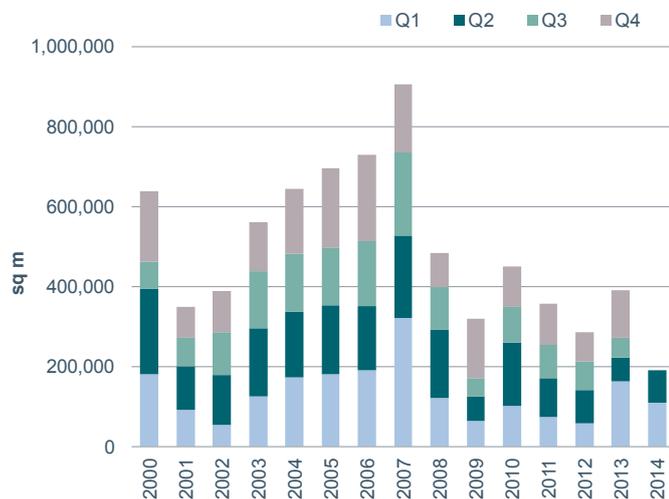


# Market report Madrid offices

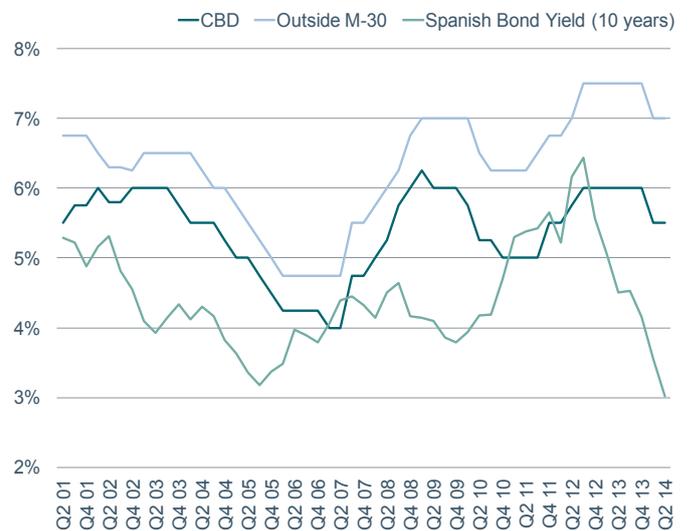
Q2 2014

GRAPH 1  
Annual Take-up



Source: Savills

GRAPH 2  
Prime yields vs Spanish bond yields



Source: Savills, INE

## SUMMARY

We are gearing up for what is expected to be the most active second half in terms of investment deals since the start of the crisis

■ Take-up in H1 2014 reached just over 190,000 sq m, which is a 14% y-o-y decrease, although if we disregard the Vodafone letting (50,000 sq m) signed at the beginning of 2013, the difference would be +11%.

■ Demand is beginning to show moderate signs of improvement, with a 15% increase in the number of transactions completed.

■ The overall market vacancy rate continues to touch on 14%.

■ Demand activity will dictate just how much the vacancy rate will alter,

but despite the expected increase in take-up between now and year-end and the drop in the amount of new and renovated space, we do not expect to see the vacancy rate fall significantly, as many of the mega-deals signed over the past few months are still yet to vacate their old headquarters.

■ We are now in a two-tier rental market. Whilst the CBD, its immediately surrounding areas and the main business parks are seeing positive growth, the areas furthest from the city centre continue to see rents fall.

■ The Madrid office investment market

is coming out of its slumber. Between January and June, Madrid registered close to €450m of investment, accounting for just over 60% of all office investment in Spain.

■ International capital accounted for almost 60% of this, thanks to the acquisitions of the Vodafone headquarters and the IBM headquarters, both of which were sold for over €100m.

■ The entry of Socimis on to the scene will favour a more upbeat investment market, which will continue to be extremely active up until the end of the year.

### Economic situation

The Spanish economy has now returned to growth, which has allowed it to technically come out of recession. The main economic indicators now suggest that the economy is expanding and short term forecasts are promising.

The GDP figure published by INE for Q1 2014 indicated y-o-y growth of 0.5%, which is the first positive figure after 10 consecutive quarters of decreases. In addition, the q-o-q change registered signs of growth for the third consecutive quarter, posting an increase of 0.4%.

In terms of the job market, the Q2 2014 Labour Force Survey (EPA) confirmed the first increase in the working population since Q3 2008. The unemployment rate stands at 24.5% and this fall is due, not only to the reduction in the working population, but also due to the rise in those employed. This therefore corroborates central government forecasts on job creation in a growing economy, which now stands at 1.5%.

In terms of private consumption, domestic demand is now at levels that are verging on optimistic. After 22 quarters of negative figures, Q1 2014 was the first positive growth figure and everything suggests that private consumption will continue to increase. The 1.6% registered in Q1 2014, is the best figure since the start of the crisis. In addition, it

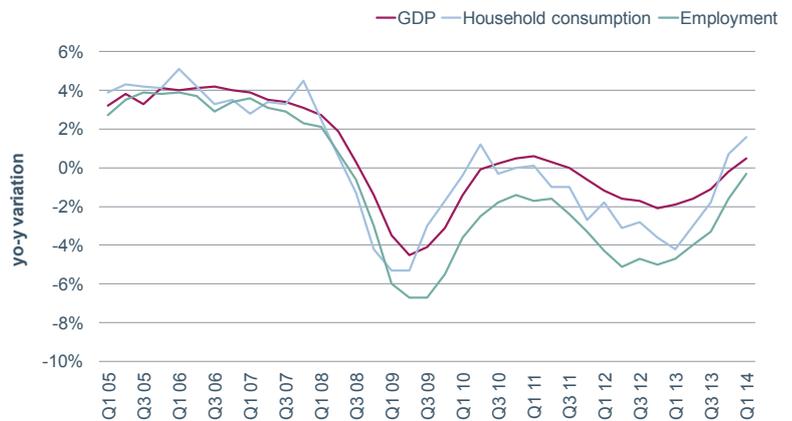
appears that things are continuing to improve, as the consumer confidence index is again looking promising, with figures similar to those seen prior to the economic downturn.

Finally, Spain's position versus other countries, achieved financial capability for the first time in 15 years in 2013, which stood at close to €15.8b. However, this has changed in the first half of the year, with the need for €7.3b, which is something that tends to be seen more in boom times, when the government is implementing growth policies.

Despite this, the Spanish economy has entered a period of prosperity, in which both national and international confidence is beginning to improve. Investors of

various different nationalities are now all interested in Spain and the continued improvement in Spain's economic indicators over the past few quarters has meant that various bodies have improved their short-term economic forecasts. Q2 2014 will round off a full year of q-o-q economic growth.

GRAPH 4  
GDP, consumption and employment



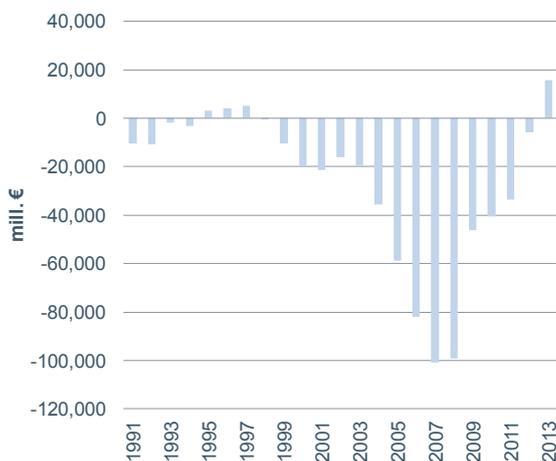
Source: INE

TABLE 1  
Economic indicators

Indicator	2013	2014*	2015*	2016*	2017*
GDP	-1.2%	1.1%	1.6%	1.9%	2.0%
Consumer spending	-2.1%	1.3%	1.4%	1.7%	1.9%
Unemployment	26.1%	25.0%	23.9%	22.6%	21.1%
CPI	1.5%	0.2%	0.8%	1.1%	1.3%

Source: Focus Economics (July2014) / \*forecasts

GRAPH 3  
Balance of payments



Source: Banco de España

## Take-up and Demand

Take-up in Q2 2014 reached just over 80,000 sq m. This was an increase of 37% compared to the same figure the year before, but one should not forget that Q2 2013 was the all-time lowest level of take-up since records began back in 2000. Take-up in H1 2014 reached just over 190,000 sq m, which is a 14% y-o-y decrease, although if we disregard the Vodafone letting (50,000 sq m - signed in Q1 2013), which skewed the reality of the market, the difference would be +11%.

In terms of the number of transactions, both quarterly and half-yearly figures reflect growth of around 15%. Hence, it looks like demand is on the up, albeit at a more moderate rate.

## Size of spaces

Small lettings (≤499 sq m) continue to lose ground to medium-sized and large spaces. The types of companies that traditionally take this size of space are still not up to full speed and are still seeing moderate levels of turnover. According to the latest Financial Study on Spanish Business, which was recently published by Cepyme (Spanish association for small and medium-sized companies) and EADA Business School Barcelona, Spanish business saw a 4% fall in turnover in 2013, which was the third consecutive fall, although the business confidence indicator provided by INE has been posting increases since mid 2013 and double

digit growth for all 2014 figures.

Large lettings (exceeding 1,000 sq m) have improved, although there continue to be few lettings over 3,000 sq m. In terms of the latter, various companies are taking new space in order to consolidate all of their different business lines under one roof, that were previously located in various locations around the city, which in the majority of cases has meant that there has not actually been an actual increase in space taken up until now.

This was the case with Duro Felguera, which was the largest deal of the quarter, which acquired the property in the Campo de las Naciones that was previously occupied by BBVA, up until it moved to its new finance city. The Asturian group took advantage of the down cycle in order to amalgamate all of its headquarters in Madrid and the business area replicas managed by the parent company, in order to save costs and improve its visibility.

## City centre vs. out-of-town

The city centre, or at least the area within the M-30 ring road, continues to be of most interest to occupiers. Between April and June, 63% of lettings were signed within the M-30, which is 22 consecutive quarters of this figure standing at over 50%.

The extensive amount of out-dated office space in Madrid is primarily located in the city centre and given the large amount of second hand

## Demand

### Occupier demand has improved due to the impending shift in the property cycle in the best areas of the Madrid office market

After various years of office searches being primarily focused on aiding lease renegotiations, we have seen an increase in occupiers looking for higher quality space, i.e. those companies looking for office space have a genuine need for that space and a desire to change office, rather than just sounding out the market in order to negotiate a discount on the space they already occupied.

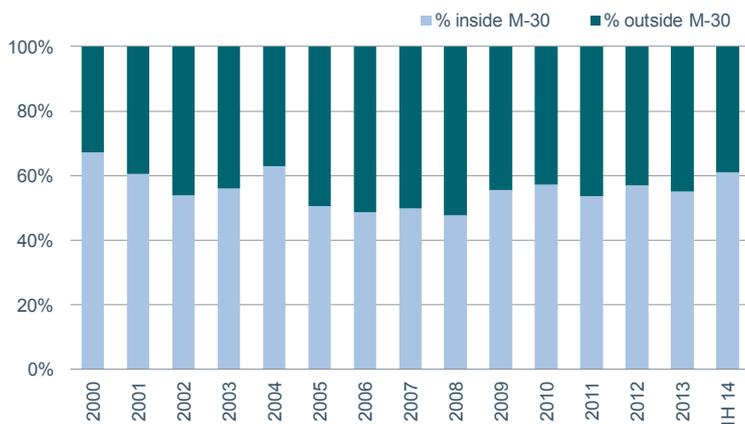
This is helping to cut decision-making time and the wide range of temporary rental discounts, which previously ranged from months of rent-free periods to capital contributions for office fit-outs. This is more the case in the CBD, where the lack of quality spaces has meant that the aforementioned commercial incentives have almost halved..

Another factor that companies are taking in to consideration in order to speed up the search process, is to take advantage of the bottom of the rental cycle. In the CBD, it is ever more common to see closing rents above the achievable rent, which would suggest that we are about to start to see rents increase for the best properties in the best areas.

In addition, the improved economic outlook and the short-medium term growth expectations, are favouring an increase in the average size of space occupiers are looking for, many of whom are looking to take positions prior to an upturn in business, which will then mean they will need a larger workforce.

GRAPH 5

## Number of deals with regards to the M-30



Source: Savills

space coming on to the market due to companies closing or taking less space, many property owners have taken advantage of this situation in order to improve their properties and adapt them to the needs of occupiers currently looking for space.

The investment in these types of works has paid off, as most of these renovated offices have been quickly snapped up. Given the extensive amount of competition, occupiers particularly value competitive properties, not only in terms of rents, but also in terms of their specifications and services.

### Current Availability

At the end of June, there was around 1.8 million sq m of vacant space in the Madrid office market, which is a 1.5% q-o-q increase. The moderate upturn in demand has meant that the overall market vacancy rate remains at its record high of close to 14%.

However, this is not the case for vacancy rates in the CBD and the main out-of-town business areas, which stand at more healthy levels of between 4% and 8%. On the other hand, the areas furthest from the city and those that are less consolidated have vacancy rates that are double or even triple that of the overall average market vacancy rate.

However, one must take in to consideration that there is a lack of quality office space in all sub-markets, which is causing ever more marked differences in asking rents and closing rents.

Demand activity will determine just how much the vacancy rate will change. Despite the fact that we expect to see an increase in take-up between now and year-end and the drop in the amount of new and renovated space coming on to the market, we do not expect to see a significant fall in the vacancy rate, as many of the mega-deals signed over the past few months are yet to vacate their old headquarters. Hence, we expect to see the overall

vacancy rate increase in the short-term.

### Delivery of new space

No new stock is expected to come on to the market until 2015, which is when phase 2 of the new BBVA headquarters in the north of Madrid will be delivered. There continue to be virtually no new developments on the market, particularly speculative schemes. The lion's share of new-built office properties is currently comprised of two owner-occupied properties, the BBVA and Banco Popular headquarters, which will increase the office stock by 140,000 sq m and account for more than 90% of new office space in the pipeline up until 2016.

In terms of the whole market, and with the majority of delivery dates set for at least 2016, new-built projects hardly equate to 40%. The remaining 60% is comprised of refurbishment projects, the success of which lies in adapting out-dated spaces to current occupiers' requirements. The lack of quality space available, primarily in the city centre, means that there is an opportunity to refurbish these well located properties and put them back on the market.

### Committed space

Over the past few years, the ever growing number of refurbishment projects have meant that pre-let contracts were signed for part of the

refurbished space, before it came on to the market. The busiest period for this type of transaction was between 2011 and 2013 and the amount of space committed via a pre-let contract tended to equate to around 25% of the space. We do not expect to see any buildings being delivered under these types of agreements in 2014, although similar agreements are being signed for projects that will be delivered in the medium-term. The soonest will be ICEX's move to one of Repsol's old headquarters on the upper stretch of the Paseo de la Castellana, which is scheduled for Q2 2015.

### Key projects

Social and environmental responsibility in the business community are held in high regard by international companies. Up until now the search for new offices has not been dependent on the level of sustainability of the property, nor in order to obtain a green seal of approval, although it can be a determining factor when it comes down to the final decision of which property to choose.

Various projects that are currently underway are being developed in order to be awarded internationally accredited sustainability certifications, which will make them more competitive in the occupier market and increase their appeal to the investment market.

GRAPH 6  
**Vacancy rate**



Source: Savills

GRAPH 7  
**New developments and refurbishment projects**



Source: Savills / \*forecasts

### Tipping point

For the first time in five years, the average value calculated based on all of the closing rents achieved in business properties (sole office use and high tech) has increased. It was only a 3% increase, but it is a change nonetheless.

Unfortunately not all areas are expected to see similar levels of growth. Whilst the CBD, its immediately surrounding areas and the main business parks are seeing positive growth, the areas furthest from the city centre, with an oversupply of office space and little demand, continue to see rents fall. Hence it is very much a two-tier market.

The CBD is heading up this change. The lack of quality supply has driven asking rents up and the difficulty of finding spaces that meet these exacting standards, have meant that rents have not been able to be reduced as much as they used to be in the negotiating phase.

In addition, it is becoming evermore common to see lettings signed over the achievable rent. At the moment these are one-off cases, in very specific properties or under very specific circumstances, but at the same time we have seen a drop in the number of lettings with single digit rents.

"We are now in a two-tier market. The lack of prime properties on the market in the CBD and other consolidated areas, are driving closing rents up, whilst the areas furthest away from the city continue to see rents adjust" Gema de la Fuente, Savills Research

Another factor to take in to consideration is the reduction in incentives in consolidated markets. Not only are rent-free periods declining, but other temporary rental discounts are also being left out at the negotiating stage, and in those cases where the initial rent has not been increased significantly, this means the net rent would rise.

### Achievable rents

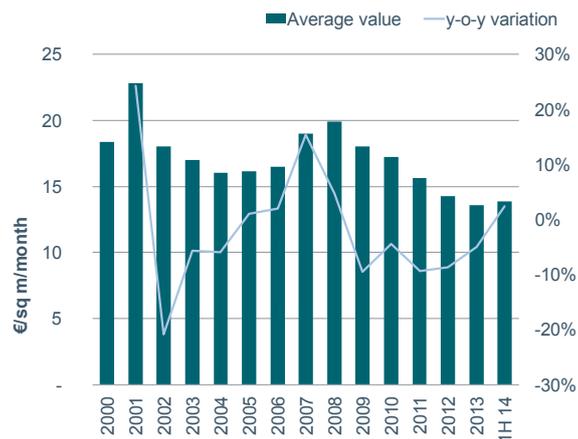
The achievable rental value in the CBD remains the same as in the previous quarter, €24.75 per sq m/month, as the leases that have been signed above that are one-off exceptions. In any event, the market is definitely showing signs of growth in this area, fuelled by the lack of quality supply.

TABLE 2 Main deals - Occupier market - Q2 2014

Tenant	Zone	Floor area (sq m)	Activity sector
Duro Felguera	Campo de las Naciones	16,000	Industry and Manufacture
Confidential	Norte	4,800	Energy
Confidential *	Área urbana	4,500	Education
JP Morgan	CBD	3,500	Bank
CIMD	Área urbana	3,200	Bank

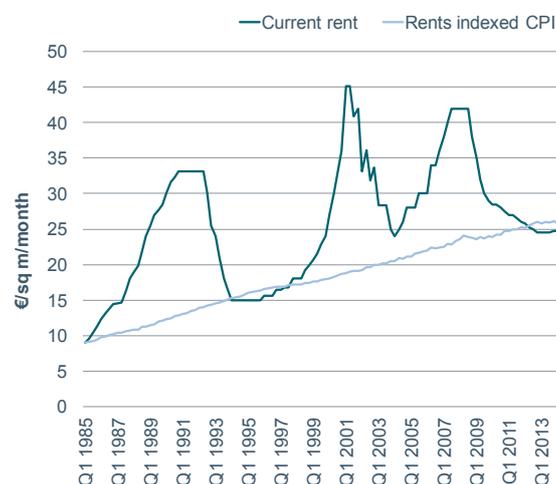
Source: Savills / \*advised by Savills

GRAPH 8 Average closing rent and y-o-y variation



Source: Savills

GRAPH 9 CBD Rent



Source: Savills / INE

### Investment Market

The Madrid office investment market is coming out of its slumber. The continued increase in investor activity that started at the end of last year has meant that close to €730m of investment was clocked up in the first half of the year. This figure includes all of the real estate investment deals for the office market in Spain and amounts to more than 70% of the total annual investment volume achieved in 2013.

In terms of investment, Madrid is back at the top of the leader board, accounting for 64% of all office deals. The €450m of investment equates to around 95% of 2013's total investment figure.

Looking at these figures ushers in a sense of optimism, which is then added to when one sees the large number of national and international investors interested in investing in

the Spanish market. The catalyst in this increase in confidence was the improvement in the economic outlook, which has been confirmed thanks to the continued increase in the main economic indicators, which has also coincided with the bottom of the property cycle. Thanks to this situation, the perception of needing to take advantage of these opportunities has reduced the risk sentiment that had plagued the Spanish market over the past few years.

On the other hand, the exponential increase in liquidity from investment funds, as well as the appearance on the scene of Socimis (Spanish

equivalent of REITs), would explain the increase in investor activity looking for investment opportunities.

### Lack of properties for sale

In this respect, the market is not being very accommodating, given that despite the fact that evermore properties are being put up for sale, a great deal of deals are being carried out off-market, with the aim of avoiding the competition, which would mean various investors pitting themselves against each other in the same sales process.

We spoke of this several months ago, but it is interesting to see that whilst

## Assets in decentralized areas

The gap between prime and secondary product in the periphery is reducing

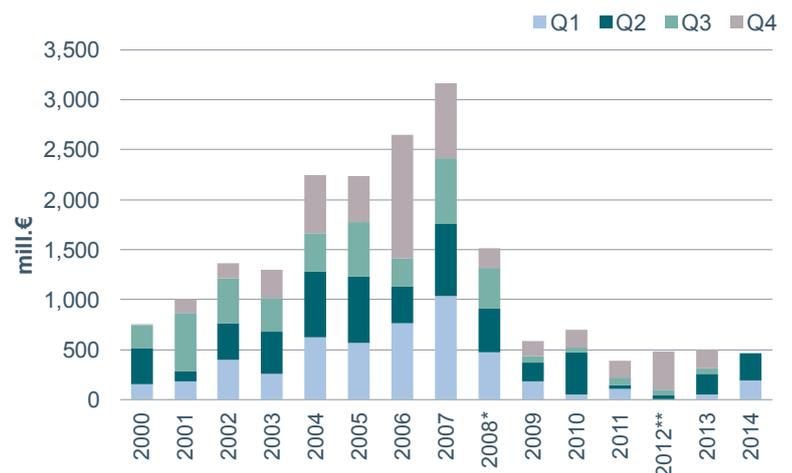
With the lack of transactionable product in the CBD and urban area, both on and off the market, the de-centralized locations are receiving increased attention.

The gap between theoretical yield levels between prime and secondary assets outside the M-30 was only 65 basic points in 2007, and increased as the market began to struggle, until reaching 170 in 2012. Since then, there has been a fall of 20 additional basis points which has held stable in 2013 and H1 2014.

Furthermore, by observing the average yields throughout the historical series, it is interesting to note that assets which may have been considered secondary during periods of economic boom, are becoming increasingly prime

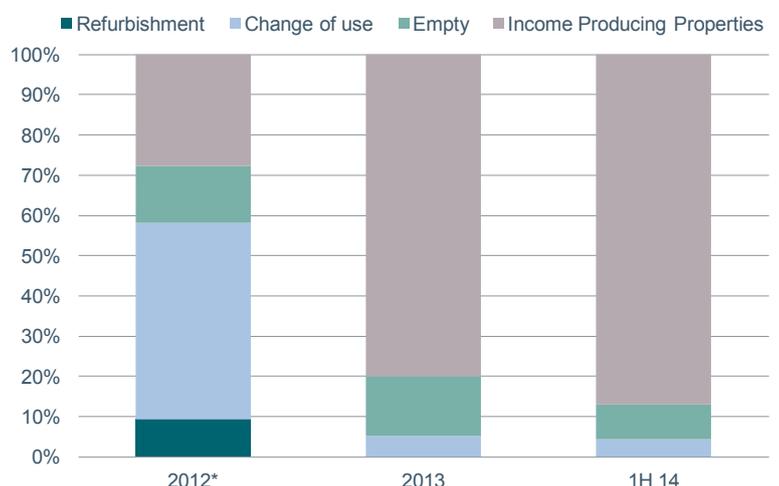
What will be difficult will be identifying the best positioned product in the market, especially in such an opaque point in time as we are currently seeing.

GRAPH 10 Investment volume



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

GRAPH 11 Investment volume by type of deal



Source: Savills / \*excluding Torre Picasso

"The new Socimis (Spanish equivalent of REITs) have caught the interest of national and international capital and we expect to see them increase their investment activity over the coming months, as they are already in advanced stages of negotiating the completion of various deals". Pablo Pavía, Spain Investment

in 2013 hardly 30% of the office market deals signed in Madrid were completed off-market, in the first six months of 2014, this figure rose to 50%.

### Origin of investors

National investors continue to lose ground to international investors. Between January and June, national investors accounted for little more than 41% of total investment, but one must take in to consideration that the two mega deals signed up until now, the Vodafone headquarters and the IBM headquarters, both of which were for more than €100 million, were completed with international investors (European and Latin American respectively).

### Socimis

Socimis, which are the Spanish equivalent of REITs, are gaining

ground in the investment market. They were not very prevalent over the first half of the year, hardly accounting for more than 4% of total office market investment and they focused on hotels, shopping centres and offices in the main markets (Madrid and Barcelona).

Little by little they are gaining more market share and will increase their investments, taking advantage of the property cycle to buy cheap and subsequently sell when the market has recovered. Hispania, Azona's socimi, recently acquired Oncisa's office portfolio for slightly more than €120m, although this figure was not included in the figure for the first half of the year, as it was completed in July.

July was an especially busy month for the Socimis created so far (Hispania, Lar, Merlin properties

and Axia), which are currently in advanced negotiations on various deals.

In addition, we would also note that Socimis are also attracting the interest not only of national investors, but also international investors, who see them as a safe way of entering a market they do not know. In addition is important to highlight the tax benefit

In this sense it is also important to highlight the tax benefits for this investment vehicles as well as for their shareholders (both natural persons and legal persons).

### Yields

The imbalance between supply and demand for prime properties has driven the prime yield down in the CBD: 50 basis points compared to the average level since mid-2012, to now stand at 5.50%. This figure was very much our interpretation of the market, as there have been a lack of comparable deals, which has been confirmed with the signing of a property on the first stretch of the main office market in Madrid at this yield.

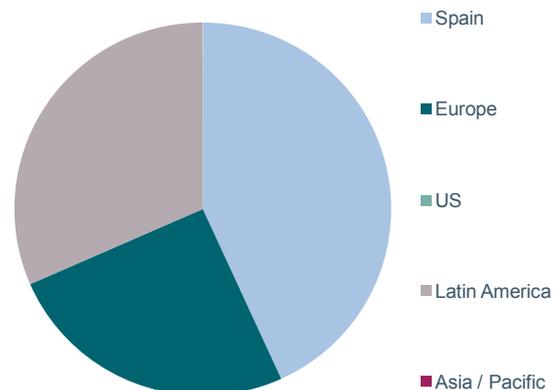
As has become the norm, trophy assets continue to be in national buyers' sights. For lot sizes of around €30m and less, lower yields would be achieved, as domestic investors, who know the market well, purchase on price per sq m terms. ■

GRAPH 12 Prime CBD investment indicators



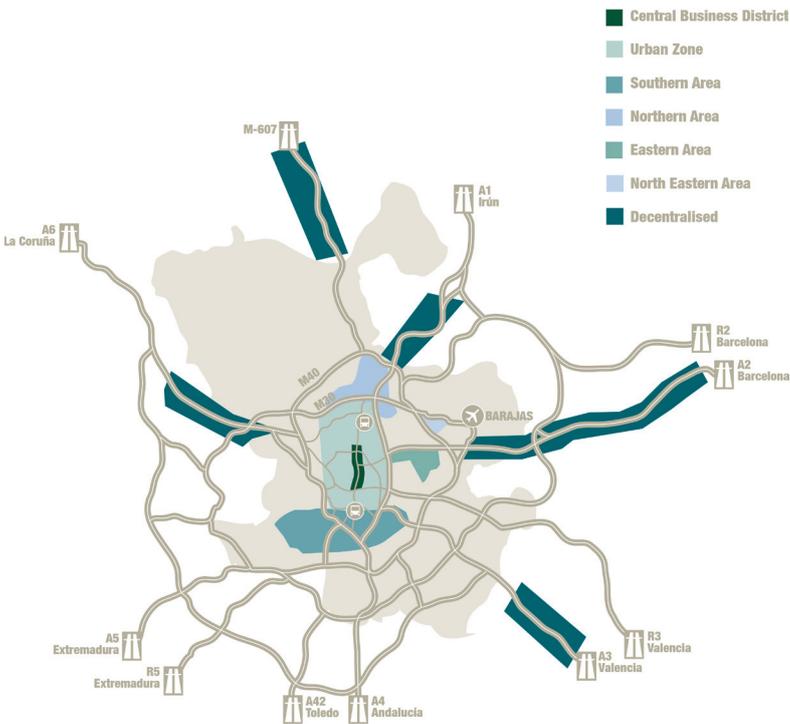
Source: Savills

GRAPH 13 Investment volume by purchasers origin - Madrid Q2 14



Source: Savills

MAP 1  
**Madrid office market**



## OUTLOOK

### 2014

■ The impending recovery in demand, coupled with the continued improvement in short-term economic forecasts, would suggest that we are likely to see a higher annual take-up figure than was registered in 2013. The psychological barrier of 400,000 sq m could well be broken.

■ Despite the expected increase in take-up and the drop in delivery of vacant projects, we do not expect to see a sudden drop in the overall market vacancy rate.

■ The CBD and various highly consolidated business areas are moving at a different rate to the rest of the market. They have managed to reach a healthy balance between supply and demand, which has allowed them to see a slight increase in closing rents.

■ The Madrid investment market continues to have a lack of product for sale on the open market. Despite this, the intense activity that began at the end of 2013, has meant that office investment reached €450m in H1 2014 (almost 95% of all office investment in 2013). Strong investment activity continued during the summer and July registered an investment volume of more than €300m. If things continue to go at the same pace, the Madrid office investment market could close out the year at between €1b and €1.5b.

■ Growing demand and the lack of quality product in the best areas in the market, will dictate how much yields will contract. By the end of the year, the CBD could see yields at 4.50%.

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