Portuguese Real Estate Advisors

Lisbon Office Market Outlook

1st
Half
2014

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Lisbon Office Market Outlook

Research & Market Analysis Report

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2014

Summary and Outlook 2014

In Spring 2014 the 3 year bailout plan was concluded with a “clean exit” and official registered success by major entities: EU, ECB and IMF. Major austerity measures are already put into practice including severe tax increases and major cuts in public expenditure (although resilience on pensions and public wages is still underway).

In the context of improving economic performance consumers’ confidence index is now rising and private consumption, unemployment and investment are looking better.

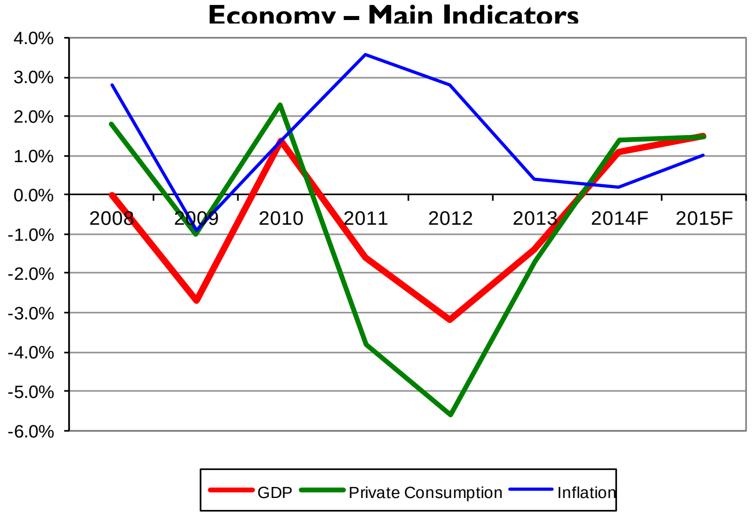
GDP fell more than 6% during the bailout period and now forecasts point to a moderate growth of GDP of 1% to 1.5% in the next two years.

Although better economic data still bad news occur: Some holdings of GES - Espirito Santo Group – one of the most important in Portugal asked for creditors’ protection in Luxembourg and restructuring or bankruptcy will be determined in October. BES – Banco Espirito Santo – major Portuguese bank partially (20%) held by the group is largely exposed to the group debt.

Although authorities claim the bank is solid and safeguarded the final results of the process are still to be determined either by increasing private capital by old or new shareholders or, in ultimate case, by state intervention lending troika’s capital reserves for banks (up to 6 billion of non used capital,) imitating the process held in three banks (BCP, BPI and Banif) during the troika period with success.

With better economic performance office market seems to be recovering and gross take-up rose 60% from equivalent prior period to 41000 sq m in first semester. This year is expected to be a turning point and economic indicators are now more positive: GDP is forecasted to grow around 1% in 2014, consumers’ confidence index is consistently increasing, unemployment shows better figures and investment is forecasted to grow for the first time in many years.

Economy – Main Indicators



Despite the better demand figures average rents are still under pressure although prime rents are less volatile and commercial incentives are still growing due to major availability of supply in most zones.

Summary:

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"“In Spring 2014 the bailout plan was concluded with a clean exit”

“Economic indicators are now more positive although still fragile”

“Take-Up levels rose 60% in 1S 2014 comparing to same period in prior year”

“Regain of confidence and investment are forecasted to be very slow and progressive”

“Decrease of interest rates in long term government bonds may set the context for additional compression of yields”

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The Economy

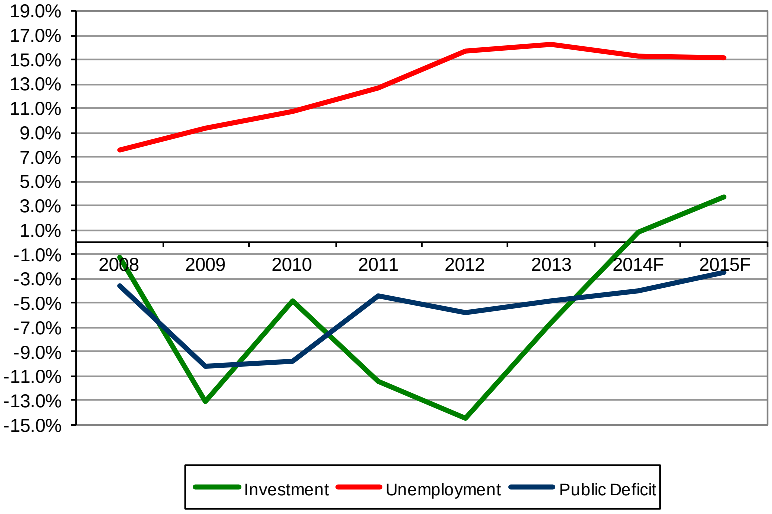
Economic performance is improving after real economy suffered from vast austerity measures put in place in the last three years.

In fact unemployment data shows significant declines in consecutive quarters (although partially due to emigration and cleaning of files) and private consumption is performing better with 1.4% growth forecasted for this year. In fact consumers' confidence index rose significantly during the last quarters meaning that consumer spending is now more likely to grow.

Moreover, investment seems to be returning to players' agenda and a growth below 1% is forecasted for this year. That fact is most important due to major declines in investment figures since 2008.

All data considered it seems recession has been halted and moderate growth is now on economic agents' horizon. Nevertheless some caution is necessary due to extreme fragility of economic indicators at this point. Also extreme dependency on European economy performance is traditional although exports continue to grow significantly and sharply to non EU destinations.

Economy – Selected Indicators



Long term interest rates on government bonds (10Y) fell sharply and financing seems to be secured and stable on the medium term. Also 2 year and 5 year interest rates for government bonds are in record lows adding more liquidity to real economy.

Major reforms are underway although its positive results are expected only in the medium term. In order to reduce public deficit austerity measures should continue leaving only room to a tight economy although better than in recent years.

GDP Growth:
2009: - 2.7%
2010: 1.4%
2011: -1.6%
2012: - 3.2%
2013F: -1.4%
2014F: 1.1%
2015F: 1.5%

YE Public Deficit (%GDP)
2009: - 10.2%
2010: - 9.8%
2011: - 4.4%
2012: - 5.8%
2013: - 4.9%
2014F: - 4%
2015F: - 2.5%

Inflation:
2011: 3.6%
2012: 2.8%
2013:: 0.4%
2014F: 0.2%
2015F: 1.0%

Investment:
2011: -11.4%
2012: -14.5%
2013: -8.4%
2014F: 0.8%
2015F: 3.7%

Unemployment:
Avg 2011: 12.7%
Avg 2012: 15.7%
Avg 2013: 16.3%
Avg 2014F: 15.3%
Avg 2015F: 15.2%

Private Consumption:
2011: -3.8%
2012: -5.6%
2013F: -1.7%
2014F: 1.4%
2015F: 1.5%

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Take-Up and Demand

Comparing to prior equivalent period the first semester has witnessed a 60% increase in gross take-up rising up to 41000 sq m. Nevertheless, that growth might be misleading as 2013 was a record low in demand.

In fact gross demand continues to fall short of last 5 year average and although better figures are expected for this year it seems difficult to target over 100,000 sq m at year end.

Net take-up continues to be weak although better than in recent quarters as new companies and expansion of area deals are modestly rising.

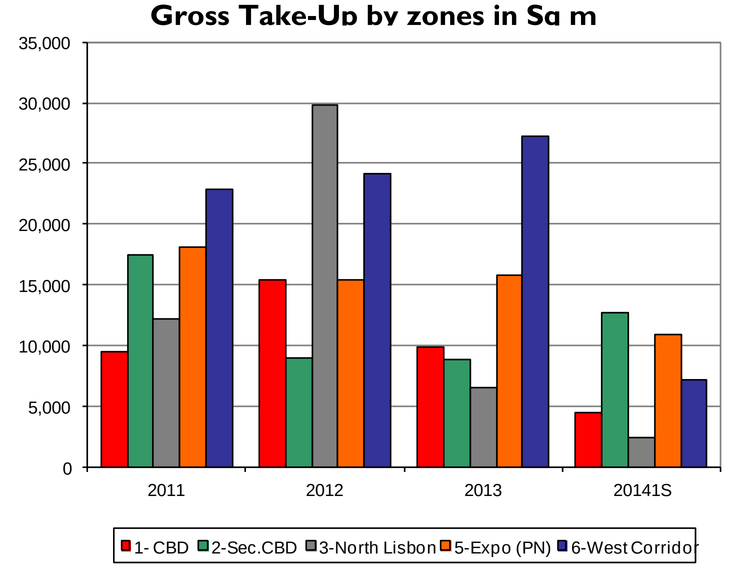
Substitution demand continues to be dominant and used space is growing in importance as new built is now scarce and pipeline is a long distance away of "boom years" average.

Renegotiation is still on players' agenda as a result of substitution demand and shorter lease contracts in the context of a more liberalised lease market as lease reform continues to take effect.

Lease market is absolutely dominant and represented almost 100% of area transacted.

Number of transactions rose (117) in comparison to 20131S and average area transacted rose moderately to 350 sq m per operation.

Used space represented approximately 70% of total area leased illustrating substitution demand dominance. New space leases were mostly done in Parque das Nações (11000 sq m) and Western Corridor (7000 sq m)



Most active zones were zones 2 (secondary CBD) and 5 (Parque das Nações) with respectively 31% and 27% of market demand. Zone 6 (Western Corridor) fell short of 18% of area transacted in 20141S.

Gross Take-Up sq m:
2009: 116,000
2010: 105,000
2011: 88,000
2012: 102,000
2013: 78,000

"Average area transacted on last five years is short of 98,000 sq m/year"

"Cost cutting and renegotiation are main drivers. Nevertheless, new companies and expansion of area deals are now more noticeable"

"Average area transacted decreased significantly to around 420 sq m per operation"

"Leases below 300 sq m are more than 50% of total lease operations"

"With some exceptions, lease operations of smaller spaces might be a trend to be observed"

"Slowness of deals and volatility characterize the market"

"Slow and progressive recovery of demand only in 2H 2014 is the mostly likely scenario at this point"

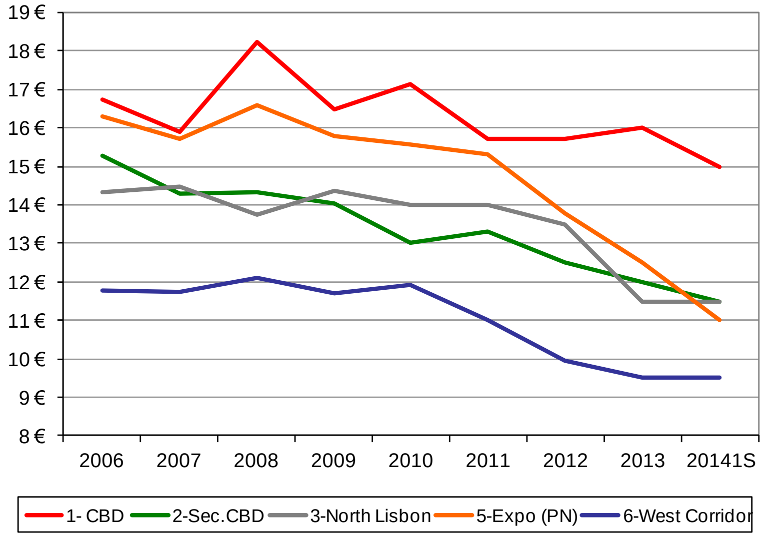
Rental levels

A strong pressure on rental levels has been felt during last years as a result of a combination of poor economic performance, slow demand and excess of supply in most zones. Average rents have decreased between 15 to 30% in most zones in the last five years. Some resilience is felt on prime CBD but still a strong decline of 10% was felt and now rental levels stand at 15 eur/sq m/month in average.

Excess of supply in most zones (mainly in zone 6) is significant with over 26% vacancy rate and may enhance rental pressure. Nevertheless, pipeline is now much lower than in recent years and developers are now very cautious.

Prime rents have managed to sustain higher levels and avoid sharper declines due to specific location and better quality or more differentiation on buildings/spaces. Also commercial incentives like rental free periods and space fit outs financial contributions are now common in order to sustain rental levels for investment funds and institutional investors.

Average Rents estimative (rounded figures) Eur/Sq m/month



Prime rents now stand at around Eur 18 Sq m/ month in CBD and at around Eur 11 on Western Corridor for prime buildings. Zone 5- Parque das Nações now presents prime rents at around 14 Eur/Sq m/month. In zone 5 a significant decrease in rental level was felt which managed to attract new tenants and deals.

In periphery zones and non prime buildings average rents have been suffering significant downward adjustments. They now stand at around 15 eur/sq m/month in CBD, around 11 Eur/Sq m/month in Parque das Nações and around 9 eur/sq m /month in Western Corridor.

Despite the decrease in new supply and forecasted pipeline conditions are met for a medium term pressure on average rents mainly on secondary locations/buildings. Analysis by zone is imperative as small fluctuations occur in different areas as a result of local market context, mainly on zones 1 and 5.

Prime Rents CBD Estimative Eur/Sq m/Month
2007: 20.5
2008: 20
2009: 19.5
2010: 18.5-19
2011: 18.5
2012: 18.5
2013: 18.5
20141S: 18

Prime Rents Expo – Parque Nações Eur/Sq m/Month
2007: 17.5
2008: 17.5
2009: 16.5
2010: 16-16.5
2011: 15.75
2012: 16
2013: 15
20141S: 14

Prime Rents Western Corridor Eur/Sq m/Month
2007: 14
2008: 14
2009: 13.5
2010: 13.5
2011: 12.5-13
2012: 12
2013: 11
20141S: 11

Average Rents:
"Strong pressure on average rents and major commercial incentives"

Average Rents on CBD – zone 1:
"Sustained resilience but declining"

Prime Rents:
"Slight downward pressure."

Supply

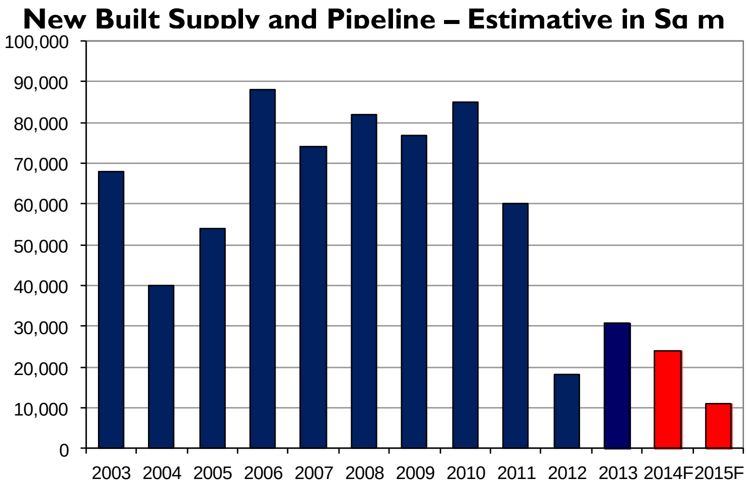
With some exceptions (in CBD for instance) available space is abundant mostly in zones 6 Western Corridor (almost 240,000 sq m) and 2 secondary CBD (120,000 sq m).

Due to poor demand market is considered in relative excess of supply although new supply and pipeline are now lower. Some pipeline and new built is already pre-let and most of operations in centre of the city are refurbishments and rehabilitation of buildings.

EDP major electric company headquarters in CBD "Maquês de Pombal" was sold to an American fund Global Asset Capital meaning that, in principle, further 20000 sq m will be put on the market after the moving of the company to its new built headquarters in historical zone in 2015.

For 2014 a total amount of 24,000 sq m is in pipeline but 60% of it is the new EDP headquarters in zone 4 historical zone. The rest will occur in CBD – Central Business District with 2 refurbished buildings.

For 2015 only 2 refurbishments in zones 1 and 2 are accounted as pipeline at this point adding up to +11,000 sqm in city centre stock.



Most actives zones in terms of new supply will be zones 1- CBD mostly refurbishments and zone 2 – Secondary CBD. Out of town and Parque das Nações have no registered pipeline at this point.

For 2016 a new major scheme in zone 2 – named Amoreiras Jardim is set to be developed comprising almost 24000 sqm of additional space.

Traditionally some delays in completions are feasible.

New Supply sq m:
2009: 77.000
2010: 85.000
2011: 60,000
2012: 18.000
2013: 31.000
2014F: 40.000
2015F: 11.000

"The pipeline for out-of town is null"

"No registered pipeline for Parque das Nações at this point"

"Most active zones in terms of pipeline are CBD (mostly refurbishments), and secondary CBD - zone 2"

Vacancy Rates

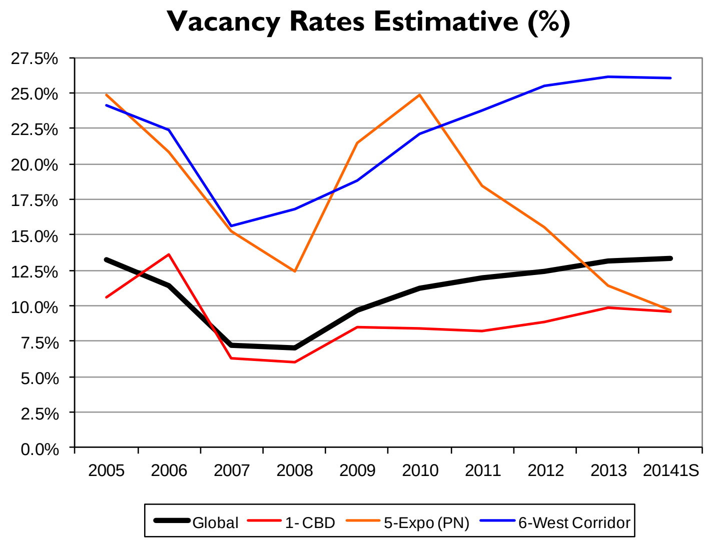
In the greater Lisbon market the global official vacancy rate is now of about 13.3%. Vacancy rates rose moderately in recent quarters but seem now more stable as new built is much lower and pipeline is more adjusted to potential demand.

Major rates are structurally observed in zone 6 - Western Corridor (26%) where available (new and mainly used) space is now very abundant.

Zone 5 – Parque das Nações with its small dimension and huge sensitivity managed to reduce its vacancy rate down to below 10% due to reduction of new built and specific/occasional large dimension lease deals along with significant reduction of rental levels.

CBD – Central Business District vacancy is still below two digits (9.6%) due to less available space and enhanced attractiveness.

Due to its large dimension zone 2 – Secondary CBD registers low figures (currently around 11.5%) but available space is considerable high (close to 120K sq m).



Vacancy rates are and will be linked to regain of take-up levels as restrain on pipeline volume is now clearly assumed by players.

Vacancy rates are expected to stabilize on the medium term as new built diminishes and take-up regains momentum along with economic performance.

Vacancy Rates (global) :

2009: 9.7% (+)
2010: 11.5% (+)
2011: 12.0% (+)
2012: 12.5% (+)
2013: 13.2%
20141S: 13.3%

"Vacancy rates rose in recent quarters in most zones but seem now more stable"

"Zone 5 Parque das nações managed to reduce its vacancy to below 10% at this point due to lack of new built and reduced rental levels"

"Zone 1 and 5 should be analysed over local market specific characteristics and dimension"

"On the medium term pressure on vacancy rates will stabilize as new built diminishes and take-up regains momentum"

Investment

2014 is already considered as the year of international investors return to Portugal, although that movement was already partially felt in 2S 2014 this year

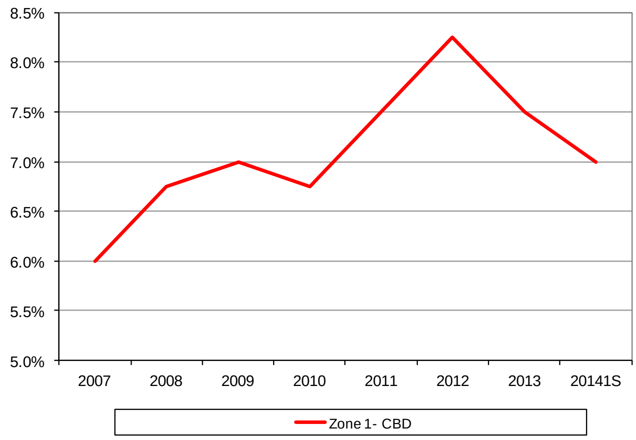
After a recent period where international investors were not particularly willing to invest in Portuguese property (due to the strong downgrading of Portuguese debt rating) investment market is experience a more dynamic approach on behalf of foreign investors. Recent wave of return of investors' focus to southern Europe seems to be now targeting Portugal seeking opportunity deals with long term sustainable returns. Return of liquidity to some of the funds (mostly foreign) may also lead to a more dynamic investment market.

Very recent rise in rating for the Portuguese republic and also some banks and major companies on behalf of Moody's enhance further appetite of foreign investors on Portuguese property mostly in central locations and first quality buildings. Agencies report more than 300 million euros in transactions in investment market in 2013, of which a significant part relates to office segment. However, due to risk avoidance potential demand is now even more focused on prime property on prime locations. Therefore, transactions are still scarce but noticeable stronger in number and volume than in recent past.

Recently EDP major electrical company headquarters was sold to an American fund GA capital and further deals seem to be on the way mainly on CBD and Parque das Nações. Most active (real and potential) buyers are German funds although Portuguese investment funds also account for a big part of deals.

Prime gross yields have already started to compress in recent quarters. Available data reports that prime gross yields now stands at around 7% after peaking at 8,25% (estimative) in 2012 for prime buildings in CBD.

Gross Prime Yields – Estimative (%)



In the periphery – out of town - perceived gross prime yields now normally imply a large premium of 2 to 3% relatively to CBD meaning that further differentiation is already occurring as forecasted and yields of 8.5% to 10% can be observed in non prime locations/buildings.

Prime Gross Yields Estimative:
2009: 7.0%
2010: 6.75%
2011: 7.5%
2012: 8.25%
2013YE : 7.5%

"Prime Gross yields managed to decrease in recent quarters in CBD".

" Some major deals brought back confidence and long term perspective"

"Globally, demand is still not meeting the supply asking prices but that can change with regain in confidence"

"Shortage of financing and liquidity is still globally felt, although some foreign players seem now more comfortable".

"On the medium term some opportunity deals may occur"

"Clean exit or cautionary program may lead to better market access leading to significant decrease of opportunity cost"

"Improvement of ratings is likely on the medium term. Some local banks have now favourable outlook by rating agencies".

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Appendix 1 – ZONE DEFINITION

Data Source: PREA based on LPI; INE, Bank of Portugal, and Min.Finance for Economics

Zone 1: CBD Central Business District
Zone 2: Secondary CBD
Zone 3: North Lisbon/Inner Circle
Zone 4: Historical Areas
Zone 5: Parque das Nações (former expo 98)
Zone:6: Western Corridor (out-of town)

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