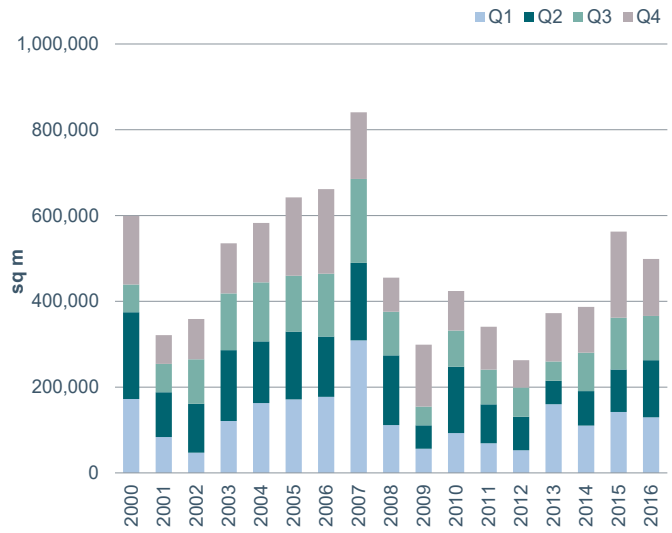
savills

Market in Minutes
Madrid Offices

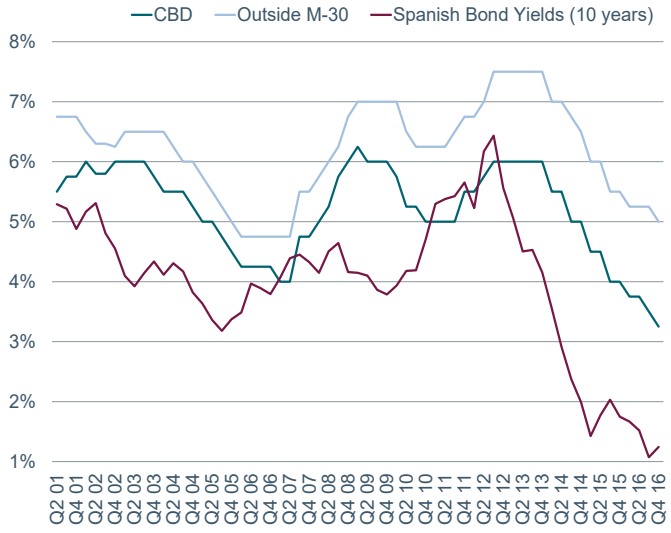
Q4 2016

GRAPH 1
Annual Take-up by Quarter



Source: Savills

GRAPH 2
Prime Yields vs. Spanish Bond Yields



Source: Savills / INE

SUMMARY

Market upswing in Q4, partly due to increased supply on the market

■ The occupier market has surpassed the psychological barrier of 500,000 sq m for the second year in a row.

■ After laying low for three quarters, mega-deals are back on the scene. 33% of total take-up in Q4 related to three office deals in excess of 10,000 sq m, although this amounted to just 9% of annual take-up.

■ If we exclude the so-called 'mega-deals', this equates to a 7% y-o-y increase, which demonstrates that growth in the market is not entirely dependent on these types of deals.

■ The vacancy rate has remained stable despite the fact that there has been a reduction in the amount of vacant office space in the market. This is due to a number of properties being excluded from the supply figure as they have undergone a change of use. Some refurbishment projects that were due to come on to the market have also had their delivery dates pushed back.

■ New, renovated or upgraded buildings are becoming a more attractive option for both, tenants and investors, who value design enhancements and more efficient use of space. Buildings with both technical and technological features are also increasingly of interest, and these typically command higher rental values compared to out-dated buildings situated in the same area.

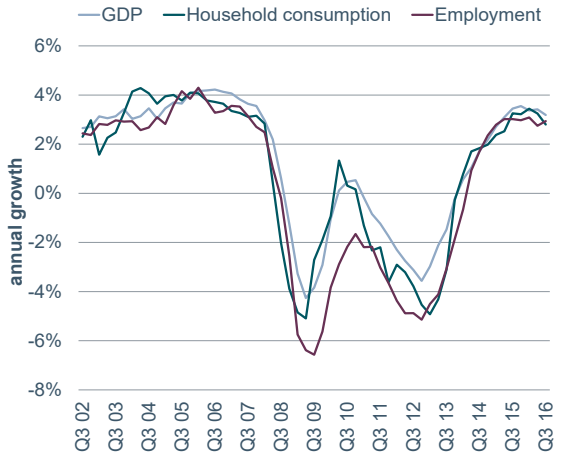
■ 75% of total investment in the commercial property sector (€2.9 billion) was invested in the Madrid office market, which shows that the city remains firmly on investors' radars.

■ Investors are maintaining a keen eye on the market, but the lack of supply has hampered both the transacted volume, as well as the number of properties available for sale (down 21% and 45% respectively).

■ The imbalance between supply and demand is now affecting all areas, with an overall decrease of 25 basis points q-o-q.

GRAPH 3

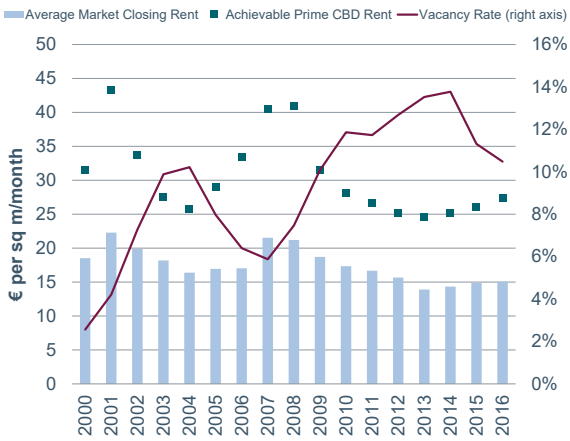
Main Economic Indicators



Source: INE

GRAPH 4

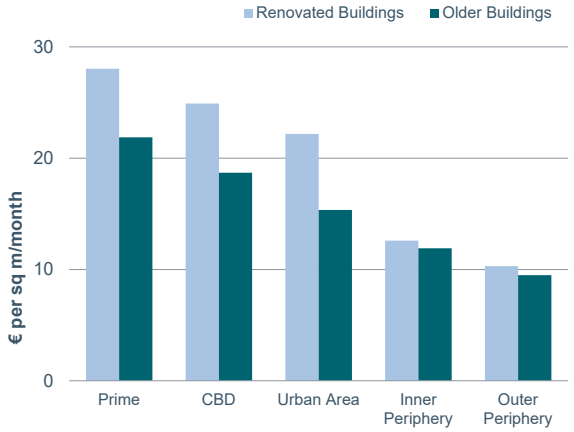
Vacancy Rate and Average Rent in the Madrid Office Market



Source: Savills

GRAPH 5

Average Closing Rent by Building Status (Exclusive Office Buildings)



Source: Savills

Economic Outlook

Despite the political instability over the last few months and the ripples of uncertainty felt globally as a result of Brexit and the election results in the US, the Spanish economy has been unaffected by this and has continued to recover.

According to the latest data published by INE, GDP rose 3.2% in Q3 16, recording the eleventh consecutive quarter of growth. Although this is slightly down quarter-on-quarter, GDP growth remains above the average figure of 2.6% between 1971 and Q3 16. Focus Economics expect that the year will close at 3.2%, in line with IMF and Eurostat forecasts.

Average GDP growth in the Eurozone in Q3 16 stood at just 1.8%, which is a far cry from the national average. If we compare Spain with other neighbouring countries, Spain ranks fourth in terms of European growth, just behind Ireland (6.6%), Luxembourg (4.8%) and Malta (3.3%).

Q4 16 unemployment data from the EPA puts the number of employed at more than 18.5 million, an average increase of 2.3% y-o-y.

Unemployment has fallen this YTD by an average of 2.4%, with the unemployment rate standing at 18.6%. Whilst still high (over four million people) unemployment is the lowest it has been since Q3 2009.

We would also note that the number of employed contributing to Social Security now stands at over 17.5 million, which is up 3.1% compared to September 2015. The annual average to Q3 stands at 2.9%.

Take-up and Demand

Take-up in the sole-office and semi-industrial market has surpassed the psychological barrier of 500,000 sq m for the second year in a row, although take-up has dropped 11% y-o-y.

Despite this slight decline in take-up, it is important to note that after three quarters of laying low, mega-deals (i.e. deals over 10,000 sq m) are now back on the scene. If we exclude these from the total, the market grew by 7%, which demonstrates that growth in the market is not entirely dependent on these types of deals.

Just shy of 600 deals have been signed, which is a 6% y-o-y increase.

Deal Sizes

The average size of office taken in 2016 has remained stable compared to 2015, standing at around 770 sq m (excluding the mega-deals), which is 16% below the historical average.

New technologies and new ways of working have had a knock-on effect on take-up for a number of years, but landlords as well as tenants also consider space optimisation a key factor in their decision-making.

In this regard, new, renovated and upgraded buildings provide better solutions in terms of space, which is also reflected in the average size of office taken. In 2016, the average size of space taken in upgraded sole-office use buildings exceeded 1,500 sq m, which is over double the average amount of space taken in unrefurbished buildings.

Current Supply

The amount of vacant space declined by approximately 2% q-o-q, but the vacancy rate only fell by a mere tenth of a per cent, to 10.5%. This was due to several buildings leaving the office market that had changed their use to residential or hotels.

Vacancy rates in and around the M-30 ring road demonstrate that occupiers prefer to be in the centre - the vacancy rate within the M-30 ring road stands at just 7%, versus 13% in periphery areas.

The return to the market of refurbished and upgraded office space in Azca and its immediate surrounding area has caused the vacancy rate in the CBD to rise slightly to 8%, while in the prime area (Recoletos and Castellana up to Gregorio Marañón), the vacancy rate remains below 5%.

Future Supply

In the upcoming 24 months, almost 250,000 sq m of new or refurbished space is expected to come onto the market, as well as 150,000 sq m that has recently been vacated or will shortly be vacated and which will undergo some form of refurbishment works.

Despite the efforts of many owners to improve their portfolios, the Madrid office market continues to have a high level of out-dated office space. Since 2010, new and refurbished spaces have only equated to 11% of total office stock and 15% of space currently available.

49% of supply currently in the pipeline will be refurbishment projects.

Rents

Rents continue to rise, but only at a moderate pace. The average weighted office rent in 2016 rose by 1% y-o-y.

Rents have increased in almost all areas of the market, with only a few areas furthest from the CBD not experiencing rental increases. We would also point out that although the majority of occupiers remain in the €10 to €15 per sq m/month rental bracket (40% in 2016), the over €25 per sq m/month bracket is growing slowly but surely. There were 33 registered deals for space in the over €25 per sq m/month bracket, which is a 22% y-o-y increase and accounted for 6% of total take-up in 2016, compared to 5% in 2015.

All offices let in the over €25 per sq m/month rental bracket in both 2015 and 2016 were located in the prime area, CBD and the surrounding area. The weighted y-o-y average for deals in the over €25 per sq m/month bracket rose by 3%.

Finally, we would also highlight that more deals were signed for new, renovated and upgraded buildings in the bracket analysed. In 2015, 48% of transactions completed in the below €25 per sq m/month bracket were in properties adapted to current occupier requirements and accounted for 77% of take-up. In 2016 this increased to almost 60% of transactions and 82% of take-up.

Investment Market

The general lack of product in the commercial property investment market, has been felt the most in the office sector. The annual investment volume in 2016 amounted to just over €2.9 billion, which is a 21% y-o-y decline. Despite this, this is the second best result achieved since 2008. The number of deals transacted has fallen by 25%.

Madrid remains the top destination for investment, with just over €2.2 billion invested in almost 50 properties. The lack of office supply affected the Madrid market the most - with transactions down by 21% y-o-y and number of properties by 45% y-o-y.

But this lack of supply has not curbed demand. New office space being released on to the market for sale after the summer break caused a significant upswing in market activity, with almost 50% of total take-up in 2016 occurring in Q4. Some transactions that commenced earlier on in 2016 have only recently completed, which means that they will be registered in 2017's figures.

Although the market will continue to see a lack of supply and significant buyer demand this year, it is hoped that there will be a gradual increase in available supply, as Socimis start to sell some of their stock. It would appear that once the 3-year asset rotation limit has passed, put in place to ensure that they remain exempt from capital gains tax, they will begin to sell some of their non-strategic assets.

Other players that have purchased large portfolios in recent years may also start to rotate their properties, in a bid to capitalise on the properties they acquired a number of years ago across different portfolios.

Despite the fall in activity, the average overall market price per sq m has increased by 20%, driven by the laws of supply and demand and this has been the case both inside and outside the M-30.

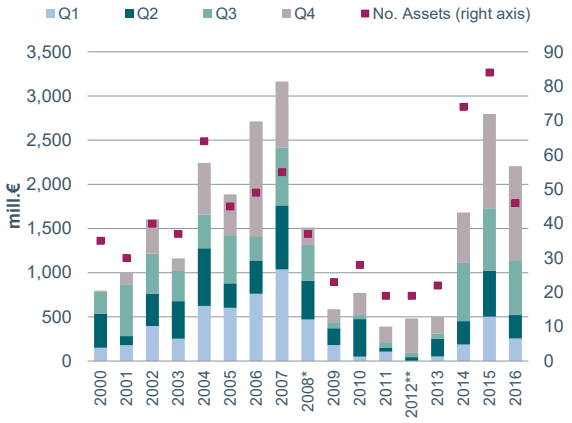
Yields

Following various quarters of the achievable Prime CBD yield remaining stable, due to a lack of comparables, the completion of various deals in the prime area, such as Paseo de la Castellana 55, have allowed yields to harden by a further 25 basis points q-o-q and 75 basis points compared to Q4 2015, to now stand at 3.25%. This is the fourth quarter where we have seen yields harden to below the figure achieved at the last peak of the market, and rents are clearly increasing.

Prime achievable yields in properties outside of the M-30 and secondary areas both inside and outside the M-30 have also hardened by 25 basis points q-o-q.

GRAPH 7

Investment Activity



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

TABLE 1

Main Deals - Occupier Market Q4 2016

Tenant	Area	Floor Area (sq m)	Activity Sector
Confidential	North Zone	21,000	IT
Renault	A-1	12,600	Industry
Confidential	Urban Area	12,200	IT
ViewNext	South Zone	5,800	Professional Services
Grupo PSN	CBD	4,400	Insurance
Allen & Overy	CBD	4,400	Professional Services

Source: Savills / *advised by Savills

TABLE 2

Main Deals - Investment Market Q4 2016

Asset	Area	Purchaser	Vendor
Adequa B.P.	North Zone	Merlin Properties	Lone Star
Almagro, 9	CBD	Axiare	Reig
Avda. San Luis, 77	North Zone	Zambal	Gas Natural
Pº Castellana, 55	Prime	Catalana Occidente	Standard Life
Confidential*	A-6	Fund	Private

Source: Savills / *advised by Savills

OUTLOOK

2017

■ Madrid's business sector is evolving, which is demonstrated by the steady increase in the number of transactions and this has driven the fourth consecutive increase in the business confidence indicator, recently published by INE. The drop in the number of mega-deals has resulted in a decline in take-up; however if we exclude these deals from the analysis, the market does not need to rely on macro-occupiers in order to survive.

■ The challenge in 2017 will be to absorb the new and refurbished space coming onto the market. The vacancy rate will increase as projects are completed, although vacancy rates in a number of business areas have already started to rise considerably.

■ The new, refurbished and renovated office buildings are attracting occupiers, who are aware of the improvements they offer and are willing to pay more rent for these buildings compared to others in the area.

■ The annual investment volume will largely be determined by the number of properties that come on to the market for sale, as investors continue to have an insatiable appetite for office space.

■ The imbalance between supply and demand will push values per sq m up, which will pave the way for further increases in rental values.

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