The forecast upturn in rents is further bolstering the appeal of Spain, which is now seen as a safe option with investment opportunities at prices that are still low.

GRAPH 3

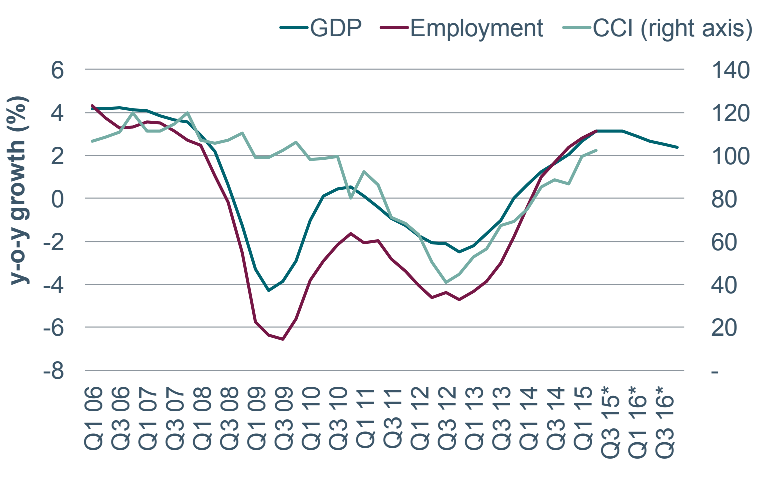
Economic Growth in the Eurozone



Source: Eurostat / *National Statistic Offices / **Q1 figure

GRAPH 4

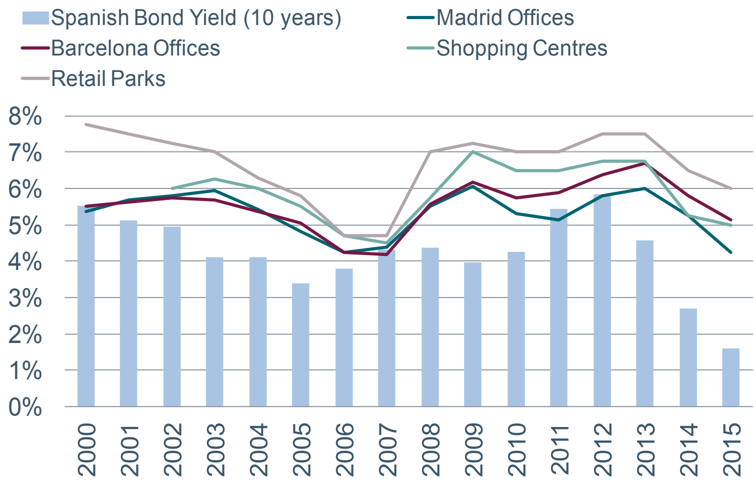
Main Economic Indicators



Source: INE / *forecasts Focus Economics October 2015

GRAPH 5

Spanish Bond Yields vs Average Prime Yields



Source: Savills

Spain has come back on to the international funds' radars that fled the market during the recession years, and new funds have also entered the market. Since 2013, overseas capital has taken up positions in the market so as not to miss out on opportunities, registering investment volumes that have doubled the figures of previous years. The appearance on the scene of SOCIMIs in 2014 put the market share of cross-border investment in the shade, although the comparison of absolute values increased by more than 200%.

Local Partners

In addition, one must take into consideration that part of the capital raised by these companies specialised in real estate investment, both at their founding, as well as their subsequent share capital increases, comes from international companies, which if taken into consideration, would significantly increase the presence of foreigners in the market.

Taking a stake in SOCIMIs has been one of the options to participate in an unknown market, where those with knowledge of the local market have the upper hand. Others have opted to search for a national partner, who will generally manage the property portfolio acquired.

Corporate Acquisitions

This continues to be the norm for foreign players that opt to acquire properties, but others are opting to purchase shares in real estate companies, such as Värde, which has taken control of Grupo San José after acquiring 51% of the shareholding, or Inmobiliaria Carso, owned by the Mexican magnate Carlos Slim, which beat Hispania to acquiring Realia.

These types of transactions are not included in the real estate investment figures detailed in this report, but they are without a doubt playing an ever greater role in the market, due to the size of the portfolios and the final size of the agreements.

However, the most noteworthy deal by sheer size, was Merlin's acquisition of Testa, for circa €1,800 million.

Yield Compression

Interest in the market has attracted a glut of liquidity from buyers that are still not finished investing in the market

In 2014, the imbalance between supply and demand favoured the start of a drop in available prime product in all of the prime commercial property sectors, which continues to be the case, although we expect to see this stabilise and that value uplift will subsequently come from rental growth.

The difference between the price of Spanish bonds and prime yields is at an all-time high

The real estate market is an interesting investment option.

The drop in country risk confirms that real estate is a solid investment alternative. When comparing prime property yields for the various commercial property sectors with Spanish 10-year bonds, one can see that although yields over time have always been higher than the level of debt, in 2015 this stood at an all-time high, with a difference of more than 350 basis points.

On the other hand, the change in achievable prime yields demonstrates that we are at a record low for some segments of the market or touching on the lowest figures in others.

Should yields stabilise, rental growth, which has already been seen in prime properties, will drive up prices per sq m.

This does not imply that deals are not being closed at below achievable yields in the real market, which will be determined based on the balance between supply and demand.

Rental increases will ripple out across the market, and we are still waiting to see rental increases in secondary and decentralised properties, where yields are expected to harden further.

However, secondary and decentralised product will continue to see their yields harden further.

Portfolios on the Market

Property portfolio disposals have increased with various companies divesting their portfolios, with figures back up to 2014 levels, although the accumulated volume is lower.

GE Capital headed up the list of the most active sellers, with the sale of 14 properties, 13 of which were spread across two portfolios.

On the buy-side, Meridia Capital focused on acquiring portfolios, purchasing a portfolio of 11 properties owned by GE spread between Madrid and Barcelona and another 33 properties owned by Naropa, comprised of offices, residential, land for development and various retail units, with the star product being six offices in Madrid, which represented 80% of the total purchase price. Meridia's diversified strategy also included the purchase of two retail unit portfolios, which are predominantly let to various supermarket chains.

Various European portfolio sales also included properties in Spain, such as the Espacio León shopping centre, acquired by Blackstone, as well as two other shopping centres in Portugal and the logistics complex owned by Warburg HIH Invest & TIAA-CREF that was included in a portfolio of prime properties in Germany, Holland and France.

Megadeals

Following various years of exponential growth, megadeals (over €100m) dropped off the radar. They have only accounted for 6% of all registered deals and little more than a third of accumulated volume since January. On the other hand, in contrast to the recent past, the average megadeal investment size for individual properties was well above the portfolio deals, at close to €285m and €180m respectively.

In any event, we would note that three of the deals exceeded €300m. This year has now been the most active in terms of these types of deals and we could well still see more signed before the year is out.

The sales of Puerto Venecia, Plenilunio and Gran Vía 32 drove the average investment volume of individual assets 60% higher than portfolios, which over recent years stood at around 25% below.

Key Players

International funds are taking on an ever more dominant role in the market. The cross border investment volume now accounts for more than half of total investment volume and close to 50% of the deals.

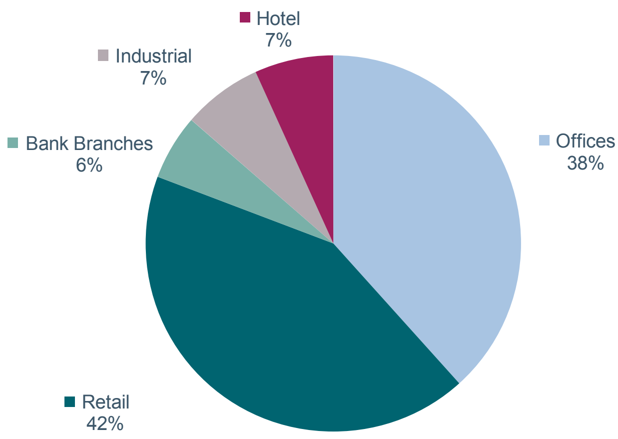
European funds are the out-and-out leader with close to €2,200m invested, equating to 60% of international capital. Funds from the United States have slowed their activity, and while in 2014 they accounted for a similar amount of investment as the European funds, in 2015 they have hardly reached 20% of the total.

In contrast, Canada has seen a spectacular spike thanks to the Puerto Venecia deal (€451m).

Among the local investors, funds, which includes SOCIMIs (Spanish equivalent of REITs) accounted for 42% of the investment volume. Then private equity firms are in second place, with almost 30% of the total, although we would note that Pontegadea's purchase of Gran Vía 32, accounted for almost half of that figure. Real estate companies are in third place and have been particularly active in acquiring properties that require value-added management. Colonial and GMP have been the most active.

GRAPH 6

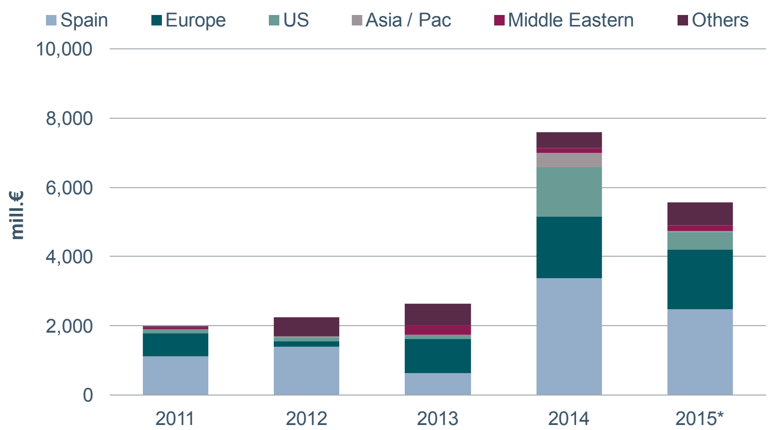
Investment Volume by Segment - 2015*



Source: Savills / *until September

GRAPH 7

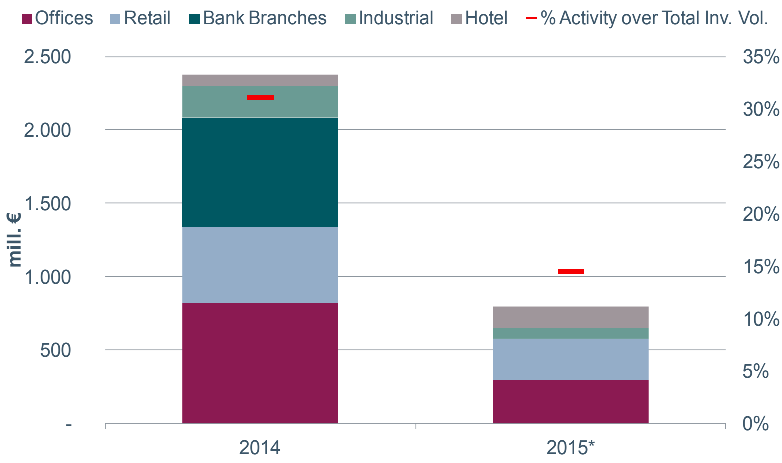
Investment Volume by Purchaser Origin



Source: Savills / *until September

GRAPH 8

Socimis in the Commercial Market



Source: Savills / *until September

Most Active Markets

The close to €2,400m invested in the retail segment account for almost 42% of total investment, which is well out ahead of the other asset classes in the commercial property market, although three of the deals accounted for 50% of this figure.

In terms of volume, offices are in second place with slightly more than €2,000m. Between the both of them, they accounted for 80% of all commercial property investment.

It is important to note that the accumulated retail investment total for the first nine months of the year has already reached that of 2014 and offices and industrial account for 70% of the investment volume the year before.

The total for the commercial property sector represents 74% of the 2014 figure, as the bank branch and hotel sectors hardly reached 40% of the annual investment volume achieved in 2014.

Merlin's acquisition of the portfolio of 880 BBVA bank branches in the summer of 2014 for more than €700m, puts the figure registered in 2015 in the shade, at slightly more than €300m.

In addition, the hotel sector is 40% below the total annual figure in 2014. The close to €400m only takes into consideration the deals signed for real estate assets and does not include acquisitions by hotel chains, as these are considered to be for owner-occupier use.

TABLE 1

Main Investment Deals ≥€100m

Segment	Asset	Province	Inv. Vol. (€m)	Vendor	Purchaser	Type of Deal
Retail	Puerto Venecia	Zaragoza	451	Orion Capital	Intu Properties	single
Retail + Offices	Gran Vía, 32	Madrid	400	Drago	Pontegadea	single
Retail	Plenilunio	Madrid	375	Orion Capital	Klepierre	single
Bank Branches	Project Yellow Banco Santander	several locations	308	Uro Property	Axa Reim	portfolio
Offices	Paseo de la Castellana, 89	Madrid	142	Ahorro Corporación	Corporación Financiera Alba	single
Hotel	Plaza de la Lealtad - Hotel Ritz	Madrid	132	Omega Capital + Orient-Express	Olayan + Mandarin	single
Offices	Portfolio GE	Madrid & Barcelona	120	GE Capital	Meridia Capital	portfolio
Hotel	Dos hoteles en Islas Canarias	Las Palmas	105	NA	Hispania Activos Inmobiliarios	portfolio

Source: Savills

Outlook

2016

■ The recovery in the main economic indicators is the reason behind the upturn in confidence in the country. The Spanish economy is now growing above the other main European powerhouses and is above the Eurozone average. Final household consumption is one of the driving forces behind the growth, underpinned by the continued record consumer confidence figures registered over the past few months. The job market continues to be the unresolved matter, although the unemployment rate is gradually falling.

■ The consensus from economic institutions is that the economy will continue to grow, although the China crisis could put downward pressure on some indicators.

■ Despite this, the country risk remains below 100 basis points and the comparison between the Spanish 10 year bond price and prime yields for the main commercial property asset classes, confirms that real estate is still an interesting investment option.

■ The socio-economic and demographic backdrop is making investors look at specific market niches that are now looking ever more appealing. Various international players have started to take up positions in segments such as hospital and health services or student halls and nursing homes.

■ After the acquisition of Pérez Galdós Student Hall in 2012, Knightsbrige Student Housing is developing various schemes in Madrid and Barcelona that are expected to be delivered between 2016 and 2018 and The Student Hotel recently acquired Melon District's two student halls in Barcelona. In addition, AXA has announced a joint venture with Medical properties Trust to construct a hospital in the Valencian town of Burjasot.

■ The good tourism figures - which continue to break all-time records (tourist arrivals, stays and average spend) and strong e-commerce growth will drive investor activity in the hotel and logistics segments respectively.

■ SOCIMIs will continue to be a key part of the market. New companies listing on the continuous and alternative stock markets, as well as the share capital increases carried out by the already established SOCIMIs, is a clear indication that the format works. One of the latest to join the MAB (*Mercado Alternativo Bursátil* - a sub-market of the Spanish Stock Market - *BME*) was Zaragoza Properties, owner of the Puerto Venecia shopping centre.

■ More than ten are preparing to list on the stock exchange before the end of the year, some of which will be specialised in one specific real estate segment.

■ The international funds continue to be active in a market where they can now find quality product with attractive returns for their parent companies, although the upcoming elections could be a determining factor or postpone some cross border players from taking decisions.

■ Forecasts for the year-end investment volume stand at between €7,500m and €8,000m, in line or slightly above that of 2014. Any megadeal pending completion, such as Torre Espacio, would affect the total.

■ An economy on the up, rents clearly on the rise, prices per sq m that are still low and improved lending terms, as well as greater access to credit, would suggest that international investors will continue to be interested in the Spanish real estate market.

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