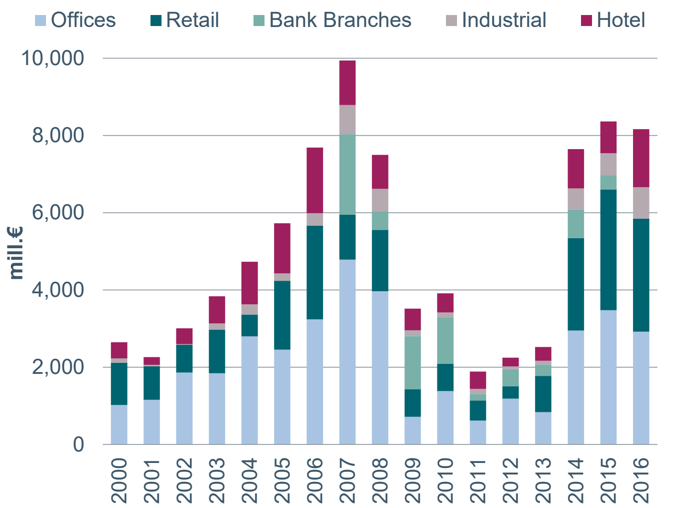
Market Report
Spain Investment

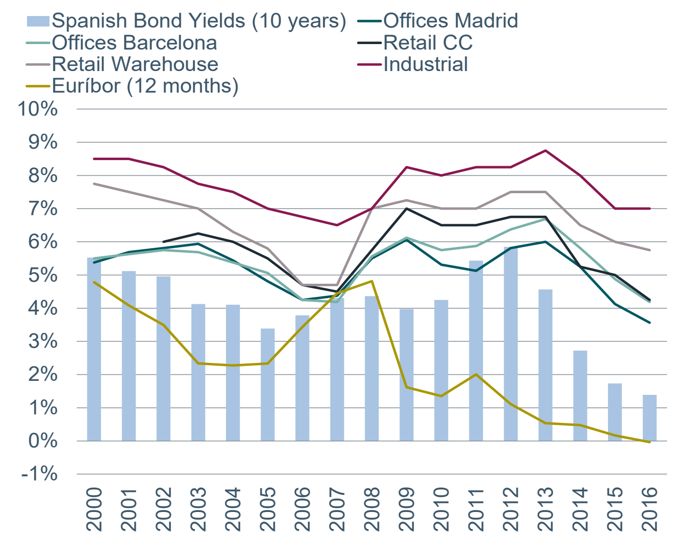
January 2017

GRAPH 1
Investment Volume by Sector



Source: Savills

GRAPH 2
Spanish Bond Yield vs. Average Prime Yields



Source: Savills / INE

SUMMARY

Strong demand but market slows somewhat due to lack of available product

■ Almost €8.2 billion was invested in commercial property in 2016, similar to the figure achieved in 2015.

■ Delayed completions of deals, as well as a lack of product on the market, were the main reasons for the slowdown in the market, with the total volume transacted just 2% down y-o-y.

■ Nevertheless, this has not been the case in every sector of the commercial real estate market - investment in the industrial/logistics market and the hotel market rose considerably y-o-y.

■ 'Alternative' emerging property sectors such as the student accommodation market are gaining ground, and are attracting the interest of specialist student market investors from other European countries.

■ Funds remain at the forefront of the market, accounting for almost two thirds of the total volume transacted in 2016. Investment funds are more focused on some sectors than others - for instance they are less focused on the office market, where they account for just one third of total investment in this sector.

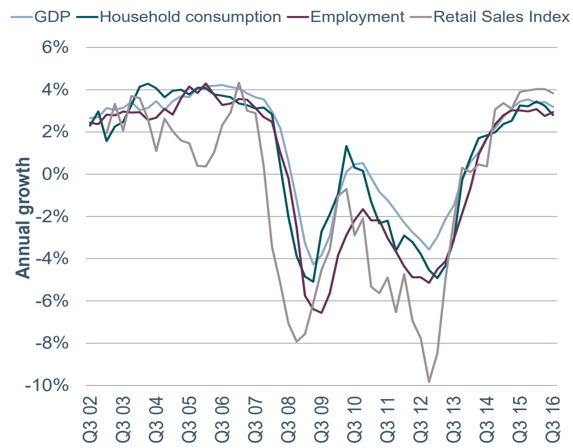
■ International investors continue to underpin the commercial property market. For the third consecutive year, international investors account for around 60% of total investment in the market.

■ Rising rents are one of the key drivers behind decision-making.

■ Value-added properties remain attractive to investors as they are an alternative to traditional markets, given the potential for increased rents following refurbishment works, office space remodelling and enhancements in property management.

GRAPH 3

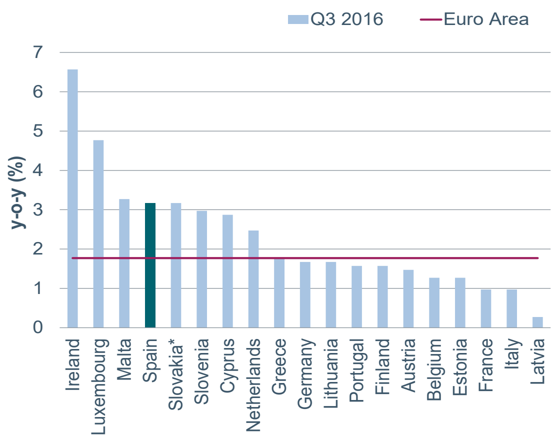
Main Economic Indicators



Source: INE

GRAPH 4

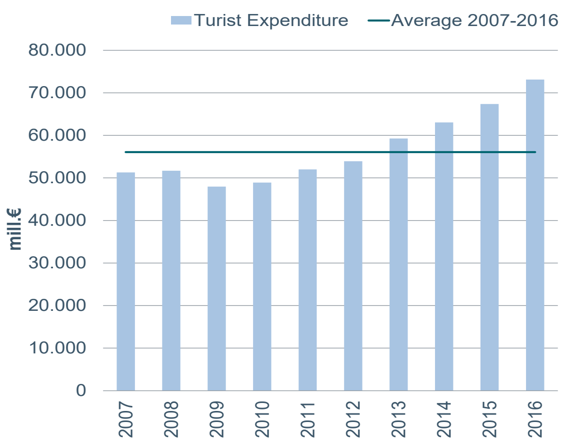
Economic Growth in the Euro Area



Source: Eurostat / *national statistics office

GRAPH 5

Turist Expenditure January-November



Source: TurEspaña

Economic overview

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 2016, 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 2016. Focus Economics expects GDP growth to top 2.7% by the end of Q4, which would reduce the average to September from 3.3% to 3.2% this year. In any event, this would still be a good sign for the economy, and would be a clear example of just how much the Spanish economy has recovered in 2016.

Average GDP growth in the Eurozone in Q3 2016 stood at just 1.8%, which is a far cry from the national average. If we compare Spain with other European countries, Spain ranks fourth in terms of European growth, just behind Ireland (6.6%), Luxembourg (4.8%) and Malta (3.3%).

Unemployment has fallen this YTD by an average of 2.3%, with the unemployment rate in Q3 standing at 18.9%. Whilst still high (over four million people) unemployment is the lowest it has been since Q3 2009.

Despite an increase in jobs, falling interest rates and tax breaks that we have seen since the beginning of this year, household consumption declined from 3.3% in Q3 2015 to 2.8% in Q3 2016.

Domestic demand's contribution to national growth shrunk from 2.9% last quarter to 2.6% this quarter. However, external demand increased slightly (by 1%) compared to June.

According to data released by the CIS, for the first time since the beginning of this year, consumer confidence has exceeded 100 points - topping 100.7 points in December. Although we have yet to return to the levels seen in 2015, this is the first positive figure this year (consumer confidence is viewed as high when it is over 100 points). The average consumer confidence figure for 2016 is 45 points above the lowest score in the data series (in 2012), 18 points above the historical average, at the beginning of 2005, and even above the annual figure registered between 2005 and 2007 prior to the start of the crisis.

One of the current hot topics regarding the economy in Spain is tourism. Tourism spend in the first 11 months of 2016 rose by 8.3% compared to November 2015. Given the internal conflict in some countries on the Eastern shores of the Mediterranean, Spain is now being viewed as an alternative destination for thousands of holidaymakers. This so called "spin off tourism" has increased revenue - according to data from Turespaña, a record €73,124 million was spent by tourists in Spain between January and November 2016.

A glance at election results

The main government organisations re-engaged after almost a year of a caretaker government being in place, although we are of the opinion that the interim period hardly effected real estate investment.

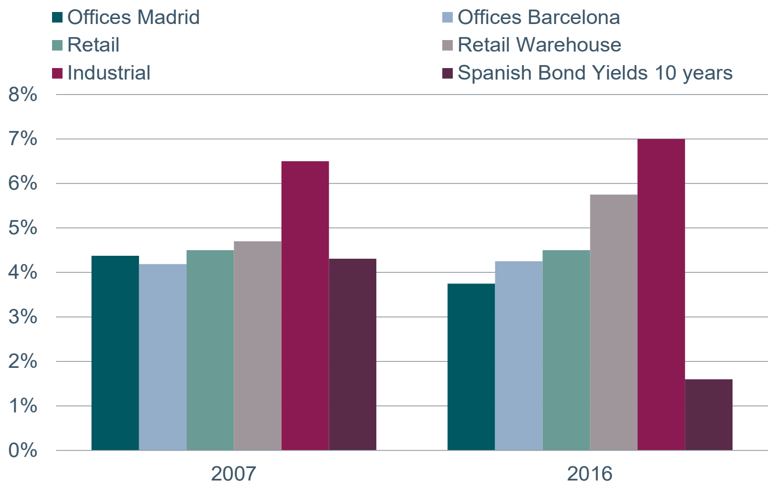
2016 was characterised by a general shortage of good quality product in the market. This was reflected in the slight decline in annual take-up (by just 2%), but was more apparent in the number of deals closed - which was around 18% down y-o-y.

Despite the negative growth, investors have remained keen on investing in a country which has showed strong signs of recovery in recent years.

In this regard, and given that just over 300 days of the transition period had passed, political stability is never a bad thing. Nevertheless, market players, particularly cross-border investors, focus on investing in countries with strong economic growth, regardless of the political climate, as long as they are not led by governments with extreme views.

GRAPH 6

Yields Prime Comparison 2007 vs. 2016



Source: Savills / INE

But Spain is not the only country in the EU with a turbulent political climate. In June, Brexit hit the UK's stock market hard, with the country's risk premium and value of the Pound also being affected. After a few months of readjustment, the announcement by the Prime Minister to go for a 'hard' or 'clean' Brexit and abandon the single market has put investors on high alert. In view of the situation, several key players in the City have decided to relocate to other European cities, as their presence in London will no longer guarantee direct access to the European market.

The Italian market, on the other hand, does not appear to have reacted negatively to the referendum result on constitutional reform, as it appears that the markets had already anticipated a "no" vote. In addition, analysts will recall that Italy is a country with significant experience with short-term governments (they have had 23 prime ministers over the past 40 years), which has not affected the country's economic growth.

In addition, a number of elections are due to take place in 2017 in several key countries in the European Union (Germany, France and Holland, to name but a few). As a result, the election outcomes will determine the rate of growth of the main macroeconomic indicators.

Investment continues

Approximately €8.2 billion was invested in the commercial property market in 2016, which is just a 2% y-o-y decrease. The slowdown in activity has primarily caused a drop in the number of deals closed - where the total figure has fallen by 18%.

We would note that so as not to skew the figures, this does not include corporate transactions, debt transactions, asset transfers or land deals, nor does it include properties purchased for owner-occupation in the commercial markets we have analysed.

The slight decline in investment activity is mainly due to the lack of available stock, particularly in the office market, and the delayed completion of transactions underway. Nevertheless, excess liquidity and growing investor interest in Spain has considerably increased competition for offices, with individual properties being inundated with offers.

Price is naturally a key factor in investors' decision making, which means that many companies find themselves priced out of the market. As a result of this, many firms have been forced to look for off-market deals to avoid getting involved in bidding wars.

Some funds have had to embrace the 'new normal' in the market and adapt their strategies with regard to the types of product they go for and the lot size. Investment funds are now considering properties that were previously not of interest (either due to the location of the property or size of the deal). This has meant that they have had to be more aggressive when bidding.

Despite this, not all properties in the market have met investors' expectations and as such they have had to look beyond Spain, and into other European markets.

Mega-deals

The decline in the total volume transacted has been offset to some extent by the rise in the number of so-called 'mega-deals' (deals over €100 million). There have been 18 deals of this type in total, which is 50% more than last year. Mega-deals have amounted to €4.2 billion, which is 51% up y-o-y, and accounted for 52% of the total number of deals for this year.

The retail segment registered the highest amount of commercial property investment, with around 40% of mega-deals taking place in this sector, both in terms of volume and the number of deals. In total, there were 8 transactions, although one of these was an investment portfolio of 11 Eroski hypermarkets acquired by Invesco at the beginning of the year for €358 million, and a portfolio comprising the ABC Serrano shopping centre and the retail unit occupied by the sportswear department of El Corte Ingles at Calle Preciados,for €138 million.

The largest deal of the year, at close to €500 million, was the Diagonal Mar shopping centre in Barcelona, followed by Torre Cepsa, which was purchased by Pontegadea for €490 million.

Activity by segment

It is interesting to note that 36% of the total figure invested in the commercial market in 2016 related to office and retail property. Given the number of mega-deals that were signed for retail properties between January and September, the retail sector was the leading market over this period.

However, investment in the office market gained ground towards the end of the year as it finally picked up the pace in the market, with 42% of the total amount transacted in this sector taking place in Q4.

The lack of available product for sale has had a negative impact on investment in office market to date, although we would note that this was tempered somewhat thanks to a number of off-market deals.

In Madrid, off-market transactions accounted for 33% of the total number of deals and just over 25% of the total investment volume figure, excluding Torre Cepsa and Ciudad Adequa from the analysis.

Despite this, the retail and office sectors experienced negative growth y-o-y (-7% and -15% respectively), whilst there was a 43% increase in the number of storage and distribution warehouses and hotels transactions - which is almost double the figure achieved the year before (just over €1.5 billion amounts to 83% more than the total figure for 2015).

According to data released by the CNMC in January 2017, the e-commerce sector performed strongly, growing by 20% in the first half of 2016. This has driven activity in the logistics market and consequently the investment market.

In addition, in 2016 the number of tourists visiting Spain exceeded 75 million, up 10% from last year. But Spain hasn't just benefited from an increase in the number of visitors - tourists have also spent more - the average spend per tourist increased by 3% and average daily spend by 6.5%.

Brexit has not yet had an impact on the sector. From January to November 2016, the UK topped the ranking with around 17 million tourists visiting Spain. The number of UK tourists increased by 12.3% y-o-y, which is just behind Ireland, at 23%, and Portugal at 18%.

Catalonia, the Canary Islands, Madrid and the Balearic Islands were the top tourist destinations in 2016, with hotel investment in these autonomous communities following suit.

Investor profiles

Investment funds remain at the helm of the market, with a 60% share of the market. They invested approximately €5 billion in 2016, which is 21% higher than in 2015.

We would highlight that investment has not increased in every commercial property sector. Whilst

TABLE 1

Mega-deals > €100m (2H 16)

Market	Asset	Region	inv. Vol. (mill.€)	Vendor	Purchaser	Type of deal
Hotel	19 hotels*	Several Locations	535	Merlin	Foncière des Regions	portfolio
Retail	Diagonal Mar	Barcelona	498	Northwood	Deutsche Bank	single
Offices	Cepsa Tower	Madrid	490	Mustari Group	Pontegadea	single
Offices	Adequa	Madrid	380	Lone Star	Merlin	single
Hotel	20 hotels	Several Locations	350	Caixa Bank	Apollo	portfolio
Retail HS	Pº Castellana, 83	Madrid	150	El Corte Ingles	Monthisa	single
Logistics	Mango Center	Barcelona	150	Mango	VGP	single
Retail SC	Gran Vía de Vigo	Pontevedra	141	Oaktree	Lar	single
Retail SC	Nassica	Madrid	140	KKR	TH Real Estate Neinver (JV)	single
Offices	Almagro, 9	Madrid	134	Reig Capital	Axiare	single
Offices	Avda. San Luis, 77	Madrid	120	Gas Natural	Zambal	single
Retail SC	L'Aljub	Alicante	115	TH Real Estate	TPG	single

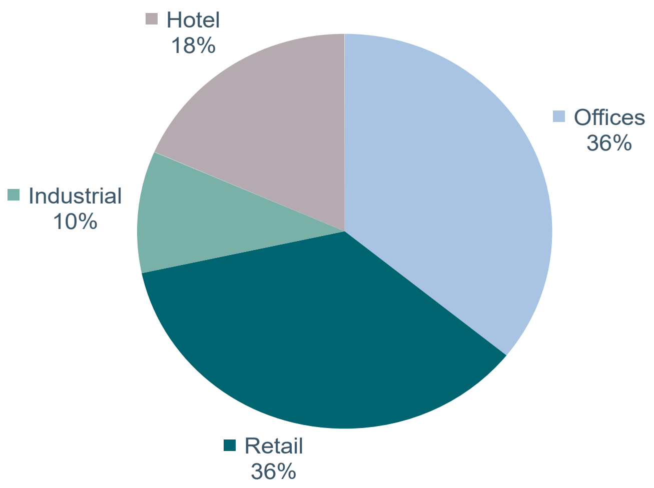
Source: Savills / *deal closed in December 2016, and published by CNMV in January 2017 investment in the retail sector has remained stable and almost a third of the total was invested in offices, investment in logistics buildings and hotels have increased fourfold y-o-y.

It is not just the funds that have been investing more in commercial property. Real estate companies have invested 39% more y-o-y, although as a whole they amount to just 10% of the total. We would highlight Colonial, which has been a key player in the office market this year, which has continued to add properties to its portfolio. Colonial has invested in two office buildings, one of which is in Barcelona and is currently under construction, and the other in Madrid. The latter is a classic example of an added value transaction, as the refurbishment works undertaken over the last few months have enabled them to increase rents by 20% and reduce the vacancy rate by almost 35%.

But these are not the only buildings that Colonial has purchased. In return for integrating IBM's original headquarters on Calle Santa Hortensia and BNP Paribas' previous office on Calle Serrano into its portfolio, Colonial granted Finaccess an 8% stake in Colonial.

GRAPH 7

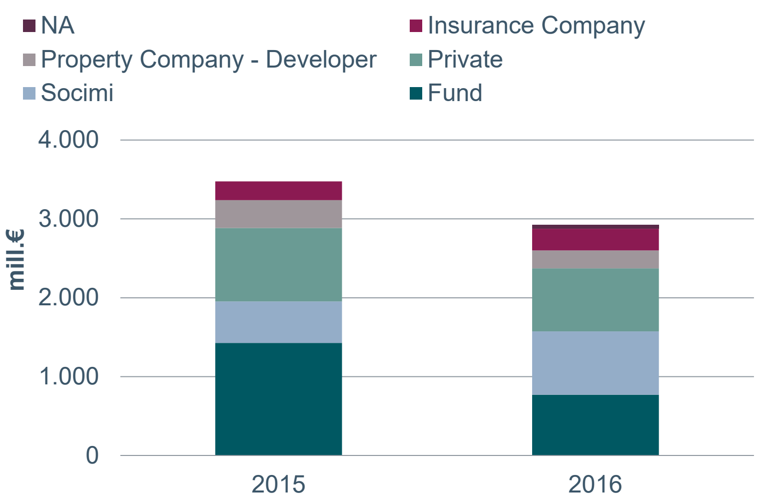
Investment Volume by Segment - 2016



Source: Savills

GRAPH 8

Investment Volume by Type of Investor



Source: Savills

Other key transactions in the market in terms of volume include Monthisa and the Belgian firm VGP. Both firms were involved in mega-deals amounting to €150 million, including the purchase of El Corte Ingles' retail unit at Paseo de la Castellana, 83-85 and Mango's logistics centre in Barcelona.

Grupo Ibosa also deserves a special mention as it has purchased a number of office to residential schemes.

Socimis continue to underpin the investment market. Although the total figure invested by Socimis is down by -17% compared to last year, they accounted for 15% of the total transacted volume in the commercial property market. Socimis had their eye on the office market in 2016, investing just over €800 million, which is a 53% y-o-y increase, whilst they invested on average 50% less in the retail, industrial and hotels markets.

Finally, we would highlight that insurance and mutual insurance companies have returned to the market. The insurance sector invested approximately €300 million in the office market this year, which is a 15% y-o-y increase.

Investor origin

Overseas capital is once again proving to be the market driver, accounting for 60% of the total transacted volume for commercial real estate. They are the market leaders in the retail, industrial/ logistics and hotels markets, where they control over 80% of the market on average. On the other hand, local investors continue to dominate the office market, accounting for 78% of total investment in this market.

By way of clarification, Socimis are considered to be national firms, regardless of the fact that a considerable proportion of their capital comes from overseas.

It is interesting to note that there has been an increase in the number of Spanish firms being involved in mega-deals.

Out of the six transactions completed by Spanish firms that exceeded €100 million, four were Socimis, although the largest transaction was the acquisition of Torre Cepsa by a private firm, Pontegadea.

Per region, Europeans amounted for a third of the total transacted volume (56% of international capital), followed by the US, at almost 25% (40% of international capital). It is also important to note that both the Europeans and Americans invested more than they did in 2015 - we would particularly note investment from the US, which at €2 billion, is almost double last year's figure.

Although the US topped the ranking, we would also highlight that Germany invested around €700 million, followed by France, which invested just over €665 million.

Alternative product

Investors are increasingly looking towards less traditional markets.

In recent years we have seen European firms specialising in student halls of residence move into the Spanish market, and they have started to develop small property portfolios.

There are a number of positive factors that have contributed to several European players entering this niche market - for instance, there has been a 90% increase in the number of private universities since 2000, and Spanish universities are beginning to expand globally, by offering bilingual degree courses in Spanish and English. In addition, there has been a steady rise in the number of international students attending Spanish universities - the number of international students has doubled over the past decade.

Identifying the most suitable properties in university cities is key - not just in terms of their size, but investors are also looking for cities with an attractive lifestyle, with an interesting cultural and leisure offering, a transport network big enough for the city, etc. We would highlight that it is difficult to enter the student accommodation market, as it is an opaque and fragmented market.

Almost 90% of university halls of residence belong to the private sector (including public universities managed by private operators via a temporary administrative concession). There are a number of large firms that control the majority of student accommodation in the market, but smaller scale operators, many of which are religious organisations that manage just one university, are the most common.

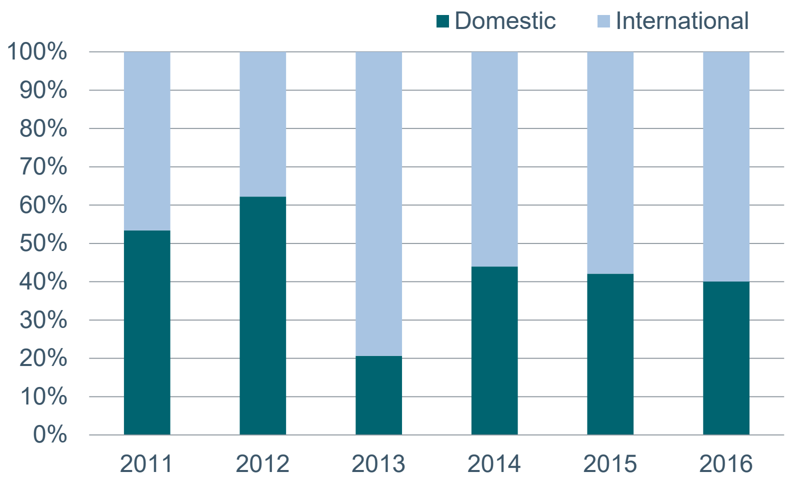
The Swiss fund Corestate has just entered the market with its acquisition of the Colegio Mayor Hispano-Mexicano Santiago Galas Arce, which is near Madrid's Ciudad Universitaria (University City). The building has been closed for several years, but Corestate are planning to demolish the current building and rebuild a new residence that meets the requirements and demands of today's students.

On the other hand, if one considers the ageing population, care homes for the elderly are now in several investors' sights.

We would also highlight that given the improved quality of life and life expectancy, coupled with the older population's high purchasing power, investors are looking further than traditional types of nursing homes offering medical and care services

GRAPH 9

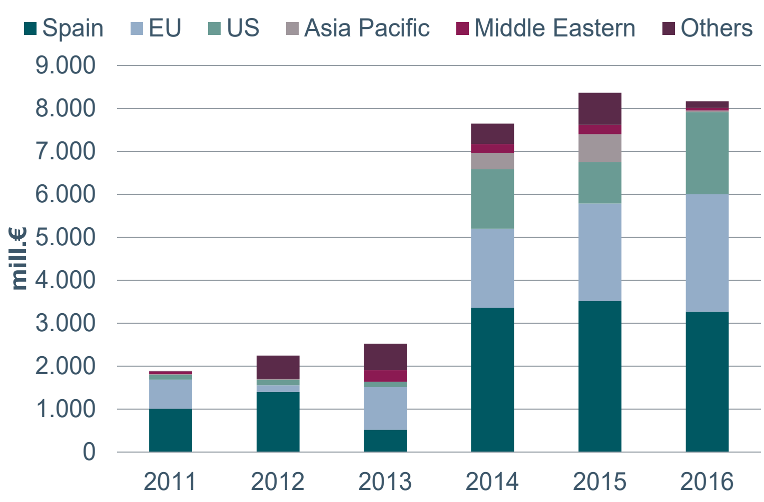
Distribution of Cross Border Investment



Source: Savills

GRAPH 10

Investment Volume by Investor Nationality



Source: Savills

to cater to the needs of older people. Investors are now looking at residential and holiday complexes as an interesting alternative to investment and these are attracting both national and European occupiers.

In fact, according to the latest data published by INE, 72% of foreign residents in Spain originate from the EU, and out of this, the UK and Germany are the largest groups (44% and 15% of total foreign residents respectively).

The favourable climate in coastal areas of Spain has made these areas the ideal location for these types of properties. These residences are the perfect option for independent older people, not just from Spain, but from across the world, where they can benefit from leisure activities, as well as home help. Having said this, there are some residences that are focused on one particular nationality, such as the Spanish population.

Just as is the case with student residences, it is difficult to invest in this market as it is a closed market with fragmented assets. According to the report entitled 'Statistics for sheltered accommodation: distribution of residences and accommodation space per province', published by Envejecimiento en Red, 71% of residences and 73% of accommodation spaces offered are owned by private firms. The large firms control a significant proportion of the supply in the market and small-scale private operators cover the remainder of the market.

The residential market has also attracted institutional investors. Slowly but surely, people are starting to consider renting as an option. According to the latest data published by INE, joint ownership has risen slightly to 77%, but since 2004 it has fallen by just over 2%, whilst the number of households renting has increased.

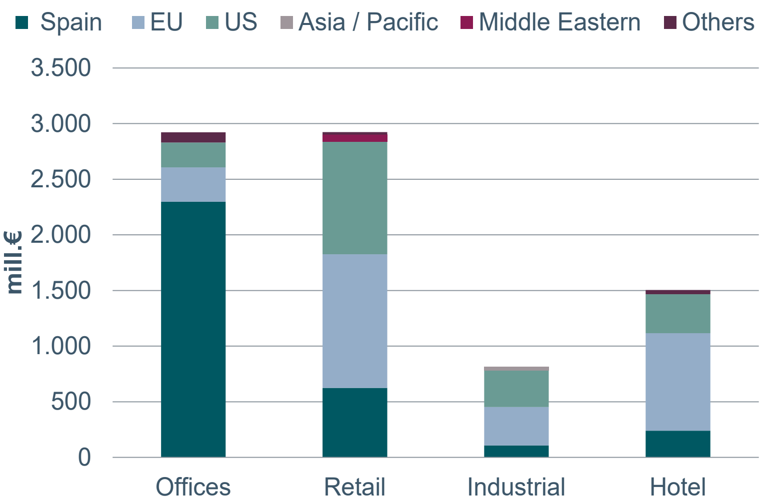
One of the reasons for this is affordability as house prices have increased. We would also note that renting is flexible if there is a change in your personal circumstances or employment, thus encouraging labour mobility.

However, if we compare Spain to the Eurozone as a whole, where 34% of properties are rented, there is still considerable room for growth.

We also need to consider that given the high level of youth unemployment, it is much more difficult for so-called 'millennials' to purchase their own home. That said, they do value living in the city centre as they like to be close to cultural and leisure activities.

GRAPH 11

Investment by Segment and Investor Origin - 2016



Source: Savills

Outlook

2017

Demand

■ Investors remain keen to enter the Spanish market and there is significant demand for residential property.

■ The market remains attractive to investors given the strong economic growth forecasts, which are higher than other countries in Europe, in addition to the key market indicators.

■ We expect several transactions that commenced in 2016 to complete, but that these transactions will be registered in 2017's figures.

■ The best properties in the best areas across the commercial property market are now seeing rental growth, but rents have not increased as much as expected.

■ Investors are primarily focused on rental growth, in addition to expanding towards secondary products.

■ In the first few weeks of January around €400 million was invested in the commercial property market, of which over 40% relates to just one property. The iconic Torre Agbar building now forms part of the Merlin portfolio.

Supply

■ New properties for sale will offset the lack of supply we have seen over the last few months.

■ A proportion of this supply will come from Socimis - they will begin to sell some of their stock once the 3 year asset rotation limit has passed, to ensure that they remain exempt from capital gains tax.

■ Investors, predominantly funds, that are now looking to rotate their properties will start to put their properties up for sale, in a bid to capitalise on the increase in rents and compressing yields.

■ In any event, the lack of supply of prime products in all areas of the commercial real estate market will remain an issue, and as a result investors will look towards buildings with a view to adding value via renovation

Yields

■ Excess liquidity in the market and the ease of acquiring finance, coupled with a lack of prime product will cause prices per sqm to increase, and in some segments, yield compression.

■ The difference between yields for prime real estate in 2007 (at the last peak in the market before the recession) and 2016 clearly shows that there is room for yields for retail and industrial parks to move inwards. Yields for prime shopping centres have already exceeded the pre-2007 figure, whilst offices remain below this. An increase in rents will pave the way for further yield compression.

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