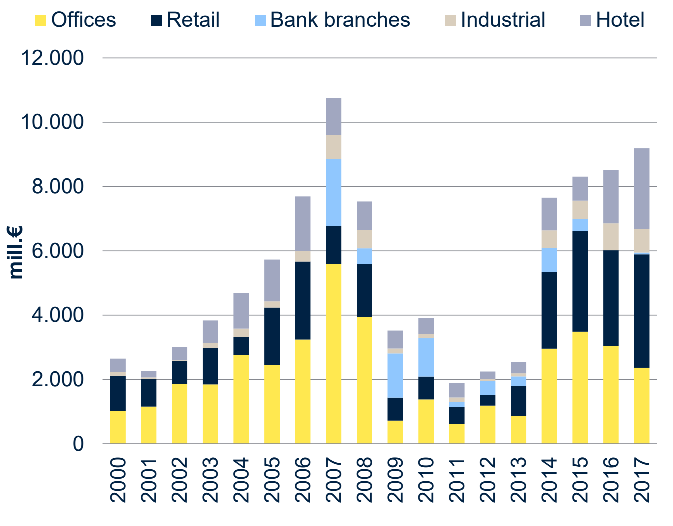
Market report
Spain Investment

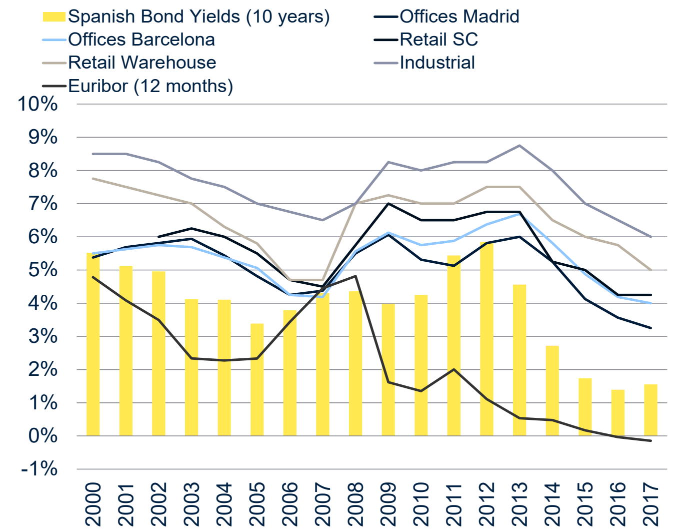
January 2018

GRAPH 1
Investment volume by sector



Source: Savills Aguirre Newman

GRAPH 2
Spanish bond yields vs average prime yields



Source: Savills Aguirre Newman / INE

SUMMARY

Best year for investment in a decade despite activity slowing in last quarter

■ Just over €9,000 million was transacted in the commercial property market in 2017, making it the best year in a decade and the second-best year on record. This figure fell just 20% short of the €10,700 million invested in 2007.

■ 2017 was a record year for investment in hotels and retail. The rise in tourism and consumption has attracted investors to these areas.

■ On the other hand, total investment in offices and logistics fell y-o-y due to a severe lack of product.

■ Alternative markets are becoming even stronger in the real estate investment market. The huge number of players in the most common markets (offices, retail, industrial/ logistics and hotels), the lack of product for sale or open-market processes, less dependence on economic cycles and the potential to obtain higher yields, have all helped to divert investor attention towards these types of properties, whilst attracting global firms that specialise in these markets in their home countries.

■ The Catalan conflict has stalled a number of sales under negotiation in Barcelona, and has also delayed product from coming onto the market due to fears of price cuts. However, the central government has the necessary tools to guarantee the stability of the region and its legal security, which will help to regain the confidence of international players.

■ Cross-border capital which accounte for 63% of the commercial property total, will continue to drive the market , with US-based funds leading the way, followed by the UK and France.

■ Prime yields remained stable in 2017 and we expect them to remain as such in 2018. Only yields for retail parks, which are still above pre-crisis levels, will tighten slightly.

Economic overview

The Spanish economy continued to remain upbeat in 2017. Y-o-y growth remained stable at 3% for the first three quarters, and if the forecasts are right at 3.1% for Q4, this will mean that growth will stand at just over 3% for the year as a whole, delaying a slowdown in GDP growth to 2018. We would also highlight that Focus Economics has continued to revise its annual forecast, from the predicted 2.3% in January up to 3.1% in December, which is just two tenths below the figure recorded in 2016.

Final household consumption figures published by the INE have shown that there was a moderate level of growth compared to the previous year. The accumulated average between January and September stood at 2.7% and Focus Economics expects this to end the year at 2.5%.

With regard to retail sales, everything seems to suggest that it was a strong year for both general retail and department stores. Until November indicators show that there was a y-o-y increase of 1.4% and 1.8% respectively.

After the slowdown registered in October, which was particularly sharp in Catalonia (-4%), largely caused by the political situation in the region, the increase in turnover from Black Friday and Cyber Monday gave a significant boost to November's results, leaving the national figure up 2.9% y-o-y. Retail sales in Catalonia also increased, up by 1.7%, although it was one of the five regions with the lowest levels of growth, whilst Madrid headed up the ranking with a 5.1% increase in retail sales.

On the other hand, the Consumer Confidence Indicator for November reached above 100, following the slight decline in October where it stood at 99.60. This increase was brought about by the 3.9% uptick in expectations, cancelling out the 2.2% reduction in the evaluation of the current situation.

Figures for the job market also paint a more positive picture. In Q3, the unemployment rate stood at 16.38%, continuing to fall as it has done since mid-2013, and according to forecasts by Focus Economics, it will continue to do so until at least 2022. In terms of national accounting, there was a 2.9% y-o-y increase in job creation, and although the end of the summer season had an impact on October's figures, at year-end the number of unemployed stood at 3.41 million, falling almost 8% on the figure registered in December 2016. In the annual accumulated figure, 290,193 people found work and 611,416 more people signed up to Social Security.

The tourism sector is one of the main drivers of the economy, accounting for 11.2% of GDP in 2016, according to the latest data published by the INE.

After the record number of tourists that visited Spain in 2016 (75.3 million), the early release of figures from the Ministry of Energy and Tourism place 2017's tourism figure at 82 million, a 9% increase. The accumulated figures to November with regard to tourist arrivals (77.8 million) is already 3% up on 2016's figures, and up 9% y-o-y. Catalonia, with an accumulated increase of 6%, is the only region where there was a reduction in the number of tourists in October and November (-4.7% and -2.3% respectively).

The Ministry also announced that overseas tourists spent a total of €87,000m. The total spend grew at a greater rate than the total number of tourists, and as a result the average spend per tourist climbed to €1,061, up 3.15% y-o-y.

The Catalan Conflict

The instability brought about by the Catalan conflict resulted in a mass exodus of firms, a slump in hotel reservations, a slowdown in consumption and a rise in unemployment, which in the short-to-medium term could affect a number of segments in the real estate market. If business activity continues to slow, it will have a negative impact on the national economy.

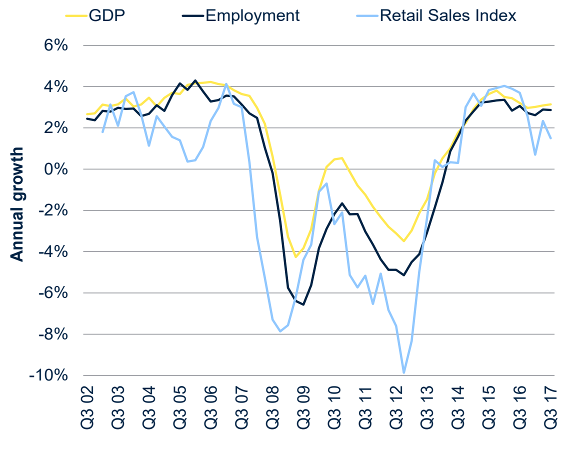
The results of the Catalan elections on 21 December were complicated but, as demonstrated in October, central government has the necessary tools to legally control any acts of disobedience, thereby guaranteeing legal stability. Additionally, support from both the international community and European institutions strengthens the hand of the state in the face of any potential rebellion.

The only way to overcome the clash between regional and central government and gain stability in the region will be via dialogue and negotiation of political proposals for the future of Catalonia, considering the full spectrum of views, and acting in full respect of the law.

Despite the current uncertainty, legal security is guaranteed, meaning that the temporary slowdown in investor activity will be resolved as soon as the conflict is brought under

GRAPH 3

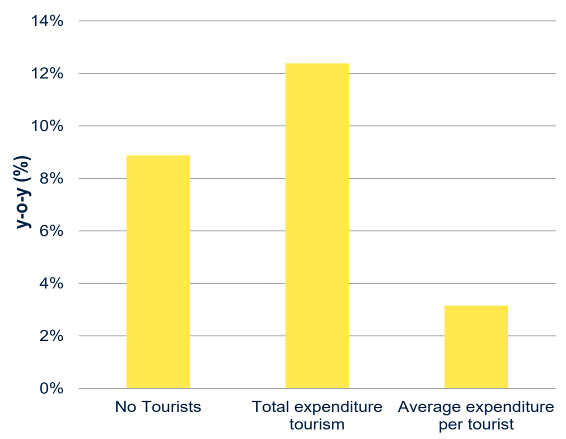
Main economic indicators



Source: INE

GRAPH 4

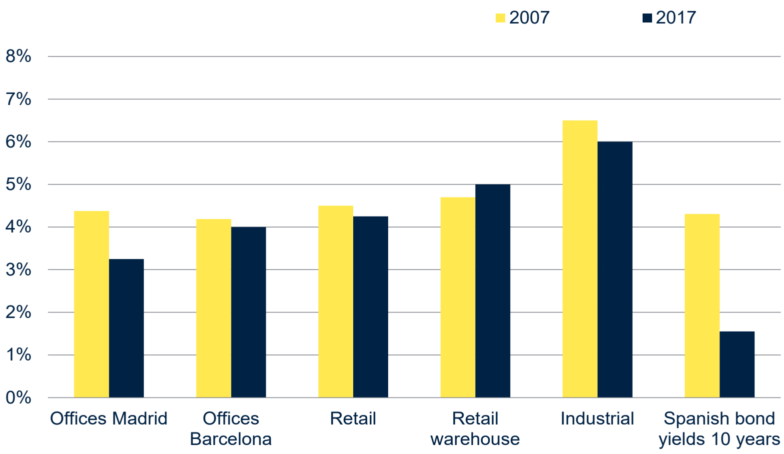
Tourism in Spain 2017*



Source: INE / * Ministry of energy and tourism advance data

GRAPH 5

Prime yields comparison 2007 vs 2017



Source: Savills Aguirre Newman / Bank of Spain

control through regulatory means. At present, the situation in Catalonia has not had a major impact on the rest of the rest of the country.

Fourth consecutive year of growth

Just over €9,000 million was invested in the commercial property market in 2017, a 8% y-o-y increase. This is the fourth consecutive year of growth, the top year for growth in the last decade and the second-highest on record in terms of volume (excluding corporate deals, land and owner occupation). The figure for 2017 is only 20% behind the record volume set in 2007.

Given their varying nature, each segment grew differently. Hotels and retail registered increases of 52% and 18%, with both markets achieving record figures, whilst the offices and industrial/logistics markets fell y-o-y by 23% and 10% respectively.

Hotels

The strong rise in tourism in Spain has been one of the key points that has captured the interest of investors. According to the latest data published by the World Tourism Organization (WTO), Spain occupies the third position in the ranking of countries with the most international tourist arrivals, behind the US and France, and second position with regard to income (with €50,622 million) behind the US which leads the way with €179,603 million. Additionally, in 2016 Spain was crowned as the top country in the world for tourism, according to the bi-annual report published by the World Economic Forum. Areas including Barcelona, Madrid and the Balearic Islands are the preferred destinations for foreigners visiting Spain.

The tourist hotspots (Catalonia, Madrid and the Balearic Islands) in terms of tourist arrivals accounted for almost 50% of the €2,500 million directly invested into hotels in Spain.

The Canary Islands accounted for almost a third of total investment, with property portfolios appearing amongst the biggest deals of the year (70% of the c. €750 million registered in the Canary Islands was invested in property portfolios).

The greatest increases in 2017 were seen in the Balearic Islands and Andalusia, with investment in both regions exceeding five times the volume seen in 2016. The main reason for this heightened activity was a need to reposition and modernise the outdated hotel stock in prime beach locations.

In terms of urban hotel stock, Barcelona has been a major focus in recent years, accounting for close to 70% of investment in Catalonia. Local government regulations will freeze hotel supply across most of Barcelona, and so most activity has been focused on properties that already had their permits approved prior to the moratorium.

Retail

The retail market was another of the year's key players, registering close to €3,500 million of investment. This amounts to almost 40% of all commercial property investment, well over its average of 28%. This is the second year above €3,000 million since 2000 and is a new all-time record, 11% higher than the €3,125 million registered in 2015.

The traditional property category (primarily comprised of shopping centres, retail warehouses and supermarkets/hypermarkets) also registered a record-breaking year, accounting for almost €3,000 million (85% of total investment).

On analysing sub-categories, there was a marked increase in the retail warehouse market, which doubled its 2016 figure to €550 million.

Accounting for just over €2,000 million, shopping centres registered a 42% y-o-y increase.

There was a rise in the number of supermarket/hypermarket deals (nine in 2017 compared to four in 2016), although lot sizes were down 16%, due to the skewing factor of the Eroski portfolio acquired by Invesco in 2016, which accounted for almost 90% of total investment. In 2017, the supermarket sector accounted for €340 million.

With a total investment volume of €505 million, the high street sector fell by 37% y-o-y. Despite the decline in activity, both in terms of sales price, as well as the number of deals (-17%), it is key to point out that international funds are now highly interested in this type of product, primarily linked to private domestic capital. In 2017, the cross-border investment figure equated to 80% of the total, whereas it has traditionally accounted for closer to 40%.

Logistics

The world of e-commerce is rapidly expanding, with chains, individual retailers, and multi-brand platforms all eager to sell online, and logistics property forms a cornerstone of this market. Proper storage and accurate, timely delivery are key factors in guaranteeing a positive shopping experience and have become a tool for winning over consumers. The importance of logistics properties in the supply chain contradicts the recent decline in investment activity following several years of constant growth.

As outlined previously, the fall in investment volume has mostly been caused by the extreme lack of product that can both satisfy investor requirements and meet the needs of operators. With this lack of quality product and the outdated nature of most logistics stock in Spain, the solution is now to purchase land in order to develop new product. The location of these plots and the quality of the end product will determine the success of the ultimate objective: a quick marketing process with high rents and a long-term contract with top-tier operators.

Offices

The lack of quality investment product available has had a major knock-on effect on the office market across Spain.

Just over €2,300 million was invested in 2017, down 23% y-o-y. The total number of properties purchased happens to be unchanged at 93, although the number of portfolio deals rose from 78 in 2016 to 80 in 2017.

In 2016, seven portfolios were purchased, comprising over 22 office properties. However, in 2017 only one deal was signed: the Boston portfolio, comprising 15 office properties (five in Madrid, eight in Barcelona and one in Valencia). With a gross book value of over €300 million, Oaktree bought this portfolio from BBVA in a joint venture with Freo.

The final price of the portfolio was brought down by the high number of properties within it, along with their need to be updated, and the fact that they were all in out-of-town locations. With regards to the average size of portfolio properties, the buildings in the Boston portfolio were 20% smaller than the properties sold in 2016.

Madrid and Barcelona lead the way in the Spanish office segment, and together they accounted for 96% of the total volume and 90% of total transactions. The percentage for Barcelona was boosted by Merlin's purchase of Torre Glories for €142 million, which equated to 18% of the annual total, and increased Barcelona's market share to 33%, which has typically stood closer to 25%.

Close to €100 million was invested in a number of properties located in other secondary cities including Valencia, Malaga, Bilbao and Zaragoza.

The main housing market indicators are performing well, and one increasingly attractive option is to buy office properties for a change of use to residential.

In Madrid and the secondary cities, all properties undergoing a change of use were located in the urban area,

TABLE 1

2017 Top Ten Mega-deals

Market	Asset	Region	Vendor	Purchaser	Type of deal
Hotel	14 hotels	several locations	Hi Partners	Blackstone	portfolio
Retail SC	Xanadu	Arroyomolinos (Madrid)	Ivanhoe	Intu Properties	single
Hotel	España building	Madrid	Trinitario Casanova	Riu	single
Retail SC	Xanadu (50%)	Arroyomolinos (Madrid)	Intu Properties	TH Real Estate	single
Logístico	11 assets	several locations	Green Oak	GIC	portfolio
Retail SC+ RP	Nueva Condomina	Murcia	varios	Klépierre	single
Hotel	4 holiday hotels	several locations	Starwood Capital + Melia	London and Regional Properties	portfolio
Retail RP	9 retail parks	several locations	Redevcp	Vukile	portfolio
Offices	14 buildings	several locations	BBVA	Oaktree + Freo	portfolio
Hotel	7 hotels	several locations	Alua Hotels & Resorts	Hispania	portfolio

Source: Savills Aguirre Newman

whereas in Barcelona several deals took place in the 22@ technology district, which has now become a key business hub in the city.

Investor activity slows in last quarter of the year

Investor activity slowed in the last quarter of the year. Investment across the sectors analysed had grown by 29%, with upticks in all segments except for industrial/ logistics, which fell by 6% due to the lack of product on the market.

The healthy economic backdrop points towards a new expansive phase for the market, and forecasts for the coming years are bright. These factors have boosted investor confidence in recent years, but were not enough to maintain high levels of investment through into the last quarter.

The investment volume between October and December stood at close to €2,050 million, down 35% y-o-y. Although figures were down across all segments, offices saw the greatest decline, down by almost 70%. This was followed by retail (-28%) and industrial/logistics (-25%). The hotel segment was the only area to grow, albeit by a moderate 1%.

The slowdown in the market was due to a number of factors. On the one hand, the lack of available product in certain segments such as offices and industrial/logistics; on the other hand, the postponement of several deals due to delays in the buying process, which could now be completed in 2018. Lastly, the Catalonia issue has halted some processes, and some investors are likely waiting for the outcome of this scenario before moving ahead with any further deals.

This was the case for Hispania's office portfolio valued at close €500m. The portfolio was all but signed at the end of the summer, but even though only three out of the twenty-four properties for sale were in Barcelona, the Socimi was forced to postpone the deal in October as a result of the Catalonia crisis.

Mega-deals in the market

We continue to see mega-deals (≥ €100m) in the market, with numbers up on 2016 (from 18 to 21), although the €4,200m total in 2017 reach a similar level than the registered in 2016.

There were mega-deals in all commercial property segments, but retail accounted for the lion’s share, with 45% of investment volume and deals. Behind retail was hotels, with 37% of investment volume and 30% of deals.

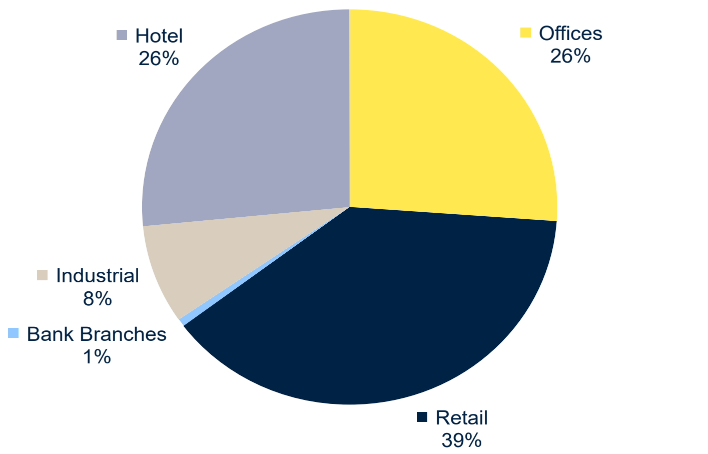
Investor profiles

Funds continue to dominate the commercial investment market, with almost €5,150 million, equating to almost 60% of the annual total. They increased their investment figure by 6% y-o-y, although their overall market share remains the same.

Insurance companies registered the highest y-o-y growth by volume, almost doubling the 2016 figure, although this only equated to 6% of total volume. Axa, with over €250 million, accounted for 53% of the annual insurance company total, and also invested in other segments including student halls of residence, purchasing the Resa university

GRAPH 6

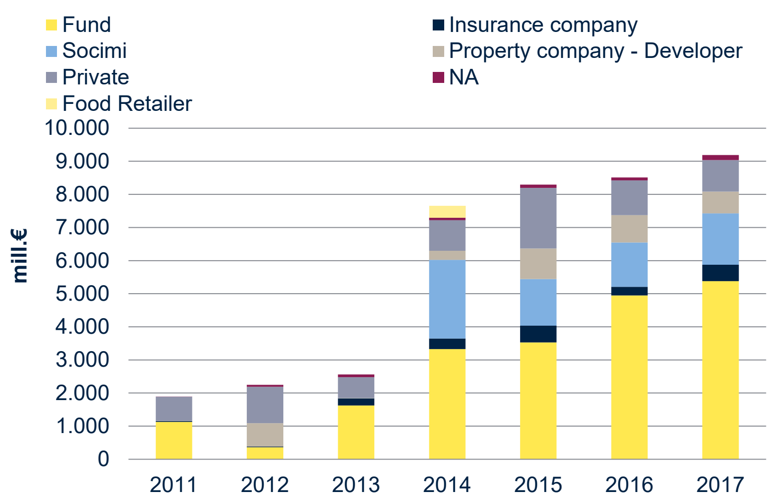
Volume by segment 2017



Source: Savills Aguirre Newman

GRAPH 7

Volume by type of investor - 2017



Source: Savills Aguirre Newman

residence portfolio, and residential, purchasing 28 properties comprising 850 homes in Madrid and Barcelona.

Socimis invested a total of €1,550 million, placing them in second place in terms of overall investment (17% market share). Most of their activity was focused on retail and offices, with 41% and 39% respectively, although looking at all investment in these segments, they accounted for 29% of offices and 18% of retail.

The rising number of Socimis listed on the Alternative Stock Exchange (MAB) (48 at YE 2017) has led to a continued increase in their market share, which now stands at 50%. The strength of the real estate market has prompted greater interest in this type of company, giving access to smaller investors with insufficient liquidity to acquire a property.

Originally, the Socimis were diversified companies, but we are now seeing the creation of more and more companies specialising in just one real estate segment.

Investor origin

Overseas capital is once again proving to be the market driver. Almost €5,700m was invested in 2017, equating to 63% of the total. Overseas investment led the way across all markets except for offices, where domestic investors accounted for 60% of investment volume.

By region, Europe provided almost 50% of cross-border investment, followed by the United States with 40%. The Middle East and Asia Pacific accounted for 4% each, in the region of €250m.

Europe also accounted for the greatest amount of retail investment (58%), whilst the United States leads the way for offices (48%) and hotels (49%). In the industrial/ logistics market, the €243m invested by the Singapore Sovereign Fund in acquiring GreenOak's logistics portfolio in Spain increased the Asia Pacific share to 42%.

China Investment's acquisition of Logicor (a corporate deal, this does not form part of the investment figure) reflects the Asian giant's enormous interest in internationalising its business. Of the €12,250m invested in its total Europe portfolio, Spain represented just 5% (c. €600m).

Although the US topped the ranking, we would also highlight that Britain invested around €1,600m, followed by France, which invested just over €725m.

Alternative assets

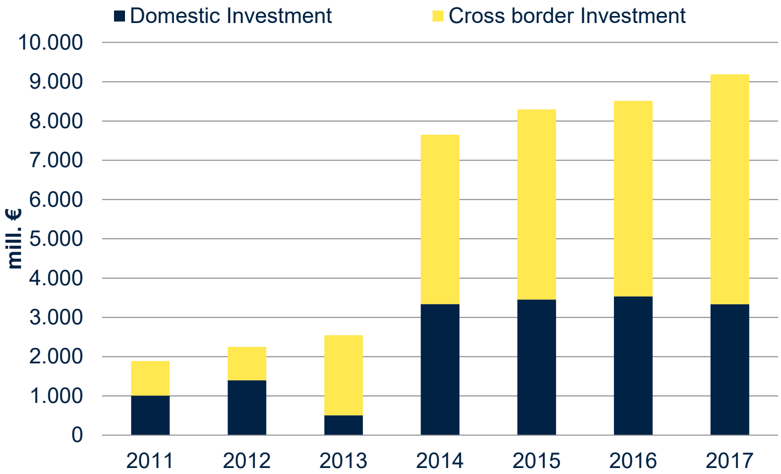
Alternative assets are becoming increasingly popular in the real estate investment market. The huge number of players in the more common markets (offices, retail, industrial/ logistics and hotels), the lack of product for sale or open-market processes, the unpredictability of economic cycles and the potential to obtain higher yields, have all helped to divert investor attention towards alternative properties.

The main difficulty facing investors is the lack of market transparency and the fragmentation of product, which is particularly the case regarding student halls of residence, care homes and health facilities.

In 2017, there were 18 alternative asset deals; 72% of these were student halls of residence and care homes, with six deals each, followed by health facilities, with 22% of deals; the remaining 6% related to car parks.

GRAPH 8

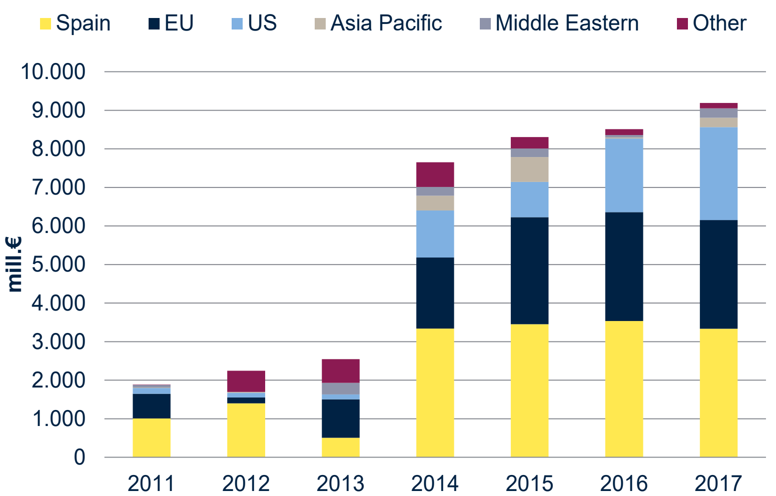
Distribution of cross border investment



Source: Savills Aguirre Newman

GRAPH 9

Investment Volume nationality



Source: Savills Aguirre Newman

Just over €1,000m was invested in this market in 2017, more than four times higher than the figure for 2016, when seven deals were completed. Given the lack of market transparency, one must also bear in mind that there were other deals signed for undisclosed sums, although this is increasingly less common (43% in 2016 and 24% in 2017).

Almost €840m was invested in student halls of residence, largely comprising the purchases of the Río and Erasmus portfolios. The Río portfolio, acquired by GSA from Oaktree and operated by Nexo, comprises four halls of residence in Madrid and two new developments in Barcelona. The Erasmus portfolio was bought in a joint venture by AXA, CBRE GI and Greystar, and comprises 37 properties run by the main operator on the market, Resa. The properties are spread across 19 provinces, with 33 trading properties and the remaining 4 in the project stage. Between them these deals accounted for 75% of the total volume.

In terms of volume, we would also particularly note another mega-deal (≥€100m) in the student accommodation market, involving the arrival of the Dutch firm The Student Hotel in Madrid, following on from its purchase of two halls of residence in Barcelona in 2015. They added the former Gaceta de Madrid printing press property to their portfolio (purchased two years ago by Knightsbridge (Oaktree)) and intend to change its use to a student hall of residence.

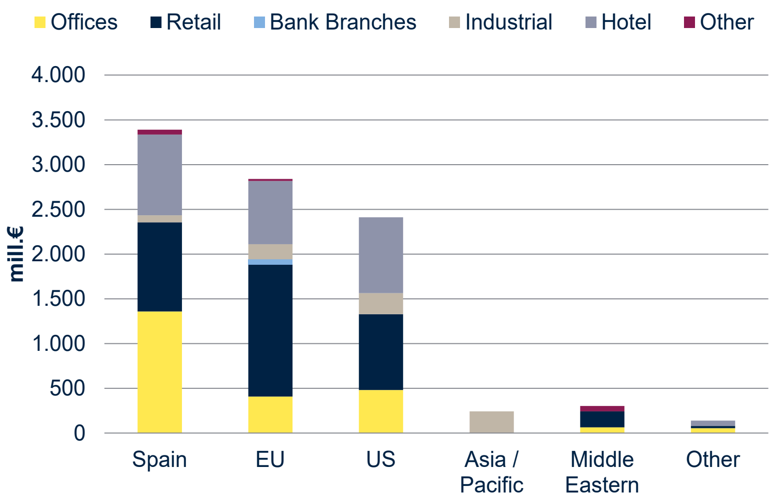
The arrival of specialist players onto the market from other countries means that the outdated stock can now be brought up to date and renovated, turning them into prime properties.

Their extensive experience in other markets means that they can divide the space in a way that better adapts to current demand. In addition, their brand is well-known among international students, therefore ensuring a continued level of growing demand.

Foreign students who are registered in the Spanish university system for the 2016-17 academic year (98,741) amount to 7% of the total. Despite the decline in the total number of students (down 9% since 2005), international students have tripled, which places them at the forefront for some operators that are already focusing on them as their target market.

GRAPH 10

Volume by segment and investor nationality - 2017



Source: Savills Aguirre Newman

Outlook

2018

Demand

■ The favourable economic climate will continue to attract international investors.

■ The economy is expected to continue to grow, with forecasts even expecting growth to be higher than other countries in Europe, which will help to make market fundamentals even more appealing.

■ The ease of acquiring finance, as well as a climate of low interest rates, which will remain stable, at least until mid-2019.

■ The uncertainty surrounding the Catalonia situation will be resolved with the creation of a new regional government, that will have to always operate within the legal framework. As long as investors see that there is institutional stability, Catalonia will come back onto investors' radars.

■ Rents will continue to rise, which will be key for investors' purchasing strategies.

■ Growth is not only affecting the best properties in the best areas, but also product further from the centre, so long as it meets current quality requirements (for offices and logistics properties).

Supply

■ Generally speaking, forecasts for investment volume and activity over the next 12 months look positive, although this will vary depending on the different aspects of each segment.

■ Strong tourism figures will reinforce investor interest in Spain. According to RCA, the total amount of hotel investment (including corporate transactions and owner occupation) reached €6,000m, more than six times the amount registered in 2016.

■ In the retail market, over €2,500m of investment potential has been identified (traditional and high street product). Strong consumer confidence and retail sales, as well as growing footfall in shopping centres indicate that the market is consolidated and will continue to attract interest from the usual market players, as well as new investors looking to enter the Spanish market.

■ Elsewhere, the offices and industrial/logistics sectors will continue to suffer from a lack of available investment product. The acquisition of land for development, which has been on the rise in the logistics sector in recent years, will become an option for the office market. Colonial has already seized the initiative with the purchase of 110,000 buildable sqm near Atocha train station in Madrid.

■ Socimis are now starting to rotate their assets, which will lead to an increase in investment opportunities. The Hispania portfolio, which was taken off the market following the Catalan crisis (even though just three of its properties were in Barcelona) is valued at €500m and will make up the bulk of office market investment.

Yields

■ The imbalance between supply and demand will place yields in the spotlight. The prime yield for the segments analysed (Madrid and Barcelona offices, shopping centres and retail and industrial parks) stands at 35 basis points below the figure registered in 2007. Yields are expected to remain stable, with increases in prices per sqm being as a result of rental growth.

■ Only yields for prime retail parks remain above pre-crisis levels, which means they will continue to tighten.

■ Prime properties in consolidated secondary locations (shopping centres and offices) will also see some yield compression.

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