SPAIN
Spotlight on the real estate market

Javier Garcia-Mateo
Partner
Financial Advisory
Deloitte
Macroeconomic View

Introduction: The Spanish economy gathers momentum

Investment analysts are projecting continued and healthy growth in Spain over at least 18 months. According to the OECD, this will be driven by supportive financial conditions, the depreciation of the euro, lower oil prices, and strengthening growth among trading partners. Additionally, its fiscal stance is assumed to be mildly contractionary. Growth in private consumption will be supported by rising employment and incomes, household tax cuts, and lower fuel prices and interest rates. Export growth will be underpinned by gains in cost-competitiveness driven by the weak euro and the recovery in Europe.

The ECB’s quantitative easing has provided a further boost and this—together with historic and prevailing conditions—will keep inflation low. Regardless of who will be governing Spain after the 2015 general elections, the Spanish government should continue to ensure the fiscal deficit is reduced to put public debt on a downward trend. Structural reforms to make it easier to start and expand a business as well as improving innovation are key to moving towards a knowledge-based economy and ensuring strong, inclusive growth and job creation. High unemployment, which has pushed up income inequality, is a key concern. Dealing with it will require greater efforts to improve both job search assistance and training options for the unemployed, many of whom are poorly skilled.

Figure 1: Spain - keys to economic recovery

OPPORTUNITIES

- Healthy GDP growth through current account surplus and rising consumer confidence.
- Export growth driven by depreciation of the euro against the British pound and the US dollar.
- Ease of general financing conditions supported by ECB’s monetary policy (QE).
- Low oil price prospects should prevent from inflation risks in the medium run.
- Reduction of public spending specific weight to GDP through austerity measures and further structural reforms within local Administrations.

THREATS

- Political uncertainty due to the upcoming parliamentary election in Catalonia and the general election which will be held by the end of the year.
- Unemployment and labour market imbalances and disparities explained by a historical overexposure of economic activity to the construction and tourism industries.
- International net debt reached 97% of GDP as a result of the expansion of Spanish companies abroad.
- Lack of innovation policies and R&D could act as a deterrent of further productivity growth.
The following reasons underpin our belief that Spain’s economic recovery is gaining momentum:

**GDP growth**

The current drivers of economic growth in Spain are different from the pre-crisis period, which was characterized by excessive public spending and domestic consumption driven by soft lending conditions. Exports were low, leading the economy to display a chronic current account deficit year on year. At present, economic growth is sustained by a current account surplus driven by structural reforms that have led to economic expansion, export growth, and rising levels of consumer confidence.

**Labour market**

In 2013, unemployment started to fall progressively across agriculture, industry, construction and service sectors. Although 2003 to 2006 unemployment levels (around 10 percent) are still a long way off, the IMF has projected a further decrease in unemployment to 19.7 percent by 2016.

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**Figure 2: GDP growth in Spain (%)**

![GDP growth in Spain (%)](image)

Source: Eurostat, IMF, EIU

**Figure 3: Consumer confidence (Basis 100)**

![Consumer confidence index](image)

Source: CIS

**Figure 4: Unemployment rate (%)**

![Unemployment rate (%)](image)

Source: INE and IMF
The turnaround
Spain’s systemic risk has fallen considerably since 2013 to 2014, while political risk seems to remain for 2015 to 2016. The chart below reflects the change in perspective over the last 36 months in Spain.

Figure 5: From a vicious to a virtuous circle

Investment analysts are projecting continued and healthy growth in Spain over at least 18 months

Source: Deloitte and Arcana
Other relevant factors: the risk premium and the euro

By mid 2012, the risk premium reached its highest level in recent years. As a result, the Spanish government undertook an ambitious economic program supported by a European Financial Stability Facility/European Stability Mechanism loan to recapitalize the banking system, paving the way for a recovery in confidence. Since then, the Spanish risk premium has decreased by more than 485 bps, from 638 bps in July 2012 to below 153 bps on 30 June 2015, despite recent volatility caused by the Greek debt crisis. This reduction in interest rates supports the ongoing recovery.

The progressive depreciation of the euro against the U.S. dollar and pound sterling since mid 2014 is helping the Spanish economy recover by growing exports and fostering international tourism. The expected rise in interest rates in the United States should potentially extend this trend in the coming quarters.

Regardless of who will be governing Spain after the 2015 general elections, the Spanish government should continue to ensure the fiscal deficit is reduced to put public debt on a downward trend.
Setting the scene

The Spanish commercial real estate market (CRE) was seriously impacted by the housing bubble that burst in 2008. At the time, Spain’s economy was significantly biased towards the construction sector. This contributed to unprecedented growth in unemployment, which reached its peak in 2013. Investment in commercial real estate declined sharply given its poor fundamentals (vacancy, rental income and absorption rates), the high country risk premium, and the lack of financing from key Spanish banks. As a result, capital values in commercial real estate contracted significantly.

Compared to other European markets where the capital values trend was mixed from 2007 to 2012, at the beginning of 2013, Spain presented highly attractive CRE pricing. As such, from 2013 to H1 2015, opportunistic and value added investors undertook a significant number of transactions executed below replacement cost levels. This phenomenon triggered the return of investor confidence in Spain.

Since 2013, a total volume of €9.1 billion has been transacted within the key CRE segments (offices, retail and logistics). Value added and opportunistic investors accounted for 26 percent of the activity during this period, while 14 percent of the total investment was priced below replacement cost. This factor was especially pronounced within the retail segment, with 25 percent of total transactions executed at a price below replacement cost.

As shown in Figure 11, the most relevant transactions executed at a price below replacement cost were conducted by investors with notable asset management capabilities.
**Figure 8: Average capital values - prime properties (€/sqm)**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>2007</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offices</td>
<td>6.188</td>
<td>5.522</td>
</tr>
<tr>
<td>Retail</td>
<td>7.263</td>
<td>4.985</td>
</tr>
<tr>
<td>Logistics</td>
<td>7.387</td>
<td>2.767</td>
</tr>
</tbody>
</table>

Source: Deloitte

**Figure 9: Capital values average adjustment 2007-2012 (%): Spain vs. key European markets**

Source: Deloitte

**Figure 10: Key CRE segments transaction analysis: 2013-2015H1 (*)**

*Core profile* | *Value added profile* | *Opportunistic profile* |
---------------|----------------------|------------------------|
$74\%$        | $16\%$               | $10\%$                 |

Price vs. replacement cost

Source: Deloitte

**Figure 11: 2013-2015H1: Top deals per asset class (price < replacement costs)**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Transaction</th>
<th>Buyer</th>
<th>Price (€m)</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offices</td>
<td>Office portfolio</td>
<td>WP Carey</td>
<td>300</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>Generalitat buildings</td>
<td>Zurich</td>
<td>201</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>Parque de las Nacione</td>
<td>Axa RE</td>
<td>180</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>Castellana 89</td>
<td>March Family</td>
<td>147</td>
<td>2015</td>
</tr>
<tr>
<td></td>
<td>IT headquarters</td>
<td>Bankia</td>
<td>144</td>
<td>2015</td>
</tr>
<tr>
<td>Logistic</td>
<td>Gran Europa</td>
<td>Blackstone</td>
<td>130</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>Parque Coslada</td>
<td>Prologis</td>
<td>100</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>Logistic portfolio</td>
<td>Confidential</td>
<td>60</td>
<td>2014</td>
</tr>
<tr>
<td>Retail</td>
<td>Puerto Venecia</td>
<td>Intu Properties</td>
<td>451</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>Plenilunio</td>
<td>Klepierre</td>
<td>375</td>
<td>2015</td>
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<tr>
<td></td>
<td>Marineda City</td>
<td>Merlin Properties</td>
<td>260</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>TIAA Henderson</td>
<td>Lazul</td>
<td>230</td>
<td>2014</td>
</tr>
<tr>
<td></td>
<td>Vastned portfolio</td>
<td>Baupost - GreenOak</td>
<td>160</td>
<td>2014</td>
</tr>
</tbody>
</table>

Source: Deloitte
Figure 12: CRE Investment pipeline breakdown: 2015H2

Figure 13: Correlation analysis - office take-up & GDP growth

Figure 14: Correlation analysis - office rental prices & GDP growth

Figure 16: Office occupancy

Figure 17: Rental prices office/retail/logistics
The opportunity

At present, the Spanish CRE market still offers attractive investment opportunities given that both rental income and capital values fell significantly during the crisis and there is still a long way to recovery. The current estimated investment pipeline amounts to €3.5 billion. Given the limited sourcing of logistics investment opportunities, with an estimated investment pipeline of €600 million and the strong competition of dominant players such as Blackstone, Colony and other emerging specialized investors such as TPG, we consider this market segment limited in terms of accessibility. On the other hand, the retail segment presents enormous potential given its €1.7 billion heterogeneous investment pipeline of both shopping centers and retail parks throughout the whole country with different asset management strategies that can be matched with a wide range of investors and asset managers. The office segment has an estimated investment pipeline of €1.2 billion.

Qualified investors holding asset class expertise and asset management capabilities will focus on opportunities located in secondary areas where prices remain around replacement cost levels. Highly skilled asset management teams will be required to turn around the performance of mismanaged properties.

Large institutional investors are benefiting from the opportunity to enter the Spanish market, aiming to exit with expected returns of around 15 percent IRR. These expected returns can be explained by the gradual recovery of key fundamentals: rental prices and occupancy levels. Going forward, these factors are expected to be correlated with the economic cycle, as historical figures show. (Figure 13 and 14).

This correlation shows an increase in gross absorption of offices in Madrid and Barcelona, driven by GDP growth.

A correlation also exists between rental prices and GDP growth. However, it is delayed by 18 months because decision makers postpone negotiations until the earliest lease contract end or break option.

The general improvement in occupancy levels should lead to higher rental levels given the existing gap seen in Figure 17.

Before providing further sector-by-sector detail, it is worth highlighting two important variables in Spain’s real estate sector, SAREB and SOCIMIs:

- SAREB, the Spanish bad bank, was set up in November 2012 to help restore the country’s financial system and, specifically, those entities with high exposure to the housing market. As more than half of SAREB’s funds are private, sale processes are not conducted through public channels. SAREB works mostly as a private entity whose aim is to maximize the asset sale price.
- SOCIMIs (“Sociedad Anonima Cotizada de Inversión en el Mercado Inmobiliario”) or “Listed corporations for investment in the Real Estate Market” are Spanish REITs. This regime was launched in 2012.

We consider the SOCIMI structure as the most suitable vehicle to make real estate investments and divestments in Spain.

At present, the Spanish CRE market still offers attractive investment opportunities given that both rental income and capital values fell significantly during the crisis and there is still a long way to recovery.
Investment volume

Spanish CRE investment volume fell from its peak in 2007 when the financial crisis hit capital markets throughout the world. After five consecutive years of decreasing activity, investment bottomed out in 2012 to grow back to 2006 levels, with turnover at almost €8.5 billion in 2014 and bolstered by the increasing activity of REITs (SOCIMIs). It should be noted that investment volume executed in H1 2015 grew by 67 percent compared with H1 2014. This phenomenon can be explained by the improvement in macroeconomic fundamentals and the progressive easing of lending conditions.

Spanish CRE investment volume fell from its peak in 2007 when the financial crisis hit capital markets throughout the world.

Figure 18: CRE investment volume trend - breakdown by typology

Figure 19: Investment volume by asset typology

Source: Deloitte
Madrid and Barcelona: keys targets for CRE investment

Madrid and Barcelona have been gaining momentum in terms of CRE investments over other Spanish cities, given the growing importance of both cities in terms of economic activity and tertiary real estate developments and refurbishments.

Figure 20: Spanish investment volume breakdown by location

Source: Deloitte