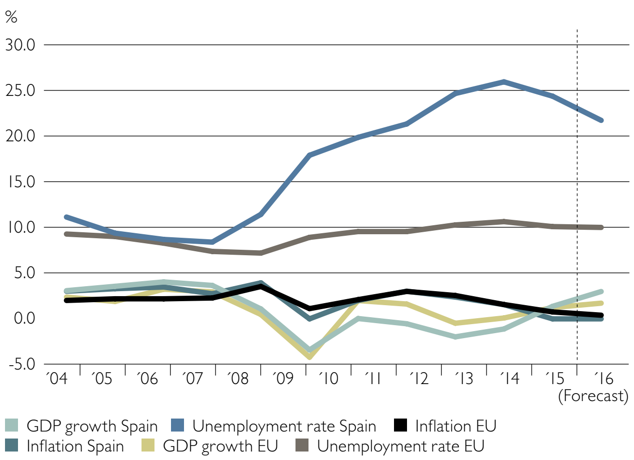
MARKET TRACKER MARCH 2016

Positive outlook for Spain's real estate sector in 2016

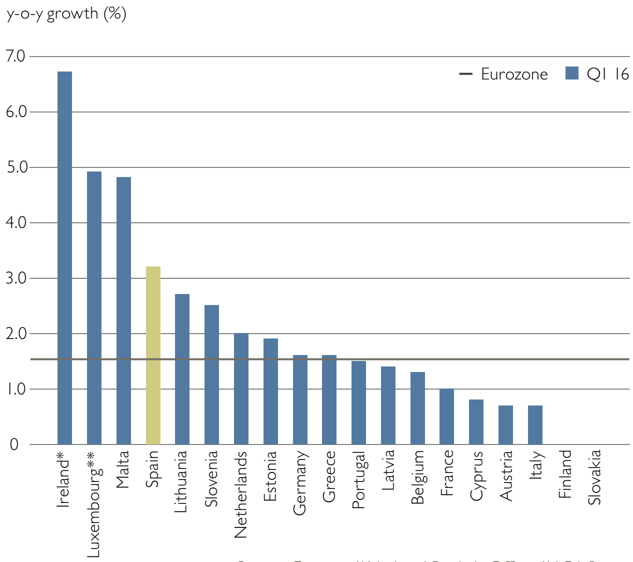
When compared with its peers in Western Europe, the Spanish economy is currently displaying stronger growth than most. The country has left the doldrums of its post-2008 economic misery behind it, and the property sector has kept pace with the more general recovery. Our analysis provides an insight into the market as it currently stands and reveals what opportunities exist for investors.

FIG. 1: MAIN ECONOMIC INDICATORS



Source: Catella Research 2016

FIG. 2: ECONOMIC GROWTH IN THE EUROZONE



Source: Eurostat/*National Statistic Offices/**Q1 figure

Madrid's ambitious programme of reforms over the past few years has had a positive impact on Spain's economy. It therefore comes as no surprise to learn that the country has once again been on the radar of real estate investors since at least 2014. Starting out, interest was largely confined to domestic family offices, but they were soon followed by opportunity-minded investors from Europe and further afield. At the same time, a growing number of investors started enquiring about asset management services. Today, scores of the international scene's core investors point to Iberia when asked for interesting investment openings in 2016.

The change that Spain has undergone can only be explained by a trio of factors: the capital markets, European real estate markets and local investment locations such as Madrid and Barcelona, followed by Bilbao, Valencia, Zaragoza, Sevilla and Málaga.

Catella is a leading financial advisor across Europe and asset manager for the areas of property, fixed-income and equity. We occupy a leading position in the real estate sector, with a strong local presence in Europe with around 500 employees across 12 countries.

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The following factors are of particular importance when analysing why Spain is currently interesting investors:

- A dynamic export ratio and stable domestic consumption levels
- A labour market that is recovering from the effects of the financial crisis
- High rates of consumer satisfaction
- Falling unemployment coupled with rising GDP
- A weak euro that enhances competitiveness against other European states

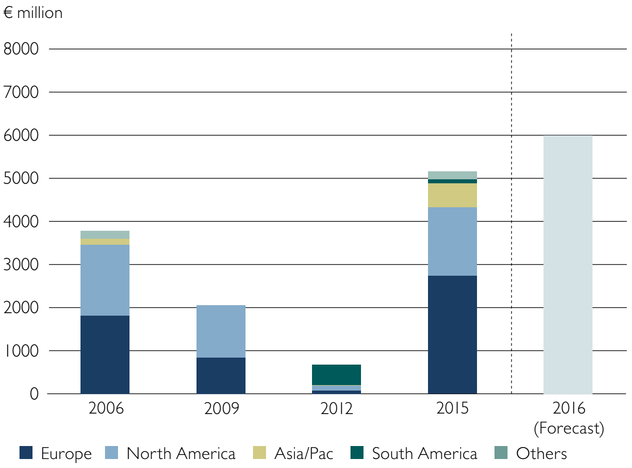
TAB. I: ECONOMIC FUNDAMENTALS SPAIN (IN %)

Economic Indicators	2013	2014	2015	2016
GDP Growth	-1.2	1.4	3.2	2.7
Consumer Spending	-2.3	2.4	3.4	2.8
Unemployment Rate	26.1	24.4	22.1	19.8
Inflation	0.3	-1.0	-0.0	0.9
Interest Rate: 3 months	0.3	0.1	-0.1	-0.1
Interest Rate: 10 years	4.1	1.6	2.0	2.9

Source: Catella Research 2016

Spain will probably withstand 2016's restrained international economic conditions, with exports and GDP growth predicted to come in at 2.7%, thereby outperforming many of its eurozone peers. The country's REITs continue to put in a good showing and will maintain their aggressive pricing policies. Almost all sectors display a slide in yields.

FIG. 3: INVESTMENT VOLUME BY INTERNATIONAL INVESTORS (OFFICE, RETAIL, RESIDENTIAL)



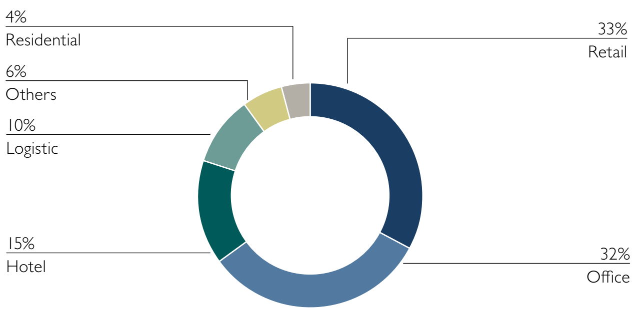
Source: Catella Research 2016

Commercial Real Estate: Sector analysis

Retail

Retail sales are showing solid growth, evidence of the economic recovery mentioned above. In the immediate term at least, Spanish consumers have more money at their disposal, and this is a benefit for the entire retail sector. Positive employment conditions, easy access to capital, low inflation and weak interest rates all serve to stimulate the country's substantial domestic demand. These extremely beneficial conditions give investors all the more reason to invest in every retail sector. In terms of demand, new and existing operators in the fashion and restaurants sectors are a particularly noticeable grouping. Some new international investors and buyers, predominantly from Europe and America, have already zeroed in on the Spanish retail market as they believe it offers great potential for their flagship stores situated in core locations. However, the space available for these outlets is limited, particularly at top locations in major cities such as Madrid and Barcelona. As a result, stiff competition has broken out between the various competitors, which of course results in falling yields. Demand continues to grow for second-tier assets in good regional locations, and for high-quality assets in secondary markets with a rising risk factor. Consequently, the gap between primary and secondary assets' yields is shrinking further as investors turn their attention more to non-core properties at promising locations.

FIG. 4: INVESTMENT VOLUME BY SEGMENT 2015/2016



Source: Catella Research 2016

Top rents: A slight rise in rents is expected at core locations (high street retail), but otherwise rents will remain relatively stable (Madrid: 255€/sq m per month).
Top yields: High-level yields will remain largely unchanging in 2016 (4%).
Supply: Dwindling in core locations, adjustment of development pipeline is slow.
Demand: Rising demand in primary and secondary markets in 2016.

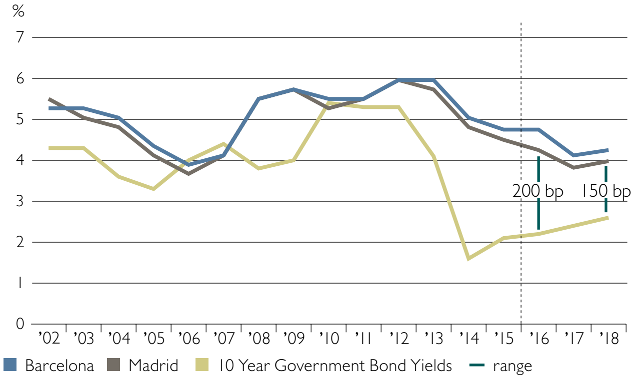
Office

Spain's growing economy benefits the market for office space. Rising demand for office space is particularly salient in the core and central business districts of Madrid and Barcelona. At present, a number of major transactions are still being negotiated, and many tenants are searching for ways to augment their floor space, improve the quality of their offices or buy/lease new facilities in more efficient office buildings. City centres are the most popular destinations for companies looking to set up shop. However, availability is low (around 7% in CBD) and rents are increasing as a consequence, but still far away from a peak. The economic powerhouses of Madrid and Barcelona will, in all likelihood, witness a turn towards speculation in the near future. Tremendous potential is available in the form of buildings in need of thorough renovation. Certain old buildings in some sections of CBD markets will probably be renovated soon. These locations will see vacancy rates fall further. While domestic companies still dominate the market today, foreign investors are gaining in prominence, and they are currently trying to stimulate competition to actively undercut yields from core real estate in Madrid and Barcelona. The limited potential of these high-demand sites is forcing some investors to put their money to work in other market subsections and second-tier cities, where they have higher yield expectations. The market for office property has swung from a buyer's to a seller's market, and investors have their work cut out for them if they want to find high-quality, low-cost facilities. Sellers will exploit this situation: the climate of competition will prompt investors to buy properties at prices that would have been unimaginable a year ago.

The gap between the 10 Year Government Yield (2,25%) and the Prime Office Yield in Madrid (4,25%) in 2016 amounts to 200 bp and will drop to 150 bp until 2018.

Top rents: Restricted supplies of quality real estate at core sites and increased demand from tenants are pushing revenue from leases upwards (Madrid CBD top rent: 33€).
Top yields: Stiffer competition for core assets in Madrid and Barcelona will put pressure on yields (Madrid CBD prime yield: 4.25%).
Supply: Supply will increase due to new developments of 100,000 sq m.
Demand: Demand will remain buoyant (550,000 sq m in 2015) due to the economic setting's recovery. This will lead to a further rise in rents in core locations.

FIG. 5: PRIME NET OFFICE YIELD & GOVERNMENT BOND YIELD



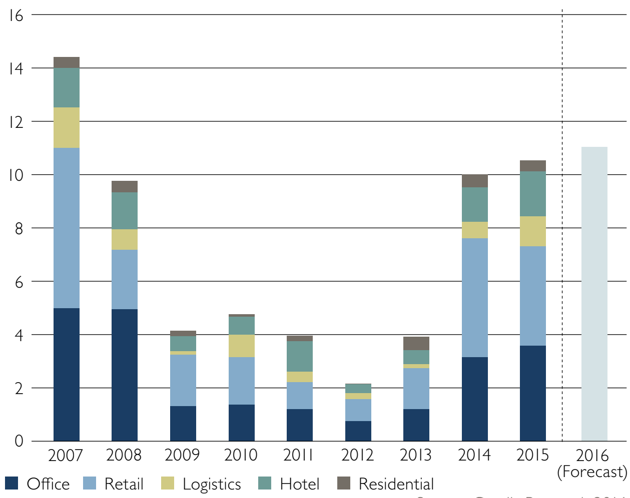
Source: Catella Research 2016

Logistics

The logistics market has also seen an upswing following the economy's rebound and growing business confidence. Consumer confidence, above all in online retail, is going from strength to strength, and this will have a major impact on demand for distribution facility space. Players from abroad are particularly busy investing as they seek better core sites while these are still available. Demand is also rising for larger logistics and storage facilities in the vicinity of the country's main conurbations. The lack of available spaces is pushing core investors to assume some development risks. Recent quarters have seen a hike in the levels of foreign investment capital aimed at the Spanish logistics market. With better yield-risk profiles and good financing conditions, many potential investors have considered real estate in the prime segment at second-tier (B-listed) or non-central sites. We are unlikely to see changes or improvements to the low supply levels at core (A-listed) sites in the near future. In contrast, we expect that demand for B-listed sites and non-central locations will climb, thereby rebalancing the delta. Consequently, yields in the prime segment will drop further over the coming period.

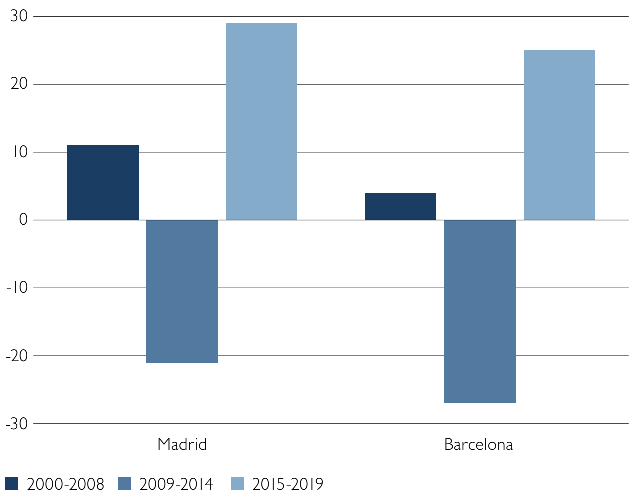
Top rents: The shortage of available high-quality space in the prime segment leads to high rents for core properties (Madrid prime maximum rent: 5€).
Top yields: We view the capital weighting for an investment in Spain's logistics market as a lucrative option as the situation regarding yields continues to come to a head (Madrid prime yield: 7%).
Supply: The general shortage of speculative options reduces the overall available space while demand moves in the opposite direction.
Demand: A more active labour market promotes the economy's recovery.

FIG. 6: TRANSACTION VOLUME SPAIN



Source: Catella Research 2016

FIG. 7: GROWTH RATES OF PRIME RENT



Source: Catella Research 2016

TAB. 2: TOP TRANSACTIONS OFFICE & RETAIL 2015/2016

Type	Market	Date	Property Name	Area in sq m	Price in EUR	Cap Rate	Buyer	Seller
Office	Madrid	Nov-15	Torre Espacio	60,142	558,000,000	n. a.	Andrew Tan	Grupo Villar Mir
Retail	Zaragoza	Sep-15	Puerto Venecia Shopping Centre	212,000	225,400,000	5%	Canada Pension Plan	Intu Properties
Retail	Madrid	Jan-15	Gran Via 32 – Primark flagship store	36,400	400,000,000	4.25%	Pontegadea	Drago Capital JV PSP Investments
Retail	Madrid	Mar-15	Plenilunio Shopping Centre	70,000	375,000,000	5%	Klépierre	Orion Capital Managers
Retail	Bilbao	Jul-15	Megapark Retail Park	63,500	170,000,000	6.25%	Oaktree	Lar España

Source: Catella Research 2016

TAB. 3: LOCATION KEY FACTS AS OF H1 2016

City	Office Prime yield [%]	Office top rent [EUR/sq m/ month]	Office average rent [EUR/sq m/ month]	Office take-up [sq m]	Office vacancy rate [%]	Office vacancy total [sq m]	Total office stock [sq m]	Office investment volume [EUR]
Madrid	4.25 ↘	33,00 ↗	27,00 →	225,000	10.50	1,426,350	12,850,000	800,000,000
Barcelona	4.75 ↘	20,00 ↗	16,00 →	150,000	11.00	704,480	5,920,000	200,000,000

→ Forecast 6 months

Source: Catella Research 2016

Catella's investment opinion:

The Spanish economy continues the rapid catch-up process in 2016. For investors, this means :

- 2016 will be in the focus of core investors, looking for stable income yields, mainly in the well-known locations. Here we expect a higher price level at the end of this year.
- Because of the yield compression and the lack of prime office and retail properties in Madrid and Barcelona we recommend also to analyse other sectors such as logistics, hotels or residential.
- Saying that, we foresee more investments in secondary locations such as Bilbao, Valencia, Sevilla or Málaga – these will be very attractive for institutional investors, who can deal with the higher risk-return ratio.
- Opportunistic investors will focus more and more on developments in order to achieve their expected returns.
- Finally, we recommend a closer look on a professional asset management – there is a higher demand, especially by international investors. This will stabilise the yields on the property level in the coming years.