

## CEE Property Investment

Full Year 2008

## Quick Stats

	Change from	
	2007	H1 2008
Investment volume	↓	↓
Number of deals	↓	↓

## Hot Topics

- € 9.5 billion was invested in institutional property in the CEE property market in 2008. This is 37% down from the 2007 figure, but 47% up on 2005 results.
- Banks will remain risk averse in the first half of 2009 and therefore trading anything but the best properties will be difficult.

## OVERVIEW

## • Property investment down, but higher than expected

In total, € 9.5 billion was invested in institutional property in the Central & Eastern European (CEE) property market in 2008. This is 37% down from the 2007 figure, but 47% up on 2005 results. The fourth quarter was extremely slow with a deal volume of around € 580 million. This low volume is a direct result of a combination of the impacts on overall investment turnover of (1) the temporary freeze of a number of German Open Ended Funds that were active earlier in 2008, (2) the limited lending that is taking place, and (3) unclear prospects on pricing.

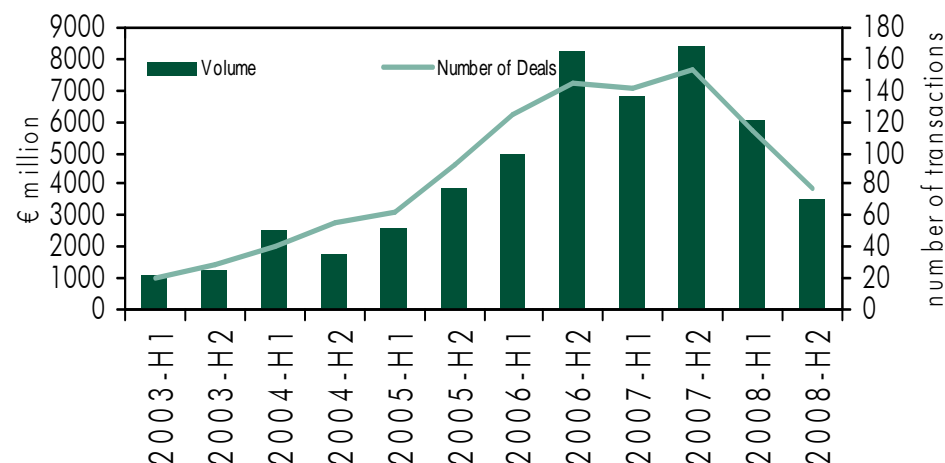
## • Equity will be key in 2009 - € 3.5 billion unleveraged equity waiting for CEE

As banks are likely to remain restrictive in their lending policies, equity will be key in 2009. Even though the amount of available capital in the market has declined sharply, there is equity available to invest in real estate. Based on a survey done among active, mainly opportunistic, investors across Europe, we calculated that more than € 3.5 billion of unleveraged equity is available to be invested in property across CEE, excluding German Open Ended Funds. In the record years of 2006 and 2007, there was approximately four to five times more equity targeting CEE than we see today. The current state of the market takes us back to 2005 market standards. The total size of the CEE investment market at that time was approximately € 6 billion. By 2006/2007 standards this looks small, but interestingly enough the market did not appear small at that time.

## • Banks are expected to remain restrictive in their lending policies in 2009

The main reason behind falling investment volumes has been banks' unwillingness and / or inability to lend money, which is entirely related to the global financial crisis. The number of banks financing property investments in CEE is limited and, as some of them are facing tight liquidity levels, the situation is not likely to change in the short term. Banks will remain risk averse in 2009 and therefore trading of anything but the best properties will be difficult. Equity is essential in concluding deals. Loan to value ratios (LTV) have fallen from 80/20 towards 50/50. A light at the end of the tunnel is that banks need to issue loans to support their shareholders' expectations. Therefore, they are likely to start lending to certain key clients again in the latter half of 2009, but will be restrictive on LTVs and will not finance speculative developments.

## Quarterly Property Investment Deal Volume and Number of Deals



Source: CB Richard Ellis

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## PROPERTY INVESTMENT DEAL FLOW

In total, € 9.5 billion was invested in institutional property in the CEE market in 2008. The most significant slowdown of investment volumes took place in Central Europe (CE). Meanwhile, investment in Southeastern Europe (SEE) remained relatively high and the volume in Eastern Europe (EE) was close to the level achieved in 2007. But this does not show that the activity slowed dramatically, especially in the fourth quarter of 2008, in both these sub-regions.

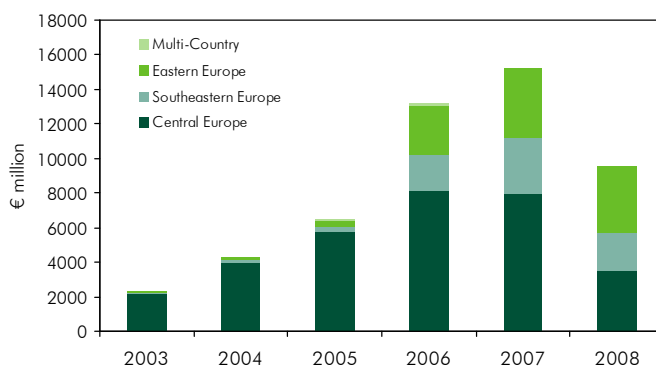
Most investment in CEE in 2008 was focused on capital cities, with some interesting changes per sub-region. In SEE, investors increasingly focused on the capital cities. This can be explained by the risk averse behaviour of banks and investors. On the other hand - despite the deteriorating outlook for Russia - an increased share of regional investments was registered as a result of increased activity in St. Petersburg.

Even though investment volume slowed in 2008, the average deal size remained similar to 2007. In EE the average transaction size declined from about € 120 million in 2007 to € 70 million in 2008, while the average deal size in SEE increased towards € 50 million in 2008.

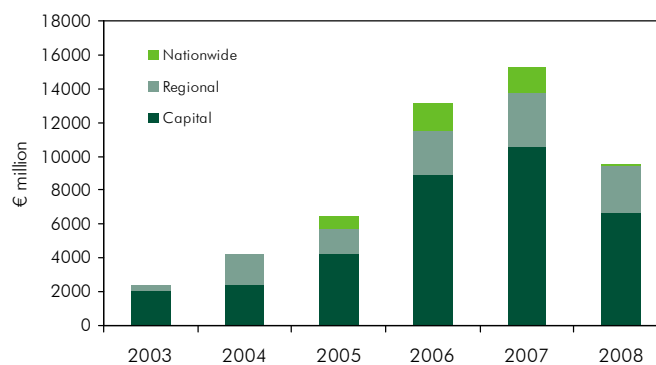
In 2008, offices attracted close to 50% of the total investment volume. This means that the office segment is the only segment that attracted significant investment in 2008 compared to previous years. Its total 2008 volume reached 80% of the record volume set in 2007. On the other hand, retail turnover decreased from 39% of all investment turnover in 2007 to 29% in 2008. This is surprising as retail is generally seen as a property sector that is relatively resilient in economic downturns. Most of this slowdown can be explained by the limited number of shopping centres sold, especially in Poland (Warsaw) and Hungary. Also, more complex mixed-use transactions slowed to a share of 4% of the total investment turnover, a direct result of the more challenging market conditions. After a strong inflow of capital in the industrial segment in recent years, the investment market for logistics space in 2008 received 7% of the total investment flow. The absolute decrease in volume expresses the challenging market conditions for the industrial segment, where yields are moving out quickly and rents remain under pressure.

The decline in investment volumes has been a direct result of the decreased activity of international investors (purchaser side). Cross border investors showed a decrease, not only in absolute terms, but also in relative terms. Despite the fact that the market remains dominated by international investors (84%), it is interesting to note that local investors remained a steady investor group in CEE.

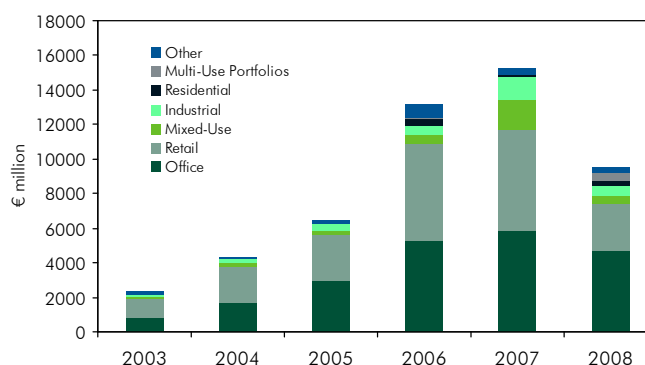
## Investment Volume by Sub-region



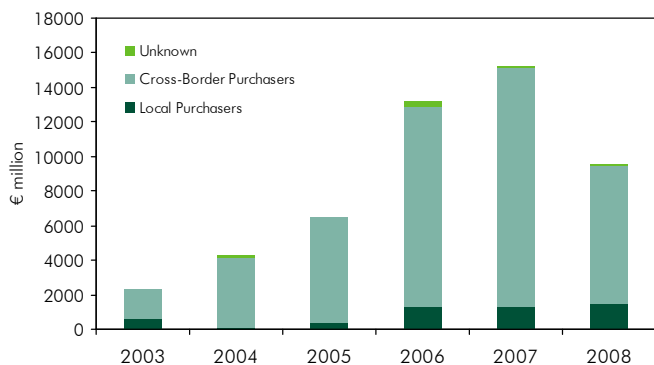
## Investment Volume by Location



## Investment by Property Sector



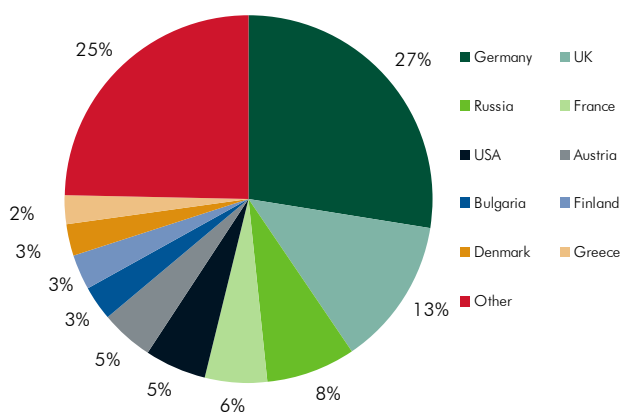
Cross-Border Investment Activity - Purchasers



Cross-Border Investment Activity - Vendors



Purchaser Activity by Nationality - 2008



Accordingly, local investors' market share increased from 8% in 2007 to 16% in 2008. In CE and SEE, cross border investment activity declined by roughly 50% in 2008. In some countries, including Bulgaria, Russia and Serbia, strong local buyers are active and have a significant impact on these markets.

In 2008, 6% of the total transaction volume was concluded through sale & leaseback transactions. In total, € 560 million was invested in 2008 through these transactions, compared to € 178 million for the whole of 2007. We expect the share of sale & leaseback transactions to remain at this higher level as an increasing number of occupiers will need to free up cash and remove real estate from their balance sheets.

As transaction volumes increased, the number of properties traded in, or as part of, portfolios increased strongly. In 2007 the total volume amounted to € 4.2 billion. This trend continued in the first half of 2008. The second half of 2008, however, showed a sharp decline. This shows that, as a result of more challenging conditions for obtaining financing, portfolios are less frequently traded.

As we pointed out earlier this year, more local owners are selling their properties. Currently the total proportion of local sellers amounts to almost half of the market. In comparison, most of the vendor market was dominated by foreign companies in 2003 (83%). The fact that local sellers are increasing their market share shows the impact of the growth of the local development market in recent years.

German investors (28%) head the list of top-10 investors by nationality in 2008. UK investors accounted for 13% of the total investment volume in 2008. The rest is divided among a large group of investor nationalities, with Russian, French and US investors being the largest in terms of volume.

The major sellers in 2008 were Russian companies with almost € 3 billion of sales, followed by companies from the UK, US, Greece and Belgium. Most of these sales were the result of developers selling their projects to an investor. Of the sales concluded by parties from the UK and the US, most were done by investors selling assets. In some cases this is caused by strategic disinvestment. In 2008 no significant forced sales took place on the open market. The listed sector accounts for 5% of the total sales; showing that forced sales have had a relatively limited impact on this sector thus far.

There were some interesting changes in investment nationality in 2008 compared to 2007. In the first three quarters of 2008, we registered a strong return of German funds to CEE markets. German investors

were the most active purchasers with a total of € 2.6 billion of direct real estate, compared to € 2.9 billion in 2007. What this figure does not show is that this amount was effectively achieved in the first three quarters of the year, as 14 German Open Ended Funds were closed for most of the fourth quarter. Despite this, Germans remained the most active investors in q4 2008, with four transactions in Central Europe.

The 'Top-10' investors list by volume in 2008 is headed by open-ended funds. KanAm Grund is at the top of the list, with a volume of close to € 1 billion. Degi was the second largest investor in the region with just over € 600 million, followed by RREEF with € 360 million.

**PRICING**

Based on the transaction evidence we have seen in the second half of 2008 – and especially in the fourth quarter of 2008 – it could be said that no one is willing to invest in property anymore. This is a misconception, however. While the number of active investors has decreased quite sharply, investors with deep pockets are waiting for the right moment to buy. Slowly but surely some distressed transactions are occurring and we believe this trend will continue in 2009. Not only standing investments are facing this issue, also recently closed forward purchases might face problems if the right funding structure is not in place.

The effects on pricing differ strongly by sub-region. The impact on yields in Central Europe has been relatively limited so far. Prime office yields in Central Europe moved out year-on-year (y-o-y) on a weighted average by 103 basis points (bps). The changes in Southeastern Europe (207 bps) and Eastern Europe (267 bps) were far more significant.

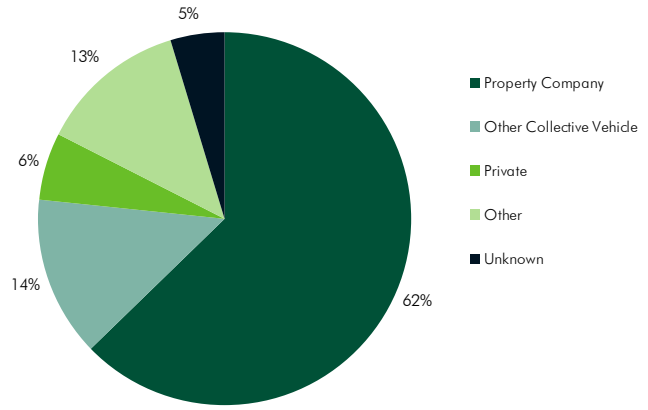
As prime yields are still below - but close to - their long-term average (since 1990) in some of the major Western European markets, further decompression of yields is to be expected.

As highly leveraged investors left the investment market, the question became: "Who will take their place?" We will discuss potential activity in 2009 by investor group.

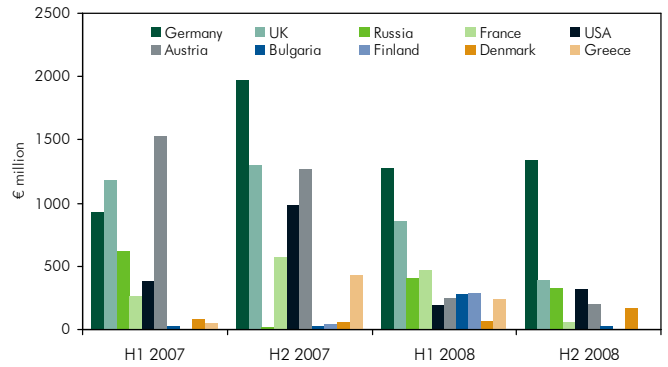
German Open Ended Funds (GOEFs)

GOEFs were the main driver of CEE investment volume in 2008. However, at the end of October, heavy outflows caused a number of funds to close. The trigger for the closures appears to be a combination of factors, all of which were outside the funds' control. The crisis surrounding major German banks, the freezing of the Pfandbrief market, the fall in the equity market and the German government's full guarantee of bank deposits in early October all contributed. In particular, it appears that many funds

**Vendor Activity by Investor Type - 2008**

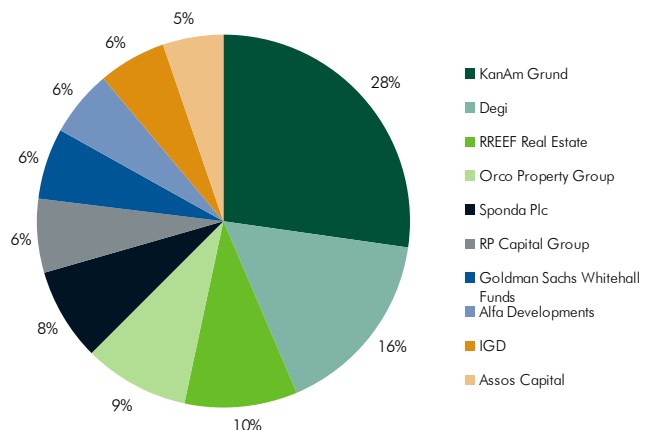


**Most Active Purchasers by Nationality 2007 v 2008**



**Top 10 Purchasers in CEE in 2008**

Total investment turnover = EUR 3.7 billion



KanAm Grund, Sponda Plc, RP Capital Group and Goldman Sachs Whitehall Funds were active only in Russia in 2008.

**(Changes) Capital Values and Prime Yields**

	Change Prime Yield Q4 07 – Q4 08 (bps)	Change Capital Value (€) Q4 07 – Q4 08 (%)	Prime Yield Q4 2008 (%)	
Belgrade	0	- 12.5	9.00	Office
Bratislava	115	- 17.0	6.75	
Bucharest	225	- 26.5	8.50	
Budapest	100	- 14.8	6.75	
Kyiv*	500	- 33.6	14.00	
Moscow*	250	- 14.2	10.00	
Prague	132	- 10.6	6.50	
Sofia	175	- 23.9	9.00	
Warsaw	85	- 21.4	6.25	
Zagreb	80	- 5.3	7.50	
Belgrade	0	0	12.00	Industrial
Bratislava	200	- 23.5	8.50	
Bucharest	n/a	n/a	9.00	
Budapest	125	- 15.6	8.00	
Kyiv*	500	- 39.9	16.00	
Moscow*	250	- 8.9	12.00	
Prague	154	- 16.1	7.75	
Sofia	125	8.6	9.50	
Warsaw	125	- 6.7	7.75	
Zagreb	175	- 21.3	8.75	
Belgrade	25	- 22.5	8.00	Shopping Centre
Bratislava	95	- 14.1	6.75	
Bucharest	100	- 6.3	8.00	
Budapest	100	- 14.8	6.75	
Kyiv*	550	n/a	15.00	
Moscow*	300	- 35.9	12.00	
Prague	130	- 19.3	6.75	
Sofia	125	1.1	8.50	
Warsaw	105	- 15.6	6.75	
Zagreb	185	- 13.4	7.75	

\* Partly as a result of exchange rate effect. Typical rents are priced in USD.

of funds have been forced to redeem their units in the GOEFs, either due to redemptions from their own investors or to rebalance their portfolios. The liquidity existing in the funds after the three- to six-month freeze period will determine activity of GOEFs in 2009. If liquidity levels are sufficient, they may become active again. If liquidity is below the threshold, these funds could be closed for another 12-24 months, depending on the fund. Some of the GOEFs, such as Deka, stayed open and remained active in CEE, until at least the time this report was written.

#### Sovereign Wealth Funds

The activity of sovereign wealth funds in CEE in commercial property has been limited so far. The funds have enormous potential, but are known as conservative and discretionary investors. Based on the most recent state of the markets in CEE, investments by sovereign wealth funds are more likely to take place in the more stable markets of Central Europe.

#### Listed Property Investors

Most listed property investors have seen a dramatic drop in their share prices. As a result these investors are facing problems in raising money. On the purchaser side, listed property investors are not expected to be the major drivers behind volumes they have been in recent years. In order to finance acquisitions, some redemptions could be made by certain investors.

#### Institutional Funds

More and more institutional funds are announcing that their returns have been hit by declining stock prices. As a result some of these funds have announced that pensions will not be indexed. Institutional funds might therefore decide to sell some real estate as the proportion of real estate in their portfolios increases as a result of declining alternative asset classes. They will probably not be as active in 2009 as they have been in previous years.

#### Private Investors

As the investment market in CEE has been very international up until now, the proportion of national private investors has been relatively limited. Now that international investors are scaling back their investments, private money in some Southeastern and Eastern European countries is increasing the market share of local investors in some countries.

## OUTLOOK

The structures of property investment markets around the world are changing as a result of the financial crisis. The years of highly leveraged investment deals have come to an end. The number of active investors has dropped quickly, but this does not mean that there are no investors around

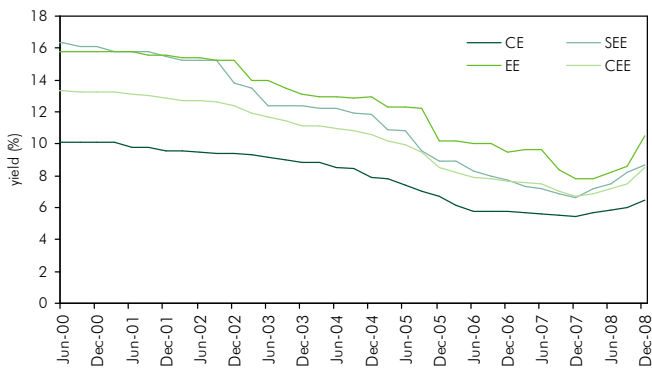
anymore. As banks are likely to remain restrictive in their lending policies, equity will be key in 2009. Even though the amount of available capital in the market has declined sharply, there is equity available to invest in real estate. In the record years of 2006 and 2007, there was approximately five times more equity targeting CEE than we see today. This takes us back to market standards in 2005. The total size of the CEE investment market at that time was approximately € 6 billion. By 2006/2007 standards this looks small, but interestingly enough the market did not appear small at that time. Moreover, the figure for 2009 does not take into account that some of the most active buyers in 2008 – the German Open Ended Funds – might return to the market in 2009.

One difference between the market in 2005 compared to current market conditions is that the development market was much smaller in 2005. If all office and retail projects under construction are delivered as planned in 2009, real estate with a potential value of around € 3 billion will come onto the market. This is likely to have a stimulus effect on investment volume. In addition to this “developer to investor market”, it is likely that the “investor to investor market” will be picking up too. Even though no significant forced sales took place on the open market in 2008, we may see more product being forced onto the market in 2009. Banks will probably be first in line when these distressed sales begin taking place.

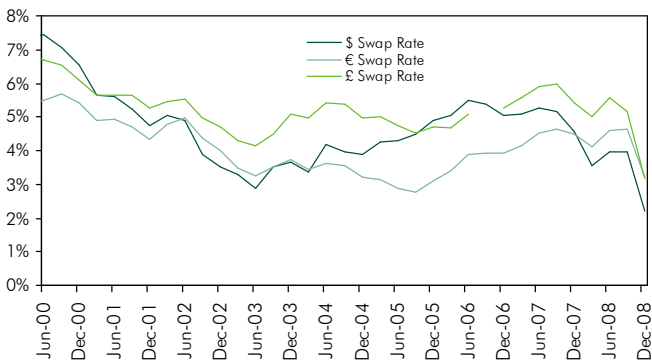
As prime yields are still below - but close to - their long-term average (since 1990) in some of the major Western European markets, further decompression of yields remains realistic. Investors with equity are applying and will apply stock picking, but they cannot wait too long. Property markets are not equity markets, and prime products can be sold to another party if the decision process takes too long. The price correction that is currently under way in property worldwide will offer chances for investors, and also in CEE. For equity investors who are currently preparing a market comeback, markets will present opportunities in 2009. Now that repricing is under way, we expect pan-European investors to start looking at CEE again.

- Driven by heavy losses in all three regions, the Global Real Estate Index was hit hard (-45.1%) in 2008 (year through November). North American listed real estate (-40.8%) “outperformed” European (-47.7%) and Asian listed real estate (-47.8%).
- The average annual return of European listed real estate equities over the past five years stands at -0.5%. These results suggest that bonds, listed real estate in Asia as well as global equities outperformed European listed real estate equities, but they outperformed North American real estate equities.

Central & Eastern European Weighted Average Prime Yield Offices



Costs of Borrowing - 5-Year Swap Rates for Euro, Dollar and Sterling



Global Real Estate Performance

	2008 Year Through November	5 Year Return	Annual Average Return
Global Listed RE Equities	-45.1%	-0.5%	-0.1%
Global Equities	-35.3%	0.6%	0.1%
Global Bonds	7.9%	26%	4.7%
European Listed RE Equities	-47.7%	-2.7%	-0.5%
North American Listed RE Equities	-40.8%	-12.1%	-2.6%
Asian Listed RE Equities	-47.8%	20.2%	3.7%

Sources: EPRA, FTSE, JP Morgan (November 2008)



## CEE COUNTRY BRIEFING

The **Bulgarian** real estate investment market slowed in H2 2008 after a strong performance in H1 2008 to €816 million. Bulgaria's 2008 volume was down only 11% from 2007's volume; however, H2 2008's volume was down 73% from H1 2008. Of note, Bulgarian sellers outsold foreign sellers in both H1 and H2 of 2008. Substantial office and retail pipelines should provide a stimulus to investment in the next few years – most of this office space will be located in Sofia, while the majority of retail space will be in regional cities. Alfa Development's purchase of a 23-property multi-use portfolio for €210 million was the largest transaction of the year.

**Croatia** recorded no investment transactions in H2 2008. This shows how the financial crisis can influence a small investment market's deal flow. Because of a relatively strong H1 2008, total investment volume for 2008 came to €109 million, which is 39% down on 2007's total volume. The purchase of Zagreb Business Park logistics facility by Helios accounted for €68 million of this, while the sale of two office buildings in Zagreb made up the rest of 2008's volume. Despite the slowdown in H2 2008, Croatia has a strong development market that will likely drive investment volume in the next few years.

Investment volume in the **Czech Republic** fell in 2008 by about 60% y-o-y to €1.032 billion over 21 transactions. Despite this slowdown, the country's H2 2008 investment volume was slightly higher than H1 2008's volume. Investors continue to see high quality office buildings in Prague as a strong investment. In 2008, 67% of total investment in the Czech Republic flowed to office properties in Prague. German investors remained active, with a total of €495 million in investment volume. This includes Degi's purchase of Prague's The Park office complex in H2 2008.

Investment activity in **Hungary** picked up in H2 2008, reaching €259 million in 8 deals, compared to €153 million in 5 deals in H1 2008. Still, Hungary's investment market was illiquid on the whole in 2008. Total volume for 2008 was down by 79% on 2007's record total. This can partially be explained by the fact that the Hungarian investment market was driven by forward purchases in recent years. Budapest still dominates the Hungarian investment market, with 78% of the year's volume flowing to Budapest. The purchase of Bank Center in Budapest by GLL and Allianz was the largest investment transaction in Hungary in 2008 with €120 million.

Property investment in **Poland** reached almost €2 billion in 52 investment deals in 2008 and remained relatively liquid. This was 36% lower than 2007's total volume, a lesser decline than in most of Poland's neighbours. Overall investment in Warsaw actually increased in H2 2008 vis-à-vis H1 2008,

reflecting its perception as a location where values will hold stronger than in some other cities or countries in the region. Investment in regional cities fell substantially, though, reflecting investors' current perceptions of risk. The most active investors by volume in Poland in 2008 were Deka, Baltic Property Trust, Degi and MacQuarie.

**Romania** saw a significant slowdown in investment activity in H2 2008. After a robust H1 2008, only two deals worth €89 million were traded in H2 2008. For the year, total volume of €1.020 billion was down by 39% on 2007's volume. Continuing a trend from 2006-2007, the majority of all investment volume in 2008 was for properties in the retail sector. Volume traded in 2008 included Romania's single largest investment transaction – RREEF's purchase of the Upground office and residential development for €340 million.

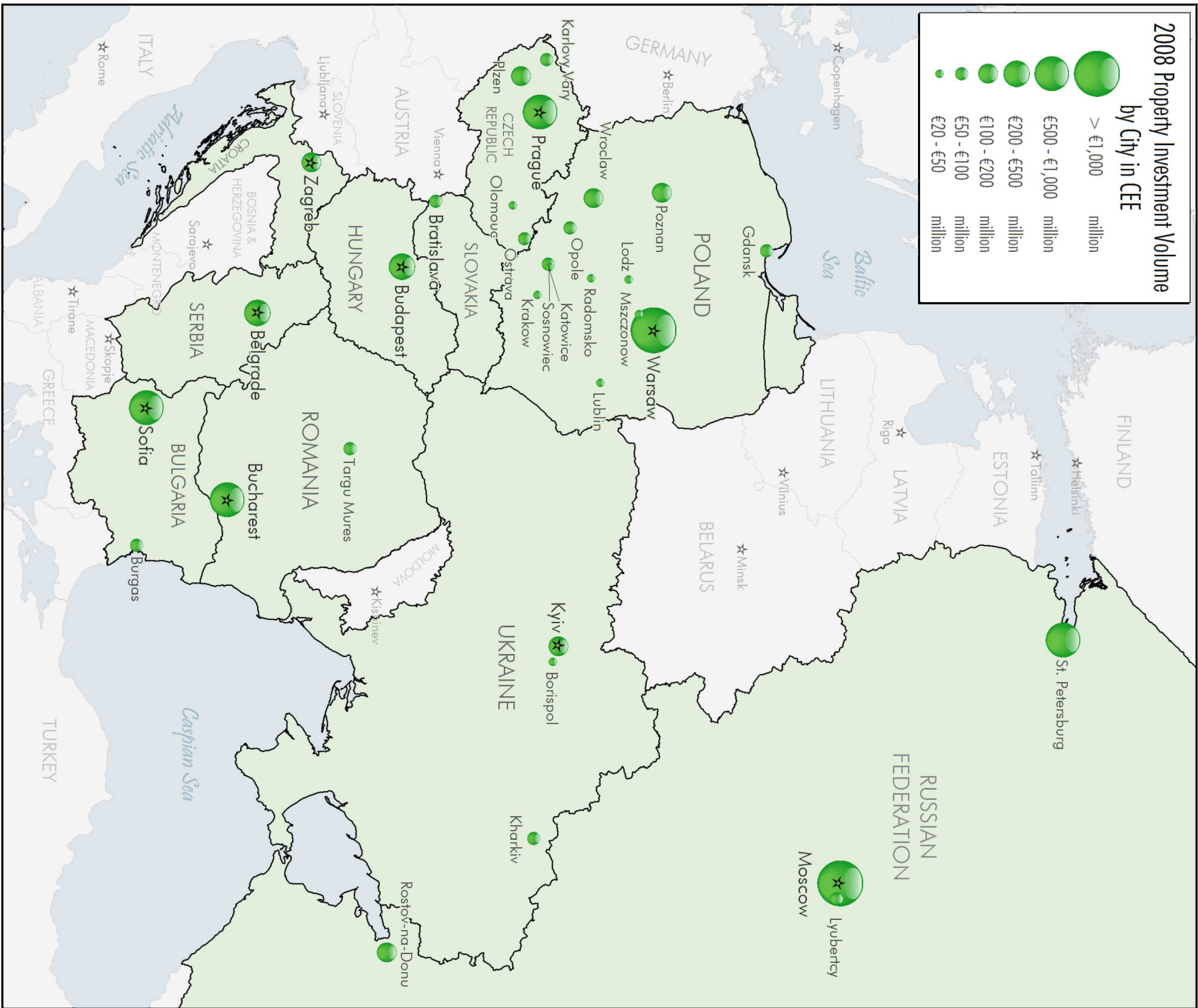
Compared to other CEE countries, **Russia's** property investment volume remained high in 2008. The year saw a total of 44 property transactions worth €3.5 billion. This total amounts to a 3% decline from 2007's volume, the smallest annual decline of any CEE country. However, volume declined by 35% in H2 2008 vis-à-vis the first half of the year. 2008 also marked the second consecutive year in which Russia was the largest CEE country by destination for investment volume. H2 2008 saw a greater proportion – more than 1/3 – of investment volume flowing to regional cities, especially St. Petersburg.

**Serbia's** investment market stagnated in H2 2008 after a strong performance in H1 2008. For the year, there were six deals worth €223 million, but only one deal worth €1.5 million was concluded in H2 2008. For the year, investment volume was down 57% from 2007's record result. Serbia differs from other CEE countries in that much of its investment volume comes from the state's sale of assets – for example, in 2008, 73% of total volume was for properties sold by the state.

The performance of **Slovakia's** investment market in 2008 reflected the market's illiquidity. For the year, volume reached €66 million in six deals, two of which worth €15 million occurred in H2 2008. Volume for all of 2008 fell by 78% from 2007. Bratislava especially has relatively substantial office and shopping centre pipelines under development by Central European capital city standards, which most likely will make the market more liquid in the near future.

Total property investment in **Ukraine** for 2008 reached €333 million in 12 transactions. This was a 15% decline from the total in 2007. This does not show that the total volume dried up in Q4 2008, however. Prime yields jumped substantially in Q4 2008 in every property sector due to economic and political turbulence. For 2009, we expect a very difficult investment environment in Ukraine. Page 7

Liquidity



## Top 3 Recommendations

### Purchasers

#### 1. Focus on prime, secondary to face challenging future

The limited number of buyers active in the market will focus on prime product only. Some of these buyers will focus only on trophy assets. These buyers are not in a hurry to spend as most of them have an investment span of 2-3 years. These opportunistic investors believe that yields will recover to a certain extent after a period of further outward movement. As soon as the price level for prime properties is set, it will become clear where pricing for secondary property is. Before this, the risks involved in investing in secondary property are perceived to be high, with limited upside potential.

#### 2. Focus on income producing properties

Even though occupier markets in CEE are still performing relatively well, it is clear that occupier markets are changing. As it is uncertain what the effect of slowing economies will be on Business Process Outsourcing (BPO) – one of the main drivers behind office take-up in CEE – investors should focus on buildings that have strong occupancy, a strong tenant base and relatively long contracts. Asset management will become more important in retaining clients, but less important in increasing value.

### Vendors

#### 3. Timing of sales important factor in optimising returns

Investors willing - or needing - to sell should be realistic in terms of pricing. As yields move out the market is changing quickly. Currently the market is relatively static, as most buyers' and vendors' expectations are not aligned. For now occupier markets are keeping up relatively well and the number of sellers is limited, which means that the effect on pricing is less severe than it potentially could be in certain segments of the market. Therefore, timing will be decisive in optimising returns.

## Methodology Definitions

**Property Investment**, all property transactions that are the result of a legally binding document between a purchaser and a vendor. All deals are recorded that CB Richard Ellis is aware of, both on the open market as well as off market deals. We include Sale & Leaseback transactions, but exclude corporate transactions in which real estate is only (a necessary) part of the transaction of the total business. Owner occupier transactions are also excluded. Forward purchases are taken into account in the year the binding purchase agreement is signed. The nationality of the purchaser is determined by the country where the money originates.

**Central and Eastern Europe (CEE)**, which includes the following countries: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Russia, Serbia, Slovakia and Ukraine.

**Central Europe (CE)**, which includes Czech Republic, Hungary, Poland and Slovakia.

**Southeastern Europe (SEE)**, which includes Bulgaria, Croatia, Romania and Serbia.

**Eastern Europe (EE)**, which includes Russia and Ukraine.

All yields mentioned in this publication are **Prime Net Initial Yields**. A net yield is derived from the net rental income (after deducting all non-recoverable expenditures) divided by total purchase costs (including price, costs and taxes). The prime yield represents the yield that an investor would receive when acquiring a grade/class A building in a prime location (for offices in the CBD, for example), which is fully let at current market value rents. Prime Yield should reflect the level at which relevant transactions are being completed in the market at the time but need not be exactly identical to any of them, particularly if deal flow is very limited or made up of unusual one-off deals. If there are no relevant transactions during the survey period, a hypothetical yield should be quoted, and is not a calculation based on particular transactions, but it is an expert opinion formed in light of market conditions, but the same criteria on building location and specification still apply.

**Prime Capital Values**, this indicator represents the hypothetical value of a square meter of prime space that is let at its full rental value. It is calculated directly from the (annual) prime rent and the prime yield – based on the definitions mentioned above.

**Currency effects**, the rents and capital values in Russia and Ukraine are based on indices denominated in US Dollars (USD) and are therefore influenced by exchange rate effects.

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