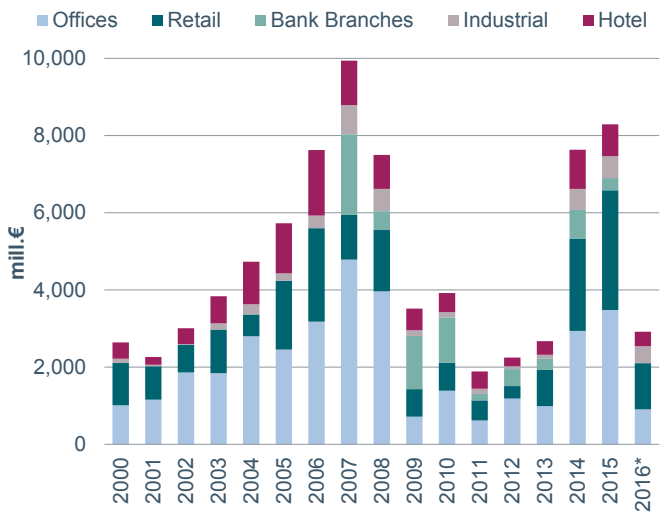
savills

Market Report
Spain Investment

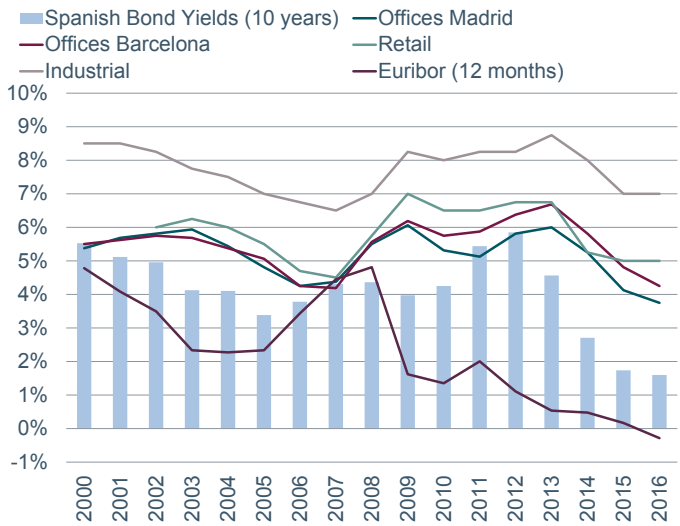
July 2016

GRAPH 1
Investment Volume by Sector



Source: Savills /* until June

GRAPH 2
Spanish Bond Yield vs. Average Prime Yields



Source: Savills

SUMMARY

Notable drop in transacted volume due to lack of available product

■ The almost €2,900 million transacted between January and June in the commercial real estate market equates to just 70% of the volume registered for H1 2015. A lack of product is the main reason for the declining activity.

■ The Eroski supermarket portfolio, sold for almost €360m, is the year's largest volume deal thus far, driving the retail segment's market share to almost 50% of the total market volume.

■ Funds continue to dominate the roost in the market. Their dominance is highly evident in the retail sector; with real estate companies remaining very active in offices, incorporating value add products into their portfolios, whilst insurance companies and mutual insurance companies are making a strong comeback.

■ Foreign capital is once again proving to be the market driver, accounting for 73% of the total transacted volume for commercial real estate. The strength of the dollar against the euro has put the European market on US investors' radar, with this group now accounting for 60% of foreign capital inflow.

"Political stability will reinforce investor confidence in the market." Luis Espadas, Capital Markets

■ Investors are largely driven by the considerable rental upside still remaining before pre-crisis market peaks are reached. The market recovery, will favour rental increases which can also be achieved by improving the assets both physically and in terms of asset management.

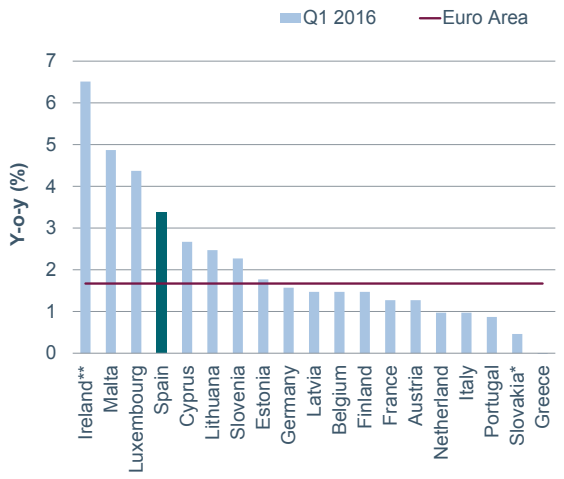
Economic Overview

The Spanish economy is set to maintain the growth trend it started two years ago despite the difficulties experienced both at national and international level. According to the latest data published by INE, GDP rose 3.4% in Q1 2016, recording the ninth consecutive quarter of growth. It also resulted in the fifth y-o-y variation to have beaten the historical average of 2.6% between 1971 – Q1 2016.

On a European level, Spanish GDP growth came in 1.7 percentage points above the Eurozone average, 1.7% according to Eurostat. Moreover, Spain holds fourth place in the GDP growth ranking, behind Ireland, Malta and Luxemburg, varying 6.5%, 6.2% and 3.6% respectively.

GRAPH 3

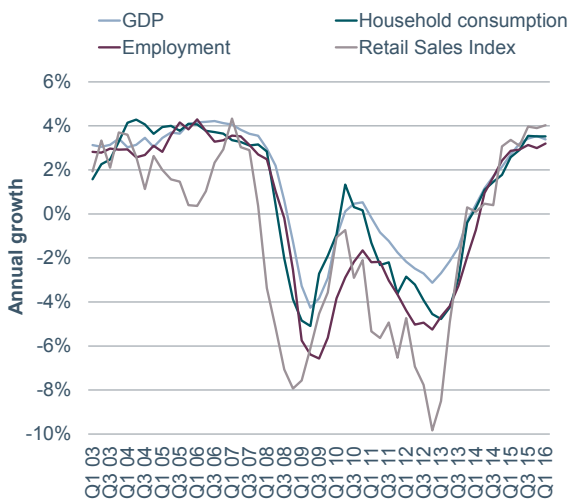
Economic Growth in the Euro Area



Source: Eurostat / *Q4 2015 / **national statistics offices

GRAPH 4

Main Economic Indicators



Source: INE

In terms of the jobs market, the number of employed in Q1 2016 rose to 18 million, 3.3% up y-o-y according to EPA and taking the unemployment rate to 21%, which although remains high represents the tenth consecutive drop. All this is accompanied by an improvement in the official figures for the number of social security registrations published by the Ministry of Economy and Taxation. In June 2016, there was a total of 17 million people registered with the social security, representing a 3.3% rise y-o-y.

Domestic demand remains one of the foundations of the economic recovery, and has been mainly boosted by the improvement in household consumption. Low interest rates, a falling CPI and tax cuts, amongst other factors were the main causes of the increased household purchasing power, which in turn took consumption up to 3.4% in Q1 2016 according to INE. This improvement in household consumption was reflected in retail activity, which continues the upward trend it began in 2014 and which is generating some promising figures, with 4.1% y-o-y growth. The increase in the number of vehicle registrations is another important effect of the rising private consumption, up 11.2% y-o-y according to data published by Anfac.

For the first time since the start of the economic recovery in 2014, the trend in consumer confidence has reversed. The political uncertainty caused since the December 2015 general election has led to the fifth y-o-y decline in consumer confidence, 90.7 in May 2016 according to CIS. In spite of this, the January – May 2016 accumulated figure remains above the historical average (recorded since 2005), coming in at 93.72 compared with the average of 75.92.
In sum, the latest forecasts published by Focus Economics (June 2016), suggest continued economic growth in 2016, although more moderate than has been registered to date and above the Eurozone average: 2.8% and 1.8% respectively.

Brexit

The Brexit shock will shake the economies of all EU members, however at present it is difficult to predict what the full impact of the repercussions on each member state will be. The markets responded immediately to the result with risk premiums rising and stock markets falling, though after a few days things began to gradually recover.

Meanwhile, sterling slumped to levels not seen since 1985, resulting in a considerable loss of purchasing power. The effects of this will be seen in the hotel sector, given that British tourists hold significant weight in total Spanish tourism figures (accounting for a quarter of all visitors in 2015). Although this is unlikely to stop British tourists coming to Spain altogether, since a number of surveys conclude that Britons consider holidays a priority expense, it will undoubtedly lead to a decline in the number of tourists, their average spend and length of stay.

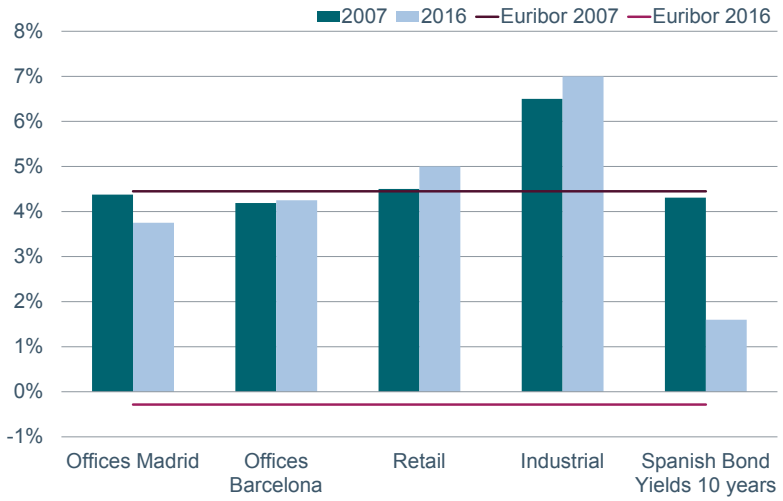
Demand for coastal properties is expected to weaken, since data from the Registrars' Association (Colegio de Registradores) shows that the British head up international demand for this property type, accounting for 21% of sales.

No changes are expected in the office market in the short term and it could even benefit from investors looking for stable European markets like Germany and France, with Spain (Madrid and Barcelona) being considered an alternative given the remaining rental upside and lower prices per sqm.

Retail could be badly affected in areas heavily exposed to international/British tourism. However, British investors acting on the purchase side in some sales processes already underway, have not lost interest or confidence in the product.

GRAPH 5

Yields Prime Comparison 2007 - 2016



Source: Savills / INE

Market slowdown

The commercial real estate investment market has eased somewhat the intense activity levels seen in 2015, when almost €8,300m was transacted (not including corporate transactions, debt acquisitions or owner-occupied buildings). This represented an 8% increase y-o-y and was almost 85% of the 2007 market peak.

The volume transacted in H1 2016 was almost €2,900m, representing just short of 70% of the figure recorded for H1 2015.

The considerable drop in activity is mainly down to the lack of available product on the market. This is effecting all real estate segments. High liquidity and strong investor demand have created highly competitive pricing levels in open-market sales processes. A number of off-market deals have improved the level of supply in the market in the office market, although the challenge of finding high-quality assets persists.

Activity by segment

No deals have been completed in the bank branch segment so far this year, unlike in H2 2015 when AXA Reim acquired the Yellow Portfolio from Santander Bank branches for just over €300m. As a result, this segment has seen the largest adjustment, even though there are currently several ongoing negotiations of bank branches on the market.

Therefore, excluding bank branches, the sector which has recorded the most significant decline is the office market, registering a drop of 35%. In both Madrid and Barcelona, the number one and two markets respectively, H1 2016 results are down y-o-y. However, in contrast, the office sector has gained weight in consolidated secondary cities, such as Seville and Valencia, where investors, mainly private, have acquired offices, in some cases with a view to changing the use of the building.

Retail has also lost market share bearing in mind the three mega-deals that were completed in H1 2015, all closed at over €300m. However, excluding all transactions over €100m in H1 2015 and H1 2016, the y-o-y comparison shows stable figures, with both coming in at just over €600m.

High demand for real estate despite low yields

The drop in interest rates and the return of lending is drawing people back to real estate investment

The lack of quality product on the market is continuing to put downward pressure on prime yields, which first started to harden in 2014.

However, the average difference between current levels and the market peak is around 35 basis points, hence there is still more room for further adjustments. The widest gaps can be seen in the retail warehouse segment and the Madrid office market, standing at 100 basis points and just over -60 basis points respectively. It is also important to highlight that in 2007, retail warehouses recorded a very similar level to that of shopping centres, meaning there is more room for further downward adjustment.

The industrial/logistics and retail sectors both have a gap of 50 basis points. The economic indicators linked to both segments allow us to be optimistic regarding future growth in results, which would be accompanied by rising rents.

High demand and low supply for office investment is reflected in the yield compression from 2007 to 2016. Barcelona, with a gap of barely 25 basis points and Madrid with a negative gap. Barcelona still has room for downward adjustments, whereas Madrid will remain relatively stable, with prices per sqm improving via rental growth.

However, the current extensive gap between expected prime commercial property yields and the 10Y bond, along with the return of lending and the sharp drop in interest rates compared with 2007 levels, makes real estate investment the winning option.

The hotel sector has also posted negative growth figures, -4%. It should be noted that investment figures do not include corporate transactions or acquisitions of properties for owner-occupation and that several hotel chains are actively expanding their portfolios via the latter. Changing the use of buildings from office to hotel is another way via which the hotel stock is growing in some main cities, although the restrictions introduced by some City Halls have brought some hotels' expansion plans to a halt and detracted investors from buying in affected cities.

Industrial/logistics is the only sector to have posted improved results. E-commerce, multi-channel buying, instant fashion, together with upbeat industrial production and consumption results are driving a greater need for storage among logistics companies, whose space and location requirements depend on what product is being distributed and the location of the end client. The outdated state of logistics stock is also spurring the development of institutional product that could then enter the investment market.

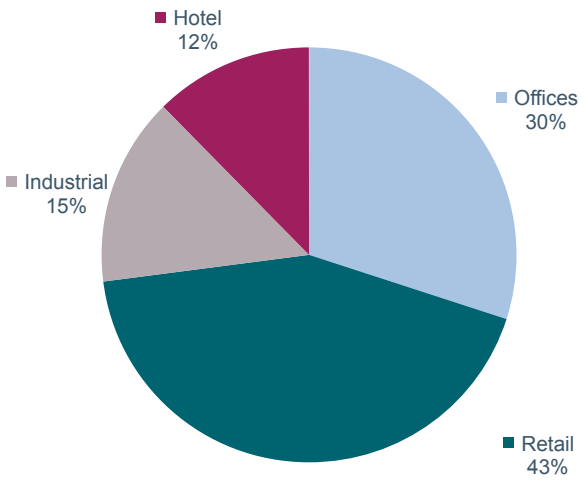
Corporate Acquisitions

Merlin's purchase of Testa for €1,800m was the largest deal in 2015 with its purchase of Testa for almost €1,800m. Spain's number one Socimi in terms of market cap, and the only one listed on the Ibex35, has further asserted its leadership after announcing a merger with Metrovacesa, a move that will turn it into a colossal company managing over €9,000m of assets.

However, Socimis are not the only companies engaged in these types of deals. The Mexican tycoon Carlos Slim, via the company Inversora Carso, has received the green light from the National Securities Market Commission (CNMV - Comisión Nacional de Mercado de Valores) to launch a takeover bid for 100% of Realia's shareholder capital. If successful, this would be the second acquisition deal completed by Inversora Carso concerning

GRAPH 6

Investment Volume by Segment - 2016*



Source: Savills / *H1

TABLE 1

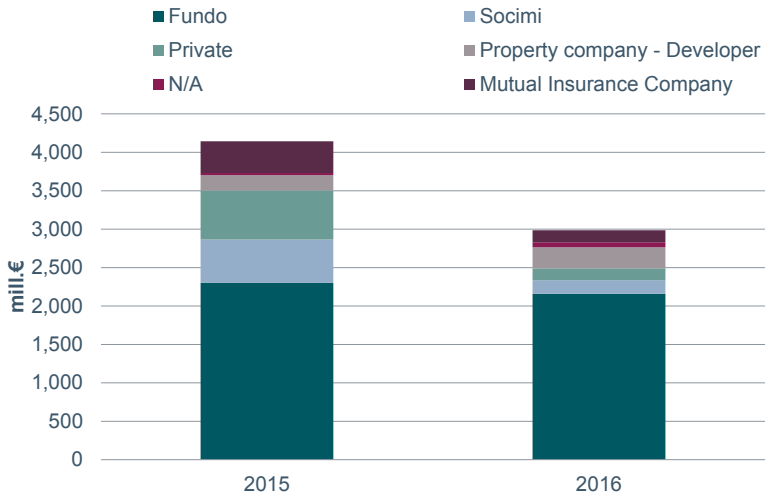
Main Investment Deals ≥ €100M.

Market	Asset	Region	inv. Vol. (mill.€)	Vendor	Purchaser	Type of deal
Retail	11 Eroski supermar-kets	Several Locations	358	Eroski	Invesco	portfolio
Hotel	Villamagna Hotel	Madrid	180	Queiroz Pereira	Dogus Holding	single
Oficces	Las Mercedes B.P.	Madrid	>125	Standard Life	GreenOak	single
Logistic	Portfolio Metrovacesa	Several Locations	100	Metrovacesa	CBRE GI	portfolio
Retail	Festival Park	Balearic Islands	100	Värde	Vía Outlets	single
Retail	Luz del Tajo	Toledo	100	Sonae	CBRE GI	single

Source: Savills

GRAPH 8

Investment Volume by Type of Investor H1



Source: Savills

Realia, following its purchase of Bankia's 24.9% stake in June 2015.

The last corporative deal was the acquisition of the assets belonging to the Finaccess portfolio by Colonial via a share deal that resulted in the latter entering into the real estate company's shareholder capital. The assets were valued at slightly over €200m.

Värde continues its quest to become one of the main players in the Spanish residential development market. After purchasing the real estate arm of the San José Group in 2015, the US fund has now acquired Aelca, a fairly new developer based in Madrid. This latest move clearly underlines Värde's focus on the Spanish real estate market and a distinctive leaning towards the residential sector.

The deals that marked the company's entry into the Spanish market at the start of the decade were highly opportunistic, acquiring the APN (retail) and Copérnico portfolios (office). Market performance and individual asset sales over recent years show that their strategy was succesful, almost doubling their original investment. The last deal signed only further corroborates this view; selling Festival Park for €100m, 43% of the total price at which they acquired the entire APN portfolio in 2011.

The upbeat economic outlook, lack of product in prime areas and the recovery of the main housing indicators (up-trending housing price index, rising number of house sales and mortgages granted, as well as increasing mortgage amounts and licence approvals for new-builds) have spurred Värde to move into this market, and not just as a servicer, a role it has occupied since the end of 2013 as a partner in the Aliseda platform.

Mega-deals

Mega-deals, transactions in excess of €100m, remain present in the market. Six such deals were signed during the first six months of the year, same figure than in H1 2015, although the accumulated volume was just 55% of 2015's figure.

Invesco's acquisition of the Eroski supermarket portfolio, which was closed at almost €360m, is the year's largest volume deal thus far.

Traditional retail products (shopping centres, supermarkets and retail warehouse) account for the lion's share of mega-deals, as was the case last year.

Another two assets falling into this mega-deal category, all with volumes in the region of €100m are: The Luz del Tajo (Toledo) shopping arcade where CBRE GIP has completed the acquisition after purchasing the Eroski hypermarket at the end of 2015; and Festival Park, whose unit value was 43% higher than the volume registered for the entire APN portfolio five years ago.

Volume mix by segment

To date, the retail segment accounts for almost 45% of the total commercial real estate volume transacted, largely thanks to the Eroski supermarkets which represent almost 30% of the total retail space.

Offices hold the second position, with a market share of almost 30%, followed by the industrial/logistics and hotel sectors with 15% and 13% respectively.

The number of deals completed is the same for both retail and office, hence raising the average retail ticket. However, in terms of average transaction volume, retail sector is down by around 50% y-o-y, whilst the average tickets of offices, industrial/logistics and hotels remain stable.

It must also be mentioned that three of the six mega-deals were retail transactions despite the drop in the average ticket.

There are currently several assets on the market with asking prices in excess of €100m, meaning the average transaction price could rise.

Investor Profiles

Funds have returned being the main player in the market. In H1 2016, they accounted for 73% of the total volume transacted, reaching almost €2,100m, just €125m lower than the figure recorded for H1 2015.

Real estate companies and developers continue to ramp up activity, adding new properties to their portfolios and generally adding value via refurbishments or new developments. GMP and Colonial account for almost 50% of products transacted since 2015 and are the clear leaders in the office sector, whilst Prologis is the number one in the logistics sector.

Socimi market share seems to have dwindled, accounting for just 6% vs. the 15% of H1 2015. After spending two years compiling their respective

portfolios, the time has come to focus on managing them, albeit continuing to analyse new investment opportunities at the same time.

Insurance companies and mutual insurance companies have also come back to the market with a boom. The "Cartera Amarilla" comprising almost 400 Santander Bank branches and acquired by AXA Reim last year accounted for 75% of the volume transacted by insurance companies. However if this deal is set aside, insurance companies focused their activity on the office sector, where they were the fifth most active in terms of transacted volume behind funds, Socimis, private capital and real estate companies.

In 2016, the almost €160M transacted by insurance companies is 51% up y-o-y, moving the segment up to second place in the ranking.

Investor Origin

Foreign capital is once again proving to be the market driver, accounting for 73% of the total transacted volume for commercial real estate. It completely dominates the retail, industrial and hotel markets, accounting for between 85% and 95% of invested capital, whilst in the office sector, domestic investors are the clear front-runners, accounting for over 65% of the volume transacted.

It is interesting to note that all of the mega deals were carried out by international investors.

The USA heads the list of international investors, although their share of total cross-border volume dropped to 58%.

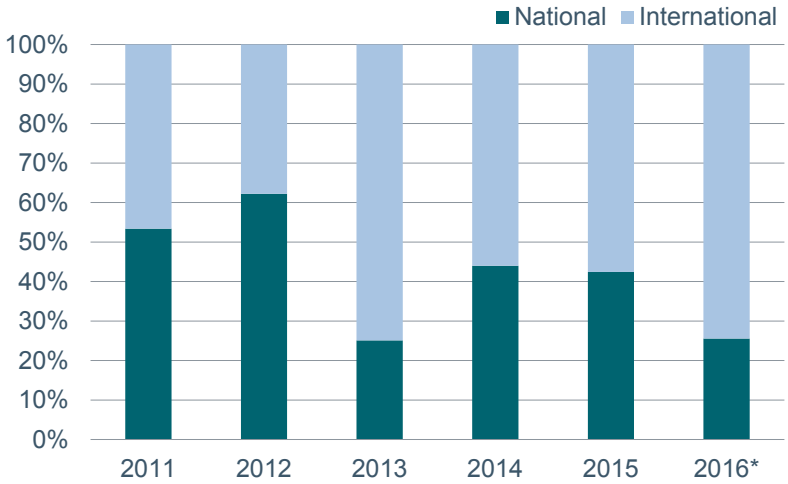
Last year several US firms made their mark in Spain and indeed remain active in the market, such as; CBRE GI and GreenOak which between the two account for almost 45% of the capital in dollars, increasing their share vs. last year when this percentage barely reached 30%; AEW which focuses largely on offices; and Thor Equities which mainly deals with retail high street assets.

Europe is second place in the cross-border rankings, accounting for 30% of the foreign capital invested, with the UK and Turkey the main players. The drop in sterling, one of the first consequences of the Brexit, could affect the participation of the British in international markets.

Other regions such as Latin America and the Middle East currently account for just 3%.

GRAPH 6

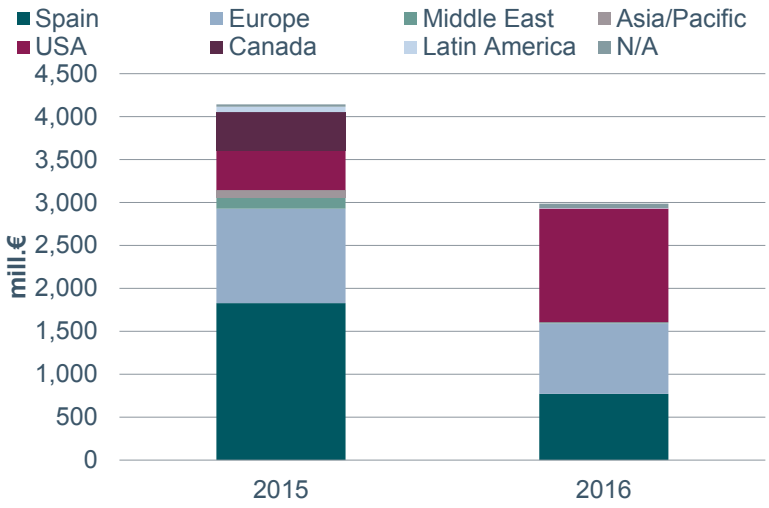
Distribution of Cross Border Investment



Source: Savills / *H1

GRAPH 7

Investment Volume by Investor Nationality H1



Source: Savills

Outlook

2016: High investment volume and futher yield compression

■ The consolidation of economic growth and the improving jobs market should provide the definitive boost needed to strengthen business sector growth, increasing the number of both companies and of people employed, and hence driving consumption.

■ The effects of the up-trending main economic indicators will be seen in occupancy levels and commercial real estate market rents. This said, there are still some segments where rental growth is not yet forecast, and others where rents are already increasing, but at a more moderate than expected rate.

■ The atypical situation of being without a government for six months has not affected investor interest in Spain. There is an ever-increasing amount of product on the market and the year-end volume for 2016 is expected to be similar to 2015's. This, however, will largely be determined by several mega-deals, amassing in the region of €400M, that may be closed in H2 2016, especially as some are already in the negotiating stages.

■ The result of the general election held at the end of June suggests that the new government will provide a guarantee of political stability, hence allowing international investors to maintain their confidence in the market.

■ Factoring in future political stability has led to an increase in the number of available assets in the investment market over the past few months. Some of which fall into the mega-deal bracket (>€100M). In offices, for example, if an agreement is reached for the purchase of two assets, almost €1,000M would be added to the year's tally. Whether or not all or some of these deals go through will determine whether the year-end figure for 2016 equals last year's or even beats it. The retail market is already expected to top the total volume transacted last year.

■ The Brexit will affect the Spanish real estate sector, although it is too soon to predict exactly how much of an impact it will have. For the time being, Spain's dependency on British demand, as well as the drop in sterling, flatten somewhat the optimistic outlooks that have been formed based on what has been the best start to a year in 15 years.

■ Market niches are gaining evermore ground. The student housing segment has sparked interest among European specialists who consider Spain to be a young market which still has huge potential to expand and grow. The highly fragmented nature of this sector combined with the outdated state of the product makes it difficult to compile a suitable portfolio quickly, hence the development of new and modern assets that meet the current requirements of university students seems the quickest way.

■ There is continued downward pressure on yields. Except for offices in Madrid, prime assets still have further room for adjustments before reaching market peaks. The lack of quality product that meets the requirements of institutional funds and of deals involving prime assets make it difficult to calculate achievable yields, but they maintain a downward trend.

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