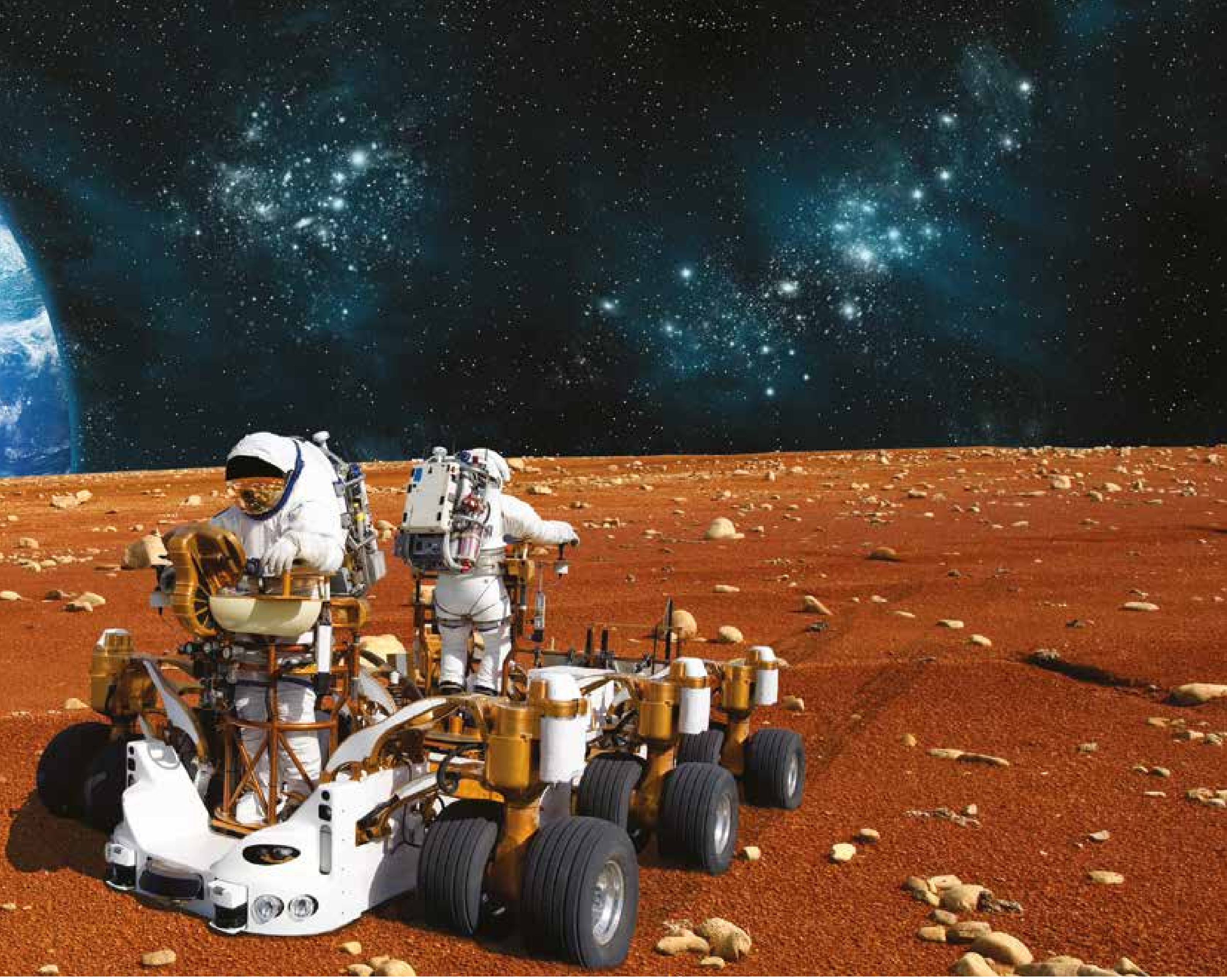
OPPORTUNITIES AHEAD

Interview with Ismael Clemente of Merlin Properties

Ismael Clemente

Being the founding partner of Merlin Properties, Ismael Clemente is currently President and CEO, in charge of the origin and structuring of real estate investments in Spain and Portugal. Over the last 20 years, Ismael has worked at Bankers Trust, DB Real Estate, and RREEF, where he was Managing Director. He has completed transactions with an aggregate value of more than €5 billion across all property sectors.

He holds degrees in Law and Economics & Business Administration, majoring in Finance, from ICADE, is a teacher of the MRE program at Instituto de Empresa, and is a member of the Spanish Council of the Urban Land Institute (ULI).



Merlin Properties SOCIMI, S.A. is the largest real estate company listed on the Spanish stock exchange, and its main line of business is the acquisition and management of commercial property assets in Spain and Portugal. It is traded on the IBEX-35 stock market index and has assets totaling €6,050 million; on 3 March 2016 its market capitalization stood at €3,200 million.

The company's main activity is the acquisition, management, operation, and selective rotation of prime commercial property assets in the core and core plus investment segments in Spain, and to a lesser extent in Portugal. Merlin focuses on the office, retail, logistics, and leased urban hotel markets. Shareholder returns are driven by annual distribution of dividends and value creation through increases in the company's EPRA NAV.

In his interview with Deloitte Partner Alberto Valls, Ismael Clemente, Founding Partner and Chairman of Merlin Properties, talks about his company and shares his views on the real estate market.

What is Merlin's current target dividend yield?

Our guideline figure stands at a minimum of €140 million pro forma in 2016 or €0.43 per share. This represents a dividend yield of close to 4.75 percent for those who have subscribed to the IPO and the subsequent capital increases. A full dividend will be reached this year as it was established in our business plan.

What are the returns on your asset portfolio?

According to our most recent portfolio appraisals, we are looking at an estimated gross yield of 5.3 percent and a net yield of 5.0 percent.

What is the company's shareholder structure?

The shareholder structure has undergone substantial rotation since the IPO. A common feature has been a move toward increasing institutionalization. The current shareholders are more focused on the long term: their attention is fixed on dividend-based returns. In contrast, the shareholders who entered at the beginning of the IPO were generally macro-investors attempting to speculate on a possible increase in the company's share price.

2015 was a record year with a total transaction volume totaling €11,700 in Spain. What are the prospects for 2016?

A similar year could only be achieved if another extraordinary transaction, such as our acquisition of Testa in 2015, came about. However, excluding transactions of this magnitude, I foresee 2016 will be similar but with slightly lower total transaction volumes.

In 2015 over 72 percent of the transactions are attributable to core or core plus investors, does this mean that Spain is now considered a core market?

The market performed as expected. Firstly, opportunistic investors played their part, although little by little these type of investors have been losing strength since institutional investors have moved in the market.

Secondly, for Spain to be recognized as a core market, it must improve in terms of legal protection and institutional response speed, among other things.

Do you see any room for growth in capital values or rents in the Spanish market?

In terms of capital values, we are seeing a certain leeway as appraisers are lagging behind the market and they are still capturing the compression of yields. Last fiscal year (2015), a substantial portion of the compression of yields was captured, however an additional portion of yield-compression will need to be captured in 2016.

Regarding rentals, we are seeing a visible improvement in shopping centers and logistics.

In shopping centers, this improvement can be attributed to an increase in footfall (7 percent in our portfolio) and sales per square metre (10 percent). Regarding logistics there is a patent improvement in this segment, both in rentals and in occupancy.

In terms of offices, we are seeing a slight nominal improvement in rent renewals, but this improvement is still countered by two factors: the first is that there is a continued downward trend in inflation. The second is that both the old and the new markets continue to coexist, what means that in a portfolio as extensive as ours there are buildings with ten year leases which were signed in 2006 at rents that currently are 20-30 percent above market. When one of these matures, it offsets the effect of many upward renewals. However, these leases will disappear this year and next. Recent, shorter lease agreements will allow us to capture faster the expected rent increase at renewals in the coming years.

Why are the REITs playing such an important role? How far do you think they can go?

In Spain, REITs have captured more than €6,000 million, yet in terms of percentage of GDP in comparison with other similar OECD countries, in the long run REITs should stand at around €25,000 million to €30,000 million. This will require time, since major property holdings would have to enter the market for this to occur, which is currently not the case. In other countries, most property investment institutions are listed.

What do you believe to be the keys to success as a manager in terms of performance, transparency, fees, portfolio managers, and governance?

The most important key to success is performance. However, if you want to work with international investors, transparency is required. This is a non-issue to management, since your only two options are that you are either transparent or penalized on the long run.

With regards to fees, we believe in internal management systems. This means that there is no "fee" concept, but rather the concept of overheads. In our case, we benchmarked ourselves against the companies with the lowest overheads worldwide, and although we are considerably smaller, we matched their limits and maximums, a fact which has been recognized and applauded by international investors.

Portfolio managers are absolutely vital: without portfolio managers you have no performance. In this regard we have improved our portfolio management teams significantly, due to the fact that we have incorporated the human capital from Testa. We now have specialist rental teams and portfolio and asset managers devoted to specific assets.

Lastly, regarding governance, it's a bit like transparency: if you want to be in the market, you have to have it.

What is your current perception of the markets—are there windows to capture capital or do they appear to be slightly closed?

I think the possibility of creating blind pools has disappeared, but there is a market for relatively large companies which have to go to the market on a recurring basis in order to fund our development programs, since we don't have the possibility to retain earnings. We also see that there are investors willing to invest in projects that make sense, keeping the market open. It is true that you have to be slightly more reactive because of the high volatility, although in the end, there still is a market.

Where is the REIT market heading—toward asset class specialization?

Specialization is great; unfortunately, the problem is that specialization is unfeasible in Spain because such a company would be tiny. This would mean that what you gain from specialization, you would lose in liquidity and in concerned shareholders due to the aforementioned disappointing liquidity and size. In Merlin Properties, we work solely in Commercial Real Estate: offices, shopping centers, high street retail, and industrial logistics; this gives us a fairly significant degree of specialization. In the future, we would like to be a mono-asset class, but for that to happen Spain must become a larger market than the one it is now.

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On financial structure: what is your LTV target?

We are currently below 50 percent; in 3 or 4 years we would like to be below 45 percent; and in 6 or 8 years below 40 percent; this is a trend we want to maintain in the long run. It is true that the interpretation given to us by the tax authorities concerning the sale of non-strategic assets is not helping our deleveraging objectives. The possibility of disposing non-strategic assets in order to reduce leverage would be very interesting—one must pay the corresponding taxes, but at least not be obligated to distribute dividends.

With regards to capital markets, in Spain there are very few bonds and companies which have obtained a rating. We are satisfied with the rating awarded to us by Standard & Poors (BBB), because it enables us to access a fairly liquid capital market. As soon as we see a window of opportunity, we will attempt to perform an issue in order to extend the shortest maturities, although at all times within the cost parameters that we set ourselves.

Have you noticed a cooling-off of the debt markets in 2016?

No, we have not noticed a cooling-off of the debt markets in 2016, there are many issuers receiving good responses. However, we have noticed a higher degree of volatility, meaning that spreads are widening as a result of the heightened uncertainty.

What do you believe to be key factors in trading trends?

When it comes to rents, in shopping centers we are seeing a clear improvement in our tenants' trade; that we hope to capture through either variable income or in the next wave of renewals.

In logistics, our tenants are obtaining contracts and things are going well for them, which will also result in an improvement in rents. In the office sector, although things are also going better for our tenants, the new prevailing ways of doing business today and the fact that many offices are rented with less space available than what would be required for the number of people working there is having an impact on them. The final result is an improvement, although not as significant as for shopping centers and logistics.

We therefore foresee that the improvement in office rents will take place towards the end of 2016 and the beginning of 2017. The issue lies in the fact that it is a market that generally lags behind improvements in the underlying economy and, although the market agents expect a rapid increase, we believe that it is going to be a little more back-ended.

Do you think that now, having acquired Testa, it is time to manage NOI then go on to consider refurbishment projects?

Our goal is to optimize the company's NOI. This will come about in several ways—firstly, as a result of the entry-into-production of certain assets. That is to say, in 2015 our aggregates reflect one year of Merlin and half a year of Testa. At the same time they reflect a year in which we have had an overly-high average cash balance; if the average cash balance decreases, it is because you have bought assets which are entering into production.

We are also improving the energy certifications of all our buildings in the portfolio. This involves a three-year plan, in which we expect to have over 90 percent of our buildings certified in the areas of logistics, offices, and shopping centers.

Returning to development, do you believe this area to be vital for your business?

Yes, we will develop our own assets—if you want to have Leed Gold or Platinum rated buildings in Spain you have to develop them yourself. It is very difficult to obtain Leed Gold or Platinum buildings by buying them. Platinum is virtually impossible as there are none; as for Gold, there are very few up for sale. The result is that if you want to have a high quality portfolio it is necessary to develop it yourself.

How do you see the company's growth? Will there be more corporate transactions?

International ones, no. We are a company that operates exclusively in Spain and Portugal; going international is not what our investors are asking for.

It would be difficult to find opportunities for big corporate transactions, and if there are any, it is probable that these are in the form of transactions in shares rather than in cash because the possibility of raising substantial cash on the market is currently far harder than it was in the past.

Lastly, we would like to leave a heavier footprint in the area of shopping centers and assert our dominance in the office and logistics markets.

How do you think the change in the account treatment on long-term leases will affect the market? Do you think it will lead to a shortening of lease terms?

In the long run it will have an effect, leading to a shortening of the average lease term (WAULT). In Spain, leaser terms are unusually long (contracts are five plus five on average) compared to other markets. For us, far from representing a threat, we believe that this represents a great opportunity as it will require a more active portfolio management. This will result in that shortcomings in marketing and management, among others, will appear among those that are not able to handle this change in the market. This will give rise to more opportunities for trading and a larger market, and moreover, those of us with large portfolios will have a wider statistical spread of risks and stand out more clearly from the competition as a consequence.

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Recent thought leadership

Interested in further reading on real estate? Take a look at Deloitte's recent thought leadership.

International Property Handbook H2/2015

The second edition of the International Property Handbook provides Deloitte's view on real estate market conditions across the 21 countries attracting the highest volume of investment around the globe. Drawing on our global network of expertise, it includes a range of data and commentary, from key deals in each of the largest markets, through current prime yields, to a detailed comparison of entry and exit tax rates.

Key results include:

- Total investment volumes were up in the US, broadly flat across Europe, and down in Asia Pacific
- Investment is more concentrated in the largest countries. Only 12 of the top 21 countries saw y/y growth, against 15 earlier in 2015
- REITs and other listed vehicles have become the most active net investors
- Prime office yields have continued to fall in most markets – in some cases by 75bps
- Poland had the highest share of foreign investment (over 80%) followed by the Netherlands. Taiwan and China had the lowest
- The strongest growth in overall investment was seen in South Korea and Norway where volumes more than doubled y/y
- The most liquid markets over the year to Sep 2015 were Norway (15% transacted), followed by Spain, Ireland and Australia

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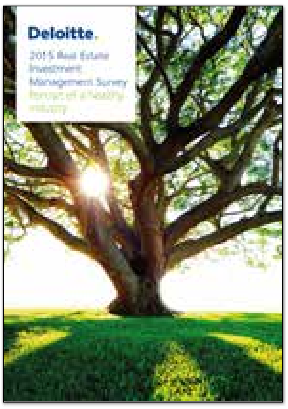

Deloitte 2015 Real Estate (RE) Investment Management Survey

Portrait of a healthy industry

The Deloitte 2015 Real Estate (RE) Investment Management Survey portrays a healthy industry that is currently adapting to new business paradigms and patterns–both those imposed by regulations and those requested by investors.

Survey participants were top players in the pan-European market with more than €200 billion regulated assets, and covered topics such as regulatory and tax challenges, growth and outlook of the industry, etc.

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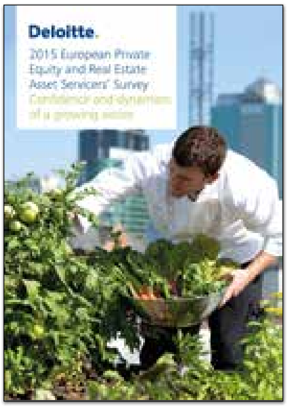

Private Equity and Real Estate (PERE) Asset Servicers' Survey

Confidence and dynamism of a growing sector

The Deloitte 2015 European Private Equity and Real Estate Asset Servicers' Survey highlights an industry in transformation, seeking to adapt its activities to reflect the asset management industry's increasingly global context.
Conducted among PE/RE asset servicers with an aggregate asset size of approximately €197 billion in assets under management and €107 billion in assets under depositary management, it was primarily designed to foster an understanding of key areas of their business, their operations and their insights into business growth and development.

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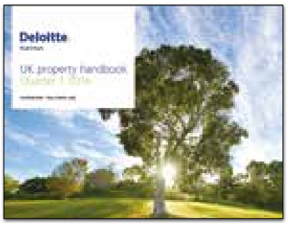

UK Property Handbook Q1 2016

The UK property handbook provides a detailed commentary on each of the market sectors, including selected deals, placed within a discussion of the broader economy and highlighting other Deloitte research relevant to real estate.

Electronic or paper copies are available upon request to James Griggs (jgriggs@deloitte.uk)
