RESEARCH

OCTOBER 2012

SPANISH RETAIL INVESTMENT MARKET REPORT

Knight Frank

HIGHLIGHTS

- The polarisation of the market continues: despite the economic situation, prime and well-established centres continue to perform well, whilst secondary schemes and cities are suffering.
- International retailers continue to demand space in prime shopping centres.
- The retail investment market remains static. There have been no high profile deals completed so far this year.
- Debt transactions are increasingly the focus of investors. Future investment sales over the short term are likely to be in the hands of the banks.
- Experienced investors continue to seek opportunities in Spain's prime cities, testimony to the belief that despite the economic climate, Spain offers the correct fundamentals for retail investment. Those with a site-specific strategy, rather than a country approach, will identify assets that meet their criteria through micro analysis.

ECONOMIC OUTLOOK

Economic Indicators	2010	2011	2012 (*)
GDP Growth	-0.1	0.4	-1.7
Unemployment rate	20.1	21.6	24.5
Consumer Price Index	1.8	3.2	2.5
Government Bond 10 yr	4.25	5.43	5.64

Source: Savings Bank Foundation (*) Annual average forecasts

The challenging macroeconomic situation in Spain needs little introduction having been the focus of many economic and political debates in recent times.

The Spanish economy, characterised by a loss of competitiveness, high levels of unemployment and falling consumption rates, continues to contract. There are a variety of GDP forecasts available but the general consensus is that economy will contract by around -1.7% in 2012, as a result of further upcoming fiscal reforms and continued low economic activity.

Unemployment in Spain now stands at approximately 24.7%. However, this is spread unevenly across the country, with the rate in Madrid being around 6 percentage points lower than the national average.

It goes without saying that factors such as the intensification of financial stress associated with sovereign debt markets, restrictions on access to credit and increased uncertainty, not only surrounding Spain but also the future of Europe, do not create the healthiest scenario for investment.

Against this backdrop, the Spanish government continues to strive to steer Spain out of the dark. Over the year, the Central Government has presented numerous fiscal measures designed to achieve Spain's deficit targets. These measures include:

- Increase in tax revenues, including VAT, corporate income tax, personal income tax and excise duties.
- Changes to unemployment benefit and social security contributions.
- Improvement of public sector efficiency and reduction of the public sector wage bill.
- Review of pension system.

The fact remains that Spain's economy is the 12th largest in the world. Despite the current situation, investors remain keen to monitor the market and to have a foot in the door for when the real opportunities begin to reappear. It is difficult to imagine how a country with a population of almost 50 million people, having experienced nearly 15 years of above average GDP growth before the slowdown in 2007, will be not be able to turn itself around and find the road to recovery. Investors recognise that the key to the Spanish market is being prepared and ready to act. The economy is unlikely to make a recovery before 2015, however there will be some interesting opportunities to be had along the way.

RETAIL MARKET

The retail market remains characterised by the polarisation between prime and secondary schemes. Some prime shopping centres are achieving 100% occupation and have in fact seen an increase in the number of visitors, as well as sales. This is a quite a different scenario from the challenges some secondary centres are facing today.

Supply and Demand

Operators remain selective when opening new stores and many expansion plans are on hold.

Spain is facing competition from other countries, particularly in Eastern Europe, where there is considered to be greater potential for economic growth, attracting the expansion of international brands. However, a number of international retailers continue to seek to increase their coverage in prime shopping centres in Spain and believe that Spain offers the correct fundamentals for retail business.

Primark remains particularly active as does the Sonae Group with Sport Zone and Zippy. A relatively new operator to the market is JD Sports, having opened several new stores this year. Other international operators, such as Superdry, remain active in their expansion but opt to reduce risk via franchising in non-prime locations.

Generally, vacancy rates vary from 2.5% - 4.5% for prime centres and are 10+% in secondary schemes, depending on the quality of the asset. Lease negotiations continue to be difficult as operators are increasingly demanding. Landlords should seriously consider fit out and financing stores to maintain competiveness.

Sales

Despite the economic situation, people do continue to shop, but consumers have adjusted their budgets to match current disposable income. On average, centres managed by Knight Frank registered a fall in sales of between 2% and 8% over the first half of the year.

In general, leisure and restaurants have particularly suffered over the last year, as have household goods retailers in certain centres. However, low cost concepts such as

McDonald's or Burger King and those brands that have repositioned to adjust to the current situation have been able to maintain their positions. Similarly, supermarkets and low cost formats such as Lidl and Aldi, are now outperforming the traditional hypermarket formats in many cases.

Some operators are finding efficiency by increasing format size and are now moving from smaller units of 100-200 sq m to larger formats of 600-700 sq m whilst maintaining very tight price margins. Smaller operators are most affected due to the lack of credit, whilst franchise and chain stores are performing better.

New Openings

Only two schemes, Gran Plaza 2 in Madrid and Serrallo Plaza in Granada, opened in the first half of 2012. However, three large new shopping centres opened in September and Puerto Venecia, belonging to British Land and Orion Capital, will open at the beginning of October in Zaragoza. By the end of 2012, we will have seen half a million square metres of GLA come to the market, an indication of the confidence key developers have in Spanish retail.

RETAIL INVESTMENT MARKET

Despite speculation about distressed sales, the market has remained very static so far this year.

Property owners that do not need cash have no motive to sell in the current market. From both an operational and transactional perspective, many property investors continue to focus on maximising the value of their current portfolios, rather than considering rotation.

This general lack of product, together with restrictions on finance, lengthy decision processes and overall uncertainty surrounding the Spanish economy, continues to make investment transactions extremely difficult.

Nevertheless, experienced investors remain positive and are opting to monitor the market rather than remove Spain from their target list. Emphasis is generally on prime cities, favouring Madrid, Barcelona and the Basque Country, as these areas have the most positive consumption and growth forecasts, and have been less affected by the economic downturn, particularly if we refer to Madrid and Barcelona.

Debt transactions are increasingly the focus of investors; even some of the more traditional asset buyers are looking at ways to form new vehicles for the purchase of securitised loans. It should be remembered that the sale of the debt does not necessarily mean that the asset is performing badly, but could be due to problems the sponsor has elsewhere or simply an attempt from the bank to reduce exposure.

It would seem that future investment sales over the short term are likely to be in the hands of the banks. However, despite their eagerness to clean up balance sheets and reduce exposure, there is a general reluctance to accept offers entailing direct loss. Opportunistic funds interested in the purchase of debt or distressed assets are, of course, expecting significant discounts in order to achieve their returns, which the banks are rejecting. The increasing distress in certain situations means that discounts not accepted today could lead to greater losses in the future, as over time, these assets will have little or no capex invested in them. They will eventually reach the market under managed and out dated, and by that time, will be far from meeting investment grade, even for opportunistic funds.

Banks not willing to accept reasonable losses in the current situation should seriously consider how they will manage foreclosed and problematic shopping centre assets. These

Main Shopping Centre Openings 2012

Scheme	Location	Developer	GLA (sq m)	Opening Date
Serrallo Plaza	Granada	Corporación García Arrabal	24,000	March 2012
Gran Plaza 2	Majadahonda, Madrid	LSGIE	57,000	April 2012
Río Shopping	Arroyo de la Encomienda, Valladolid	Inter Ikea Centre Group	100,000	September 2012
Zenia Boulevard	Orihuela, Alicante	Immochan	80,000	September 2012
El Faro	Badajoz	Unibail-Rodamco	66,000	September 2012
Puerto Venecia	Zaragoza	British Land, Orion Capital	118,000	October 2012
Luz Shopping Lifestyle Center	Jerez de la Frontera, Cadiz	Inter Ikea Centre Group	15,000	Novemeber 2012
As Cancelas	Santiago de Compostela	Carrefour Property España, Realia	50,500	Novemeber 2012

Source: Spanish Shopping Centre Association

properties require intense management in order to avoid falling into situations which allow the scheme to deteriorate and generate costs to the extent that it simply will not sell at any price.

Transactions

There have been no high profile deals on the market so far this year.

The first half of the year saw the sale of the Arambol Retail Park in Palencia to a family office investment club from Barcelona. This retail park opened last year and although it has a good tenant mix of retail warehouse operators, is considered secondary due to its location. However, this is an example of how family offices looking to diversify in the retail sector can obtain higher returns than those offered by other asset classes. Private investors can take advantage of the current situation to invest in retail warehouses, which although they do require a certain degree of specialist knowledge, do not necessarily need the same intense management as shopping centres.

It is also worth mentioning the sale of the Bahia Mar Retail Park in Cadiz to a local investor. With a tenant mix of local operators, high vacancy and short term leases, the transaction of Bahia Mar was driven by the financing bank.

Despite the low level of investment transactions, there are a number of sales processes currently underway, both on and off market, which have generated noticeable interest from investors. These potential transactions could increase the overall investment volume by the end of the year, however, their completion is uncertain and as ever, will greatly depend on finance options.

Arambol Retail Park, Palencia

We expect to see further debt portfolios and individual cases come to the market over the next 12 months. These will present good opportunities, however in the case of underperforming assets, investors would be well advised to carry out intensive due diligence in order to establish whether or not the asset is likely to deteriorate further in the current climate. In these situations, it is key to establish a sound post-acquisition strategy with the necessary measures for successful management.

Enterprising investors who are able to see beyond Spain's high risk country profile, away from a general macro analysis to concentrate on the micro surroundings, will find good products that still perform well in spite of the economic situation. Recent sales processes have shown that experienced investors continue to seek opportunities in Spain. This is testimony to the belief that despite the economic climate, Spain offers the correct fundamentals for retail investment and those with a site-specific strategy, rather than a country approach, will identify assets that meet their criteria.

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