Spain's Real Estate Market:
Like a Phoenix Rising from the Ashes

In the wake of the global financial crisis, Spain's economy got into troubled water, and so did its real estate industry when its domestic real estate bubble burst a short while later. What followed were years defined by recession and unemployment before the long hoped-for economic recovery started in 2014 and marked the turning point for the real estate market. The years since have seen business in the southern European country get back on track.

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Wüest Partner, January 2018

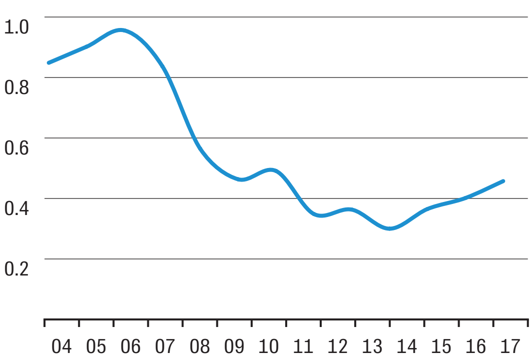
Although the economic recovery in the eurozone is gaining momentum across the board, the economy of this southernmost member of the monetary union is reporting particularly impressive growth rates. Spain's gross domestic product (GDP) rose by 3.1 percent year-on-year during the second quarter of 2017 – much faster than the eurozone average with its growth rate of 2.3 percent. The economic upturn is driven not just by a brisk growth in exports, but also by private consumer spending. This is made all the more important by the fact that the options for fiscal policy stimuli are limited: Spain's budget deficit has exceeded the debt ceiling of 3 percent that is spelled out in the EU Maastricht criteria every year since 2007, bringing the accumulated debt up to nearly 100 percent of the GDP, and thus far above the permissible threshold value of 60 percent.

The favourable economic performance has pushed down Spain's unemployment rate, reducing it to 17.2 percent. Nonetheless, the situation on the labour market remains strained, particularly with a view to the still high unemployment among the young. But leading indicators inspire optimism: The purchasing managers' indices for the manufacturing industry and services signal growth. The Bank of Spain therefore forecasts a GDP growth of 3.1 percent for 2017, and a 2.5 percent growth rate for 2018.

Homeownership Moving back Centre Stage

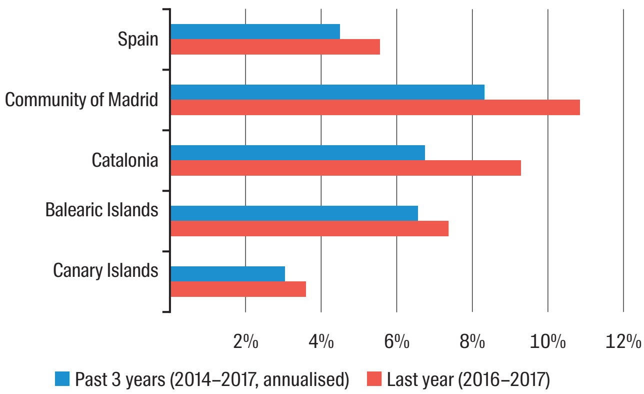
The budding optimism has improved the labour market situation, and both factors have combined with the affordable terms of financing to rekindle demand for residential real estate. For instance, transactions on the Spanish market for residential real estate have increased at an average rate of 15 percent per year after bottoming out in 2013 (Figure 1.0). Apace with growing demand, residential property prices have gone up at an annual average of 4.5 percent over the

1.0 **Number of transactions on the Spanish housing market**
(detached homes and multi-family dwelling in million)



Sources: Ministerio de Fomento; Wüest Partner

1.1 **Annual housing price growth**
(always as Q2)

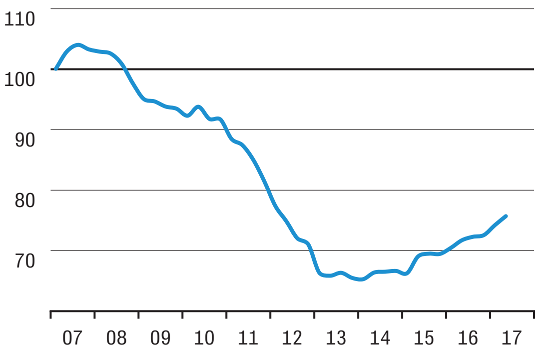


Sources: INE; Wüest Partner

past three years, with the trend picking up additional momentum last year (Figure 1.1). Sceptics have already voiced concern over the development, fearing another bubble. But while exercising caution is always a good idea, the situation seems to call for a differentiated look. One should remember that house prices in 2008, just before the Spanish real estate bubble burst, had ascended to a record level, only to be followed by years of drastic price reductions. Prices stabilised in 2013, however, they still show a 27-percent discount on their peak values (Figure 1.2).

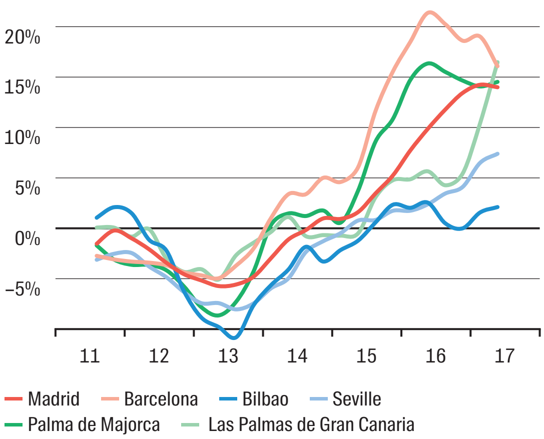
Neither does anything about the building activity to suggest that a bubble is forming. While the heavy equipment is back in action, the final throes of the excessive construction activity during the pre-crisis years are still palpable. Excess supply makes developers proceed with caution, and newly constructed buildings remain a scarce commodity as a result. At the same time, the financing situation has improved: A more prudent lending policy not only brought the volume of outstanding mortgage loans down to a quarter of its peak level before the crisis, but also brought up the share of fixed-interest mortgages from virtually 0 to almost 40 percent.

1.2 **Housing price index**
(index Q1 2007 =100)



Sources: INE; Wüest Partner

1.4 **Annual growth of asking rents**
(rolling annual mean, Q3 2011 through Q2 2017)



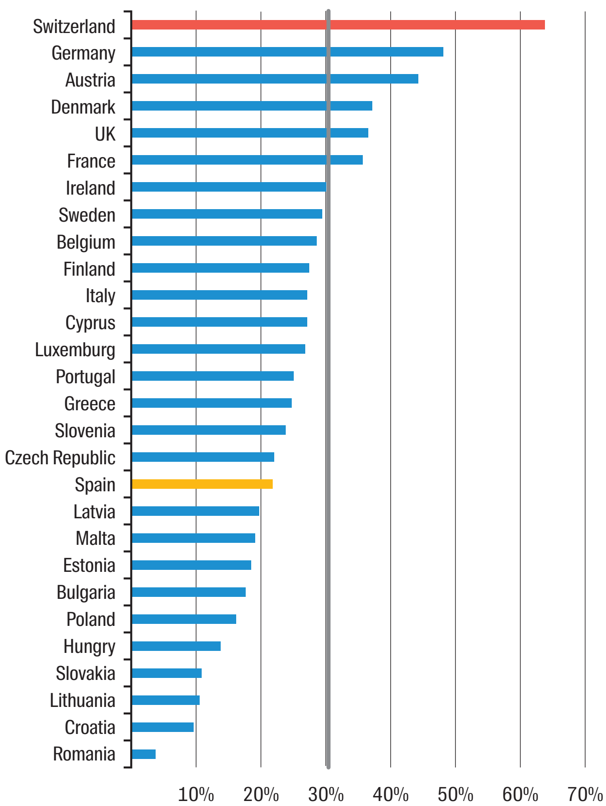
Quellen: Idealista; Wüest Partner

Rental Flats Gaining in Popularity

For real estate investors, Spain's housing segment did not use to present much of an investment universe because the Spanish are basically a people of homeowners. The tenant ratio in the Iberian kingdom equals 22 percent, which is well below the European average of 31 percent (Figure 1.3). Yet renting is now an up and coming trend, not least because for young people the traditional model of homeownership functions only to a limited extent anymore. Youth unemployment has rendered many of them financially unable to consider buying homes of their own. On top of that, the generation of millennials now growing up prefer a certain degree of flexibility and urbanity – prompting the gradual emergence of a rental market. Investors are well aware of the trend: The fast-growing presence of SOCIMIs, i.e. Spanish REITs, is likely to boost the segment's professionalism and liquidity in the short and long term.

This makes the outlook for investors quite auspicious. The conurbations of Madrid and Barcelona in particular are facing an excess demand for centrally located new housing, and the archipelagos of the Balearic Islands and the Canaries are hugely popular among foreign investors, making it reasonable to expect further rent growth in these places. In the cities of northern Spain, by contrast, the outlook is less bright (Figure 1.4).

1.3 **Tenant ratio compared to other EU member states**



Sources: Eurostat; Wüest Partner

Robust Momentum on the Office Market

The situation on the Spanish real estate market has also brightened for office accommodation, the cities of Madrid and Barcelona again taking the lead. As the national capital and seat of government, Madrid is home to many diplomatic missions and administrative institutions. The proximity to the body politic, the well developed infrastructure and a high quality of life attract companies from inside and outside Spain. Barcelona, in turn, benefits from a massive inflow of tourists whose propensity to consume is a boon for local business. With more than eight million tourists annually, the Mediterranean metropolis is one of Europe's four most-visited cities. As a result, local unemployment rates have traditionally undercut the national average (Figure 1.5).

The robust economic development has also breathed life back into the letting market. Demand for new high-quality accommodation coincides with a limited supply in both Madrid and Barcelona, and vacancy rates have declined as a result. In Madrid, the level dropped by 2.2 percentage points from its 2013 high-water mark, down to 11.1 percent by mid-2017. In Barcelona, the vacancy reduction progressed even faster, with vacancies dropping by 4.5 percentage points down to 11.0 percent (Figure 1.6). In either city, the construction activity has started to slowly gather momentum lately. However, the share in property developments without pre-lettings remains sub-average because the financing options in this sector are still relatively limited, as the painful memory of the real estate crisis lingers. Accordingly, the total office stock has barely increased in recent years.

Rent Growth is up to Speed

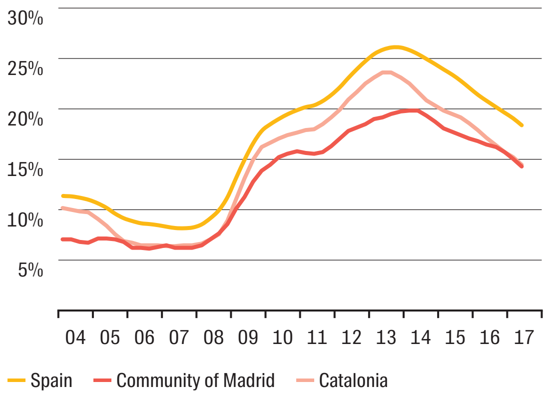
Due to the fast absorption of space, rents in both cities have been on the rise since 2014. By mid-2017, headline rents for prime locations in Madrid amounted to 357 euros per square metre and year, and 268 euros in Barcelona (Figure 1.7). This implies an annual rate of increase by 7.0 percent in Madrid, and by 8.2 percent in Barcelona. The recovery is in evidence everywhere – in central as well as in peripheral locations, and from the priciest to the most affordable segment.

While it is true that rents have been relatively quick to rise lately we ought to bear in mind that they started from a comparatively low level. During the crisis, owners of office real estate saw prices erode by up to 30 percent in Madrid and by 45 percent in Barcelona. The auspicious demand trend, which coincides with a limited supply, is likely to keep driving rent growth in the medium term.

Lively Investor Interest

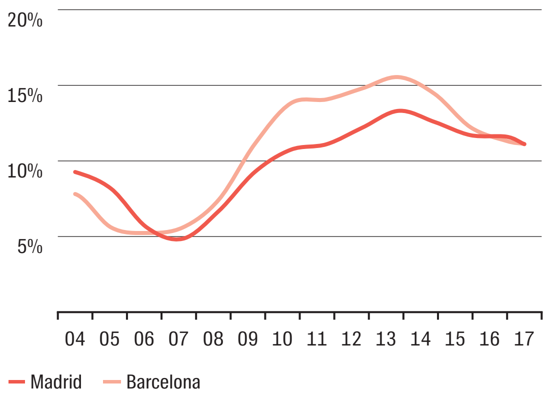
The steady improvement of the fundamentals in the years since 2014 has enhanced the appeal of the Spanish real estate market, and attracted a growing number of investors. The investment volume has thereby regained its pre-crisis level after years of slow transaction activity. In fact, 2015 marked a new record level, comparable to the year of 2007. Investors proved slightly less keen to invest in 2016, yet the dip in investment volume is most likely explained by the contracting supply on the market.

1.5 **Unemployment rate**



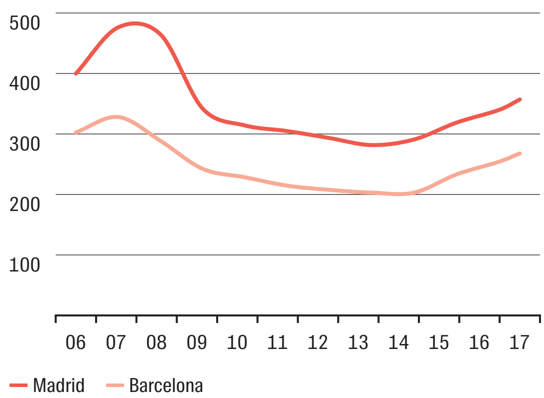
Sources: INE; Wüest Partner

1.6 **Vacant office accommodation**
(in percent of total stock)



Sources: Wüest Partner

1.7 **Prime office rents**
(in EUR per sqm and year)



Source: Wüest Partner

Meanwhile, initial yields have plummeted in the wake of the increase in market appeal, and are now on a very low level. While the average net initial yield in Barcelona still stood at 4.7 percent in late 2016, it was down to a mere 3.8 percent in Madrid (Figure 1.8). The end of the ultra-easy monetary policy in the eurozone is admittedly in sight, but interest rates will probably remain low for the time being. Given the keen investor interest, there is potential for further compression, but at least in the prime locations the already low level puts a limit on how much further yields can tighten.

The fast decline in yields and the brisk rent growth have delivered a tidy total return to real estate investors in recent years. At 16.3 percent, returns in 2015 actually broke the record of 2006, albeit by a narrow margin. Total returns in 2016, while not quite as high, were also fairly robust at 12.0 percent (Figure 1.9).

Buoyant Retail Trade

The economic upswing has plausibly made itself felt in the retail sector. Economic growth and the improved situation on the labour market have been driving up sales over the past few years. The beginning of 2017 saw a minor setback, as the elevated inflation rate negatively impacted the purchasing power of private households. Once the pace of the inflation slowed, though, sales recovered quickly.

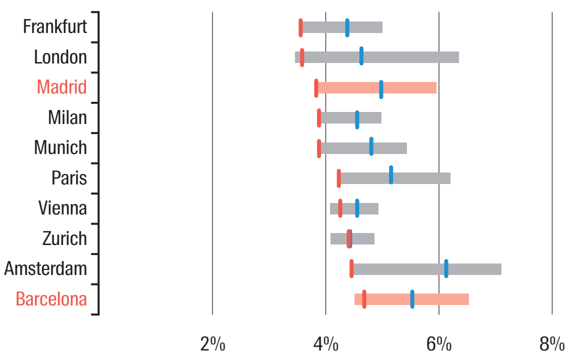
Demand for retail accomodation has concentrated mainly on established shopping centres and high footfall locations in the major cities of Madrid and Barcelona, and here it was reflected in surging rents. However, the widening footprint of online retailing presents a major challenge. Brick-and-mortar retailers have tried to buck the trend by stepping up their efforts to integrate an online approach into their in-store retail concepts.

Due to the economic upswing and the booming tourist sector, there is every reason to expect rents to keep rising, the short supply in floor space in inner cities alone suggesting as much. Investors have therefore not hesitated to venture even in the Spanish retail sector. The investment volume, half of it earmarked for shopping centres, was well above the average in recent years, putting prime yields under pressure.

Bright Outlook

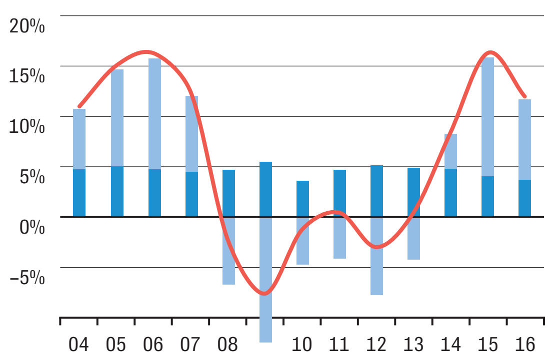
All things considered, the economic recovery spilled over into the real estate sector. Despite the risks that remain (persistently high unemployment, independence movement in Catalonia), the prospects on the Spanish real estate market are buoyed by the robust economic data. Thus, the Phoenix could arguably ascent to new heights from its ashes yet.

1.8 **Office buildings: synopsis of net initial yields**



Sources: MSCI; Wüest Partner

1.9 **Office buidings: total return in Spain**



Sources: MSCI; Wüest Partner

About Wüest Partner

We have been advising professional real estate companies and investors since 1985. While initially developing business exclusively in Switzerland, we have been expanding our in-depth expertise to international real estate markets for more than ten years. As independent and leading experts, we create the foundation for first-class decision-making. With a wide range of services consisting of data, consulting, valuation, applications and publications, we support our customers domestically and abroad. Our knowledge creates transparency and paves the way for your development in the global real estate industry.

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