

SPAIN QUARTERLY REPORT - JANUARY 2009

ECONOMIC UPDATE

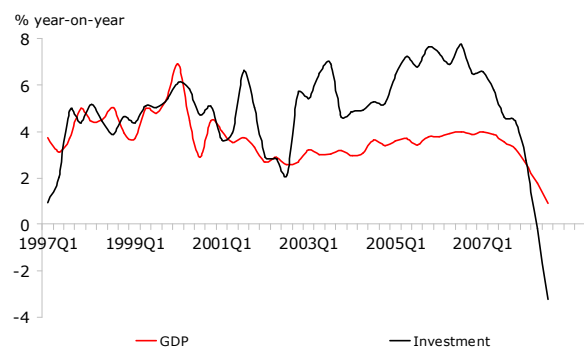
1.1 Overview

The real estate hard landing continued to undermine the Spanish economy. In Q3 2008 GDP contracted pushing Spain into recession. This is the first contraction recorded since 1993. Household consumption, the main driver of growth, dropped notably driven by soaring unemployment (11.4%) fall in income and tighter credit conditions. Leading indicators are more than gloomy: surveys, a good proxy of future activity recently collapse to an all time low. Investment in construction could plunge by 15% in 2009 and over 10% in 2010. Despite the fiscal stimuli, activity is set to continue declining with rising unemployment. GDP is expected to contract by 1.6% in 2009, a sharp drop contrasting with past performances (1.3% in 2008 after 3.7% in 2007). Unemployment is forecasted to climb to 17%, an historical high since the nineties. As mentioned in the last report, Spain failed to launch a bond last September which clearly underlined the remaining global risk aversion towards the country. "Icing on the cake" has been the recent downgrading by Standard & Poors relating to the long-term sovereign debt: Spain became the first country to lose its triple A credit rating. The move has been triggered given the deteriorating public finances and the remaining structural weaknesses of the Spanish economy. Such a decision is likely to drive up borrowing costs for Madrid governments as well as Spanish companies and finally enhance the interest burden of the Spanish state. At the end of January, the 10-year bond spread between Germany and Spain reached 115 basis points, a record since the launch of the Euro in January 1999. Such a feature clearly suggests that risk premium will increase further, producing potentially a new overshooting in yield in 2009. In the mid-term, the deterioration of public finances means higher taxes and potential shortfall for property cash flow while increase on bond yields means that property yields might remain frozen at a high level.

Near Forecasts

Demand	↘
Supply	→
Rents	↘
Yields	↘

The Contraction is huge - more bad news to come

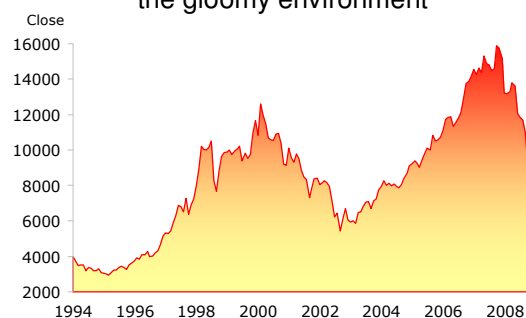


As elsewhere, the IBEX-35 has continued its freefall, corporate earnings trending downwards increasing the selling move in some values: unfortunately nothing has changed compared with our past report. More decrease is foreseen, as the IBEX is still far from its value observed in 2003.

Given the high elasticity of the office market to both economic activity and employment growth, the letting activity has continued to run out of steam, as Spanish companies have no other choice than tightening their belts. Rental values are now ebbing, in term of asking or average rents.

To cut a long story short, in 2010 rental values will decrease at a fast pace, especially as no real downward adjustment has been observed in 2009. Our song remains the same: the trajectories among submarkets will be different with a higher volatility in the more expansive locations or in areas with a high stock of new

IBEX-35: Further fall is set to continue given the gloomy environment

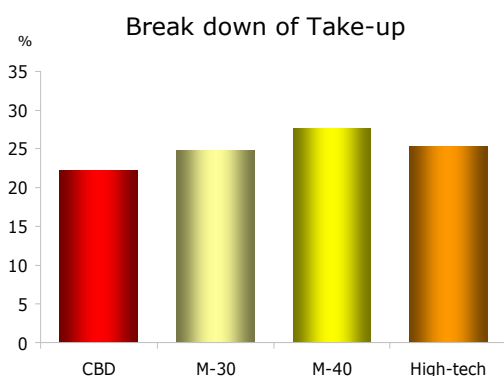


supply, like the CBD, with the completions of the towers.

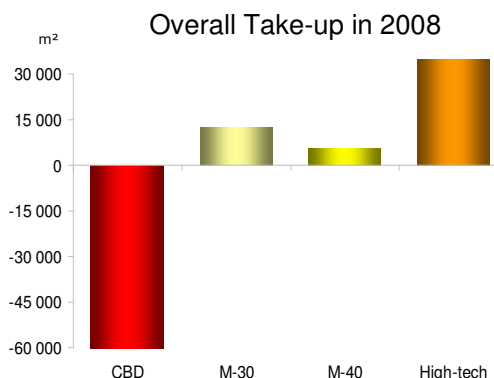
In 2008, yields have sharply shifted outward by 175 basis points from the trough. Some investors continued to be on the sidelines to find new opportunities and buy distressed properties, portfolios or bad loans across sectors at discount prices (more interestingly, the recent INREV survey, freshly show an appetite from investors for such products). The ongoing undershooting has already had terrible effects on the listed property companies. The increasing risk aversion towards Spain will continue to pressure capital values in both 2009 and 2010. The positive news is that there are now real upside for investors who want to move on the risk curve, as yields are expected to be attractive compared with other “mainstream markets”.

1.2 Demand

As Spain has entered in a recessionary phase, the letting activity in the office market has continued to loose momentum. As expected demand in Q4 notably fall, by almost 20% reaching 93 000m². Altogether, take-up almost halved compared with the peak seen in 2007, with a volume of 478 000m² compared with 860 000m² in 2007 (and a bet of 520 000m² at the end of September), a fall by 45%. As forecasted in November 2007, the fall in employment combined with rising unemployment figures will not change the course of the current downturn. The letting market is likely to remain very weak, although some forced relocations to cheaper places might sustained the level of transactions in 2009. In term of volume, the major fall is related to the CBD, as the overall take-up contracted by almost 60 000m². Interestingly, and as forecasted more than a year ago, the cheaper locations have shown better resilience with a positive net take-up. Again, the attractiveness of such locations remain the low level of rent per m² is compared with the CBD. M-30 and M-40 continued to keep the lions’ share of total demand: net take-up has increased by more than 53 000 m², in sharp contrast compared with the fall in the CBD.

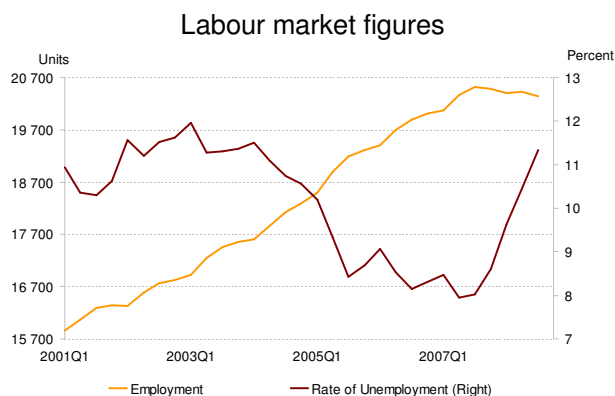


Source: Grosvenor research and C&W



Source: Grosvenor Research & C&W

Structurally, demand has continued to focus on grade A premises in the CBD. In other submarkets, quality is still an important criteria, as it is key to maintain productivity and the global environment of headcounts. The average size leased has decreased as tenants continue to tight their belts: no change is foreseen in the near future. The next step will be to reduce the average space of work per employee, as seen in past recessions.



Source: Global Insight.

Altogether, unemployment rate is foreseen to increase to 17% or 19% by 2010. Such a bleak environment, issues to roll over their corporate debts, huge fall in earning for other, Spanish companies will definitely try to adjust their cost, not only the headcount variable. As a ripple effect, the letting market will plummet further to reach a trough in 2009. Therefore, landlords will do their best to retain existing tenants by increasing the rent free period and sometimes lower the level of the rent to avoid any vacancy and further decrease of valuation, in 2009.

1.3 Supply

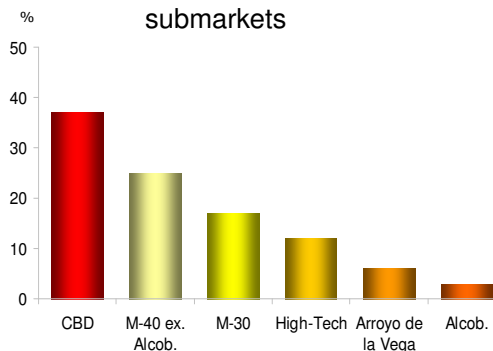
The ongoing decrease in net take-up has continue to increase the total stock, pushing upward the average vacancy rate from 4.8% in Q1 2008 to 6.2% at the end of the year (667 000 m² out of more than 10 million m² of total stock). Most vacancy rates were on the rise at the end of the year, also the average level remains below the depressive figures seen in the past cycles. There are clearly high discrepancies among markets: top markets still have a vacancy rate around 6%, while vacancy rates are higher than 15% in the lagging areas.

As forecasted, in the most expansive locations -also more volatile- vacancies rates increased notably. In Campo de la Naciones, as well as in Arturo Soria vacancies notably picked-up in the wake of a contracting demand: in Arturo Soria, the vacancy rates is now at 5.2% while it reached 6% in Campo de la Naciones. The highest increase if related to the CBD, where vacancies rose by 70%, pushing the vacancy rate to 5.4%.

In secondary locations within M-30 and M-40, vacancy rates were also on an upward trend oscillating between 11% and 30%. Conversely, although high tech submarkets are usually seen as non office markets, they have benefited from rising demand, pressuring vacancies further. The nature of the markets themselves driven by (i) the tenant's sector as well as (ii) the past completions continue to explain the differences across submarkets.

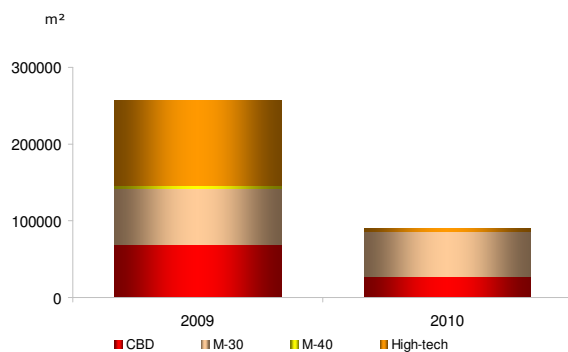
Although the CBD already comprises the highest share of total stock (37%), the new supply in 2009 will be agglomerated in the City-Center with the completions related to the "the 4 Towers": La Torre built by Repsol, and sold to Caja Madrid –end user- and Torre Cristal were a bit delayed. Such large supply has already pushed down the high asking rent as demand fall. No large volume of refurbishment is forecasted after the peak of completion driven by the 4 towers, which is probably the best news for the market.

Breakdown of Total Stock across submarkets



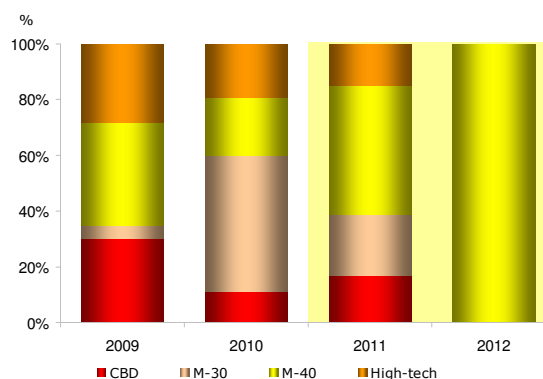
Source: Grosvenor Research & C&W

Future supply has continue to decrease



Source: Grosvenor Research & C&W

Available Future Supply by submarkets Q4



Source: Grosvenor Research & C&W

The dreadful environment combined with tougher financial credit conditions have continue to impact the development market, by freezing new projects –in yellow, the projects that are now unlikely to be done. As suggested by the chart, lots of schemes were cancelled, postponed or frozen, mainly in M-30 and the high-tech submarkets. The volume expected to be completed in 2010 has fallen by 80%, from 530 000m² to 90 700m², according to Cushman and Wakefield. Such a downward review of supply is a positive news if post consolidation processes enhance demand! As the trough of the economic downturn is foreseen to be in 2010, the monitoring of future supply is now key to appraise rental values potential. As rental values are a decreasing function of supply, with a high negative elasticity coefficient, their overall level will continue to depend to a certain extent to the the supply variable.

1.4 Rental movements

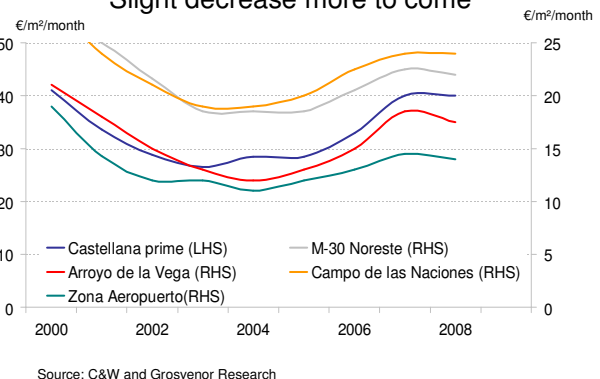
The falling demand is now pressuring rental values as commercial incentives cannot prevent the downward adjustment. In Q4 2008, rental values have continued to tumble. In the leading CBD, rents started to tumble: although prime asking rent remains high at €50 per m², both average rents and prime rents continued to slide. Prime rents in Madrid fall by -7% in 2008 while prime rents in the city centre fall by -16%. Average rents are now at €34 per m²/month while prime asking rents are at €41 per m² per month. In Castellana, there are lots of examples which show that landlords are continuing to adjust their mindset. The winning strategy is currently to secure a tenant with a strength covenant, avoiding void and uncertainty.

Turning now to Campo de las Naciones asking rents continued to remain flat, although prime rent and average rents are continuing their downward adjustment: -7% compared to 2008. Given the recessionary environment, landlords prefer securing cash flows of existing tenants when they renew their lease, rather than taking a void risk. As Campo de las Naciones is a well established district, a rent around €22per m² remains by far lower than the current level observed in the CBD.

In Arturo Soria located in M-30, a comparable to Campo de las Naciones, the picture notably changed, with a notable fall in Q4: rents for grade B offices are now at €19 per m², a real change compared with their past level.

In other leading markets such as Alcobendas-La Moraleja, prime asking rents, prime rents and average rents recently decline as the vacancy rates picked-up to 4.8%. Conversely in Arroyo de la Vega and in the second part of Alcobendas, average rent continues to show good resilience, as no downward adjustment has been seen so far. In Alcobendas, prime rent rose by 8% in Q4, while average rate remained stable at €17 per m².

Rental Values: stable until the final quarter
Slight decrease more to come



Expect this positive news, the overall picture tend to show that prime rents are globally on a decreasing trend in the non established markets of both M-30 and M-40. Such a feature clearly suggests the u-turn in the air, as these markets are by far very cheap compared with other: rents are currently at €10 per m²/month. The fresh decline implies that the gangrene is spreading quite quickly.

Econometric modelling, run quarterly, continues to indicate that the bottom of the cycle will be reached by 2010, where prime rental values are forecasted to drop at a double digit pace¹ and could reach between (€28 and €30/per m²/per month). The downward correction might stimulate demand once rental values drop significantly in the CBD, but clouds will remain as the European recession will be steeper than priory expected. Setting aside such a feature, inner and outer submarkets outside the periphery should not fall by a double digit pace, as long as some new completions have been frozen. Some forthcoming premises expected to be completed by 2009 (like the 2 remaining "Towers") will

¹ We keep such a baseline scenario, despite the drop in future supply. The falling effect of future supply, mentioned earlier should take effect by 2011.

definitely have to downgrade their rental values further as the competition to find tenant will be tougher.

On a negative note for landlords, the inflation variable will be subdued in 2009, compared with past level: in 2009, inflation is set to reach 1.5% compared with 4% in 2008 in line with a depressive domestic market. Therefore, landlords have to remain savvy enough not to lower the rental level too much, as it could not be balanced by the indexation mechanism. Worse than that, inflation should fall to 1% in 2010.

1.5 Investment market

The ongoing fall in capital values in 2008 occurred. Markets will continue to overreact as the recession's is set to be hard. So far, the overshooting has led to an outward yield shift from 175 basis points since Q4 2007 for prime locations: according to C&W yields stand now at 6.00% compared with 4.25% in the peak of the cycle. Such a huge adjustment in cap rates, almost 25% in loss in term of valuation, has been related to the distressed situation of some sellers in need of cash².

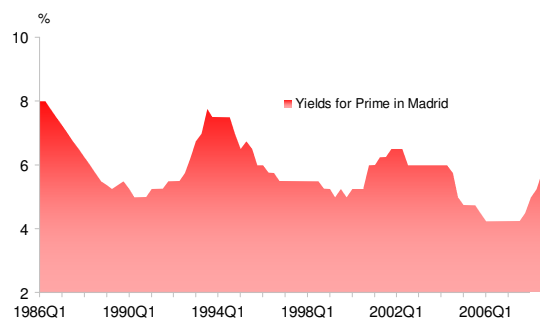
The market has continued to remain weak given ongoing lack of liquidity and a global risk aversion as more fall in value is expected (banks have now clearly close their door to financing and also avoid to share risks to club deals) Globally, almost €1.2 billion was invested excluding the deal of Santander (€1.9 billion). In the fourth quarter, a couple of medium transactions were observed.

Foreign investors remain on the sidelines still waiting for distressed situation. The private Spanish families continue to be active in search of long term income streams. Recent deals have been done.

On the money markets, official borrowings costs have not reached a floor, despite the recent ECB cut by 50 basis points to 2% - a record level not seen since 2005.

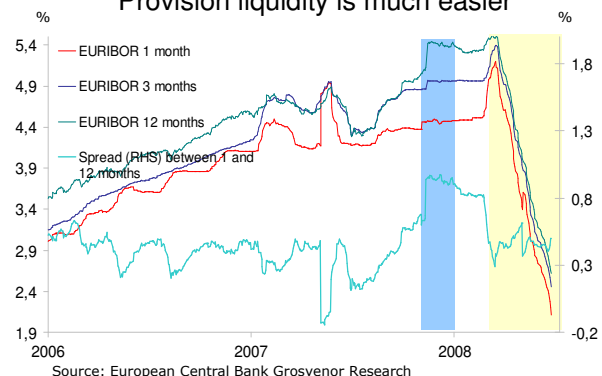
The recent move of the ECB has continued to ease tensions on the money markets: the 3-month rate, which is used for many commercial loan transaction has notably fallen since the end of the year, signalling a return to better inter-bank credit conditions. Spread of 3-month inter-bank rates over policy rates are continuing to trend downward. Such a move has clearly ease tensions on the money markets. The question remains if it will stimulate the economy. Having said that, it should be underlined that the ECB's strategy is quite singular compared with the FED and the Bank of England: the gradual move instead of slashing interest rates, tend to avoid to fall in a "liquidity trap" in which investors –and consumers- hoard money. Therefore, conditions are met for further cut in the future: the ECB could lower the refi rate to 1% by mid-2009.

New drop in capital values in Madrid
Further fall to be seen in 2009



Source: CBRE, C&W and Grosvenor Research

Savvy ECB's Policy
Provision liquidity is much easier

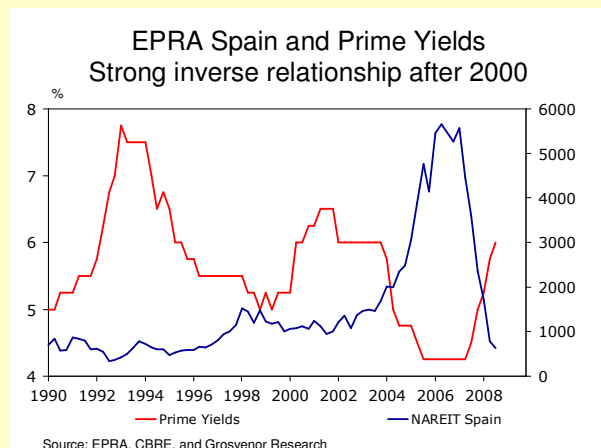
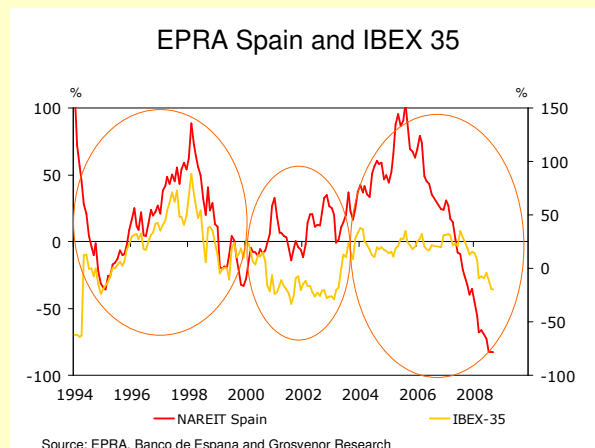


Source: European Central Bank Grosvenor Research

² Empirical works done in house showed that yield compression is a (i) decreasing function of the cost of credit as well as rental values; (ii) an increasing function of total level of stock. Although such relationships are quite intuitive, it has been found that the highest negative elasticity impacting the level of yield is the change in credit. Therefore, the sharp outward yield shift is now related to the drop of the total credit available. It should be reminded, that during the former cycle, in the early 2000's no outward yield shift was noticed, as domestic firms did not have to sell off assets in search of cash. Their hold strategy at that time helped the yield trend to remain stable while yields moved outward in other European markets.

Snapshot of Empirical work done in-house

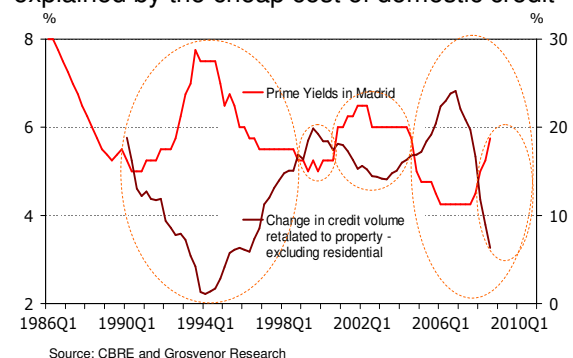
In Spain, the listed property sector has been more resilient than the entire market, IBEX-35 index, until recently. The financial turmoil, particularly tougher credit conditions, has definitely increased investors' risk-aversion towards listed property companies. Although historically the long-term correlation between both markets was strong, it has almost tripled since August 2007 when the sub-prime crisis broke out. Interestingly, recent volatility in the Spanish EPRA index can be explained by movements in the IBEX-35, up to 87% from an historical trend of 16% since the 1990's. Again, the selling move seen in other equity markets has been seen in the Spanish market with, unsurprisingly, a greater effect in the listed property market.



The big fall of the Spanish EPRA index may be explained by breakdown of the companies' portfolio – amount of residential sector exposure as well as the quality of the assets – plus its balance sheet position, as the layman would guess. The listed real estate market is usually a leading indicator of the direct investment. As shown on the chart, in the long run there is a strong inverse relationship between EPRA and the yields of the office market in Madrid ($\rho = -0.76$), which means that an increase in the EPRA index coincides with a fall in the direct real estate yield trend and inversely an decrease in the EPRA index (fall in share prices) coincides with an increase in the yield curve in the office market. Generally, the office market is usually taken as the benchmark given its long track record, in line with its higher degree of maturity, but also as it is more liquid than its other property peer markets. Analysis shows that the inverse relationship between property yield and the EPRA index strengthened with a correlation of -0.93 after 2000. Finally, turning to the volatility of the EPRA index, which is an explanation for the big swings in yields in the direct market. The 98% of the volatility of the prime yield profile in Spain can be explained by the volatility of the Spanish EPRA index since the subprime in August 2007. This feature emphasizes that the listed market has clearly impacted "pricing" in the direct investment side.

As shown by the chart, there is a strong negative relationship between the change in the credit volume in Spain and the prime yield profile in Madrid, which means that when credit volume increases, the level of the yield decreases. Again, regression analysis shows a strong relationship between the yield level and the change in the credit volume related to the property sector. The correlation coefficient stands at -0.76 over the long run. More interestingly, the volatility of yield shifts in the office sector has been largely explained by the volatility of the volume of credit, specifically over the past three years moving from a long-run correlation of 0.51

Yields' compression have been mainly explained by the cheap cost of domestic credit



to 0.89 over the past three years. Again, this means that the fast yield compression over the past few years, one of the largest shifts in the Euro zone, was “driven” by the volume of credit, which was used by domestic investors to buy assets. The shortage of credit has clearly enhanced the overshooting!

Key Investment transactions

In the fourth quarter 2008:

- Union Invest bought Portico (21,000 m²), in Calle Mahonias, from Grupo Marsans for € 115 million, reflecting an approximate yield of 6% (5,476 € / m²)
- A private investor bought the building Cristina B.P. (5,800 m²) in Via de los Poblados, from Immoseguros for € 24 million, reflecting an approximate yield of 6.5% (4,138 € / m²).
- A private investor acquired an office building (2,320 m²) in Calle Alfonso XI, from Inmobiliaria Alhambra, for € 15.5 million, reflecting an approximate yield of 5.8% (6,681 € / m²).
- In **Barcelona**, Familia Cergedá bought 273-279 Carrer de Corcega (6,000 m² fully occupied) from GE for € 28.7 million, reflecting a yield of 6.35% (4,783 € / m²).

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