

Quick Stats

	Change from	
	2007	H1 2008
Take-up	↗	↘
Vacancy Rate	↑	↑

Hot Topics

- CEE office markets continued to perform strongly in 2008 despite worsening economic conditions.
- Demand remained strong, with CEE establishing a record for take-up in 2008. Despite this, CEE markets could not completely absorb a record amount of development completions across CEE, leading to higher vacancy rates in many markets.
- How CEE office markets perform in the near term will depend to a large extent on individual markets' positioning in terms of continued economic growth, vacancy rate and size of pipeline.

OVERVIEW

• CEE office occupier markets remained strong in 2008

On the whole, CEE office markets continued to perform strongly in 2008 despite deteriorating economic conditions in the region. In fact, CEE set a new record for take-up in 2008. Despite strong demand, CEE office markets could not completely absorb record amounts of office space delivered to markets in 2008, causing vacancy to rise in many markets. Rents in Central Europe (CE) and Southeastern Europe (SEE) remained relatively stable in the second half of 2008. After strong increases in H1 2008, rents in Eastern Europe (EE) fell in H2 2008 due to rapidly deteriorating market fundamentals as well as strong exchange rate fluctuations.

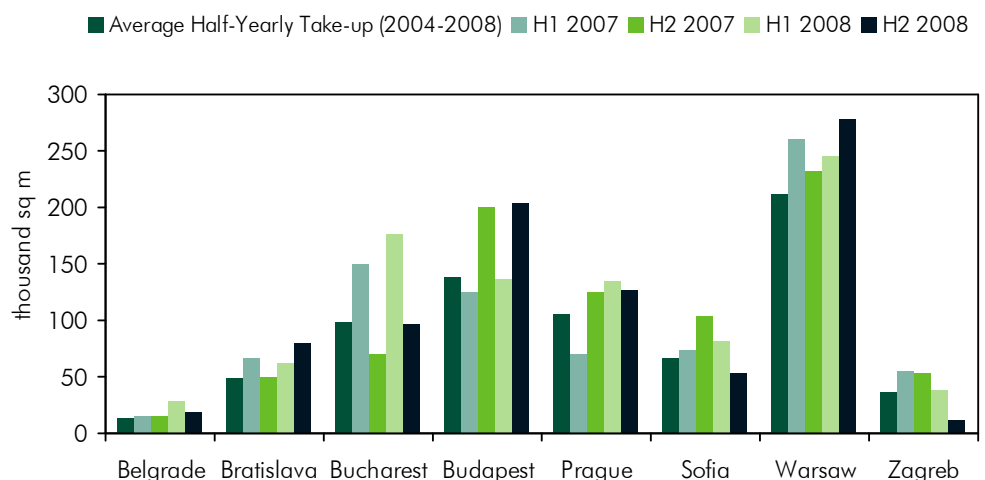
• Economic conditions deteriorating in CEE, with Central Europe more resilient

CEE economies ran into increasingly stiff headwinds as 2008 progressed. The financial services sector was affected by the worldwide credit crisis and manufacturing sectors (especially automotive) had to deal with lower demand, both domestically and from key trading partners. Additionally, Foreign Direct Investment (FDI) declined steeply across the region, limited (consumer) lending is taking place and construction sectors have slowed. Meanwhile, the credit crisis has driven the EU-15 into a recession. Most CEE countries are strongly linked to the EU-15 in terms of their trade balances, so this has led to lower growth forecasts for many CEE countries and might cause recessions in some CEE countries in 2009. Stronger growth, however, is forecast to resume in most CEE countries in 2010.

• CEE office markets' performance to diverge

How CEE office markets perform in the near term will depend to a large extent on their positioning. Markets in Central Europe, such as Warsaw and Prague, with continued economic growth, limited vacancy rates and reasonable pipelines will outperform most other markets in the region. Meanwhile, property markets in countries with weaker economies or with economies more easily influenced by external factors, such as Russia and Ukraine, are likely to become more volatile in the short- to medium-term.

CEE Office Take-up – 2007 to 2008



Source: CB Richard Ellis

This report focuses on the capital city office markets in CEE, as monitored by CB Richard Ellis offices in the region. Specifically, this report looks at Belgrade, Bratislava, Bucharest, Budapest, Kyiv, Moscow, Prague, Sofia, Warsaw and Zagreb.

Stock & Completions

Modern office stock in CEE capital cities (excluding Kyiv) grew by 20% year-on-year (y-o-y) in 2008 to 21.3 million sq m. This marks the largest y-o-y increase to overall CEE office stock since at least 2000. This strong growth underscores the extent to which foreign investment created a surge in office development in recent years. Moscow recorded 1.75 million sq m of new office space in 2008, almost one-half of all space that arrived to CEE markets in 2008. Not all markets registered such a significant increase. Zagreb (+8%) and Warsaw (+10%) were the CEE markets that recorded the most limited growth to office stock in 2008.

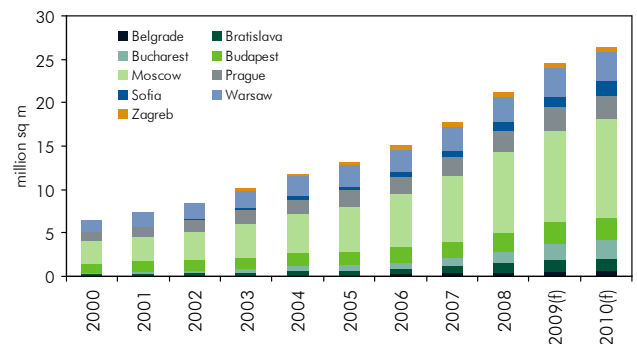
Demand

Demand for office space in CEE remained resilient in 2008. In fact, CEE set a new record for take-up in one year. Several markets, including Warsaw and Bucharest, set new records in 2008, showing the strong interest for office space in the CEE region. In 2008, most historic drivers of take-up held up well; for example, take-up by firms in the financial services sector increased from 19% in H1 2008 to 22% in H2 2008 of total CEE take-up.

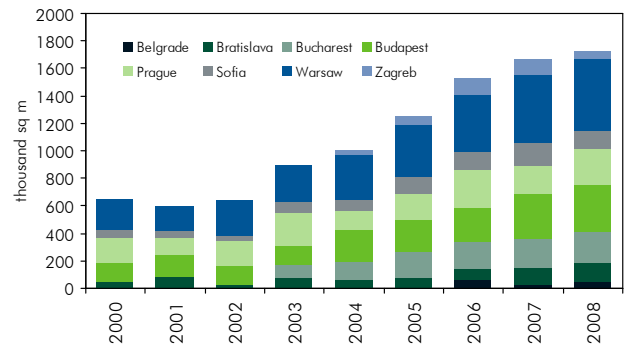
Despite strong demand, net absorption did not keep up with the record amount of completions in 2008. Moscow in particular recorded strong negative absorption, despite strong demand of almost 1.8 million sq m in 2008. Outside of Moscow, net absorption in CEE capital cities totalled about 10% less than the level of development completions for 2008 as a whole, resulting in increasing vacancy.

The balance of supply versus demand in CEE can no longer be easily summarised. Most CEE office markets were supply driven through early 2008. In recent months, however, occupiers have gained power in markets such as Moscow and Budapest, while in other markets conditions remain more favourable to investors. The key question is whether demand will hold up in 2009 under increased economic pressure. Strong take-up figures in 2008 reflect decisions that were largely made prior to the onset of severe economic troubles. One effect of the economic slowdown is that occupiers are reviewing cost structures. The medium-term perspective is that foreign (US and European) corporations will relocate (parts of) their operations to CEE to cut costs. It remains to be seen if this trend can compensate for the overall slowdown in demand.

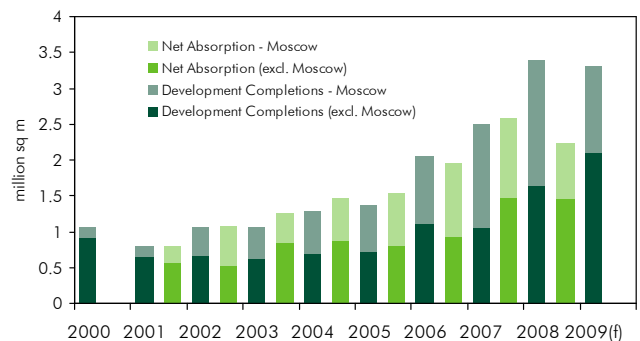
CEE Office Stock



CEE Office Take-Up (Excl. Moscow & Kyiv)

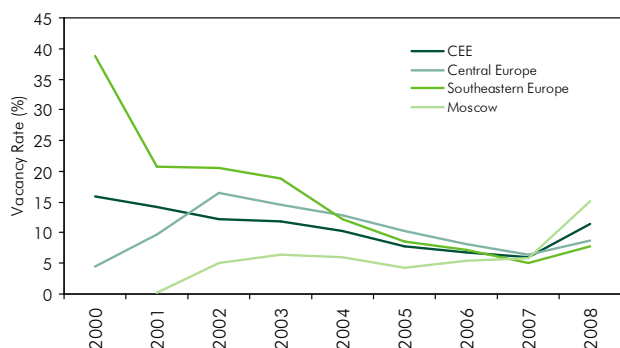


Development Completions v Net Absorption**

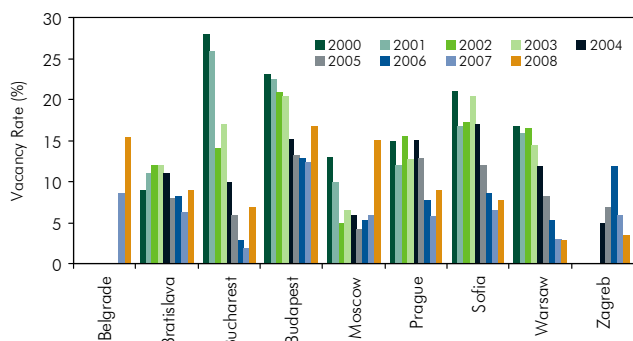


** Net Absorption relates to ((occupied stock t+1) - (occupied stock t=0))

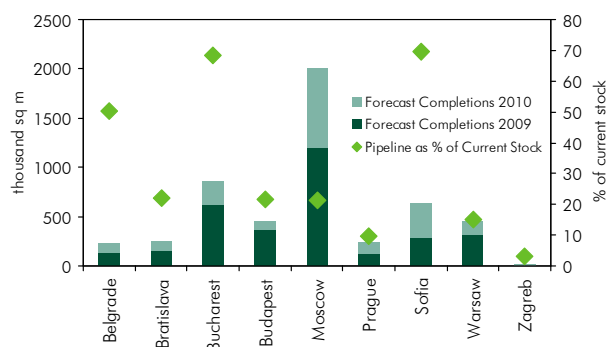
CEE Vacancy Rates by Sub-Region



CEE Office Vacancy Rate by Market



Projected Office Completions (Under Construction) Through 2010



Vacancy

The overall CEE vacancy rate increased significantly in 2008 from 6.0% to 11.3% as a direct result of the strong increase in development completions. The vacancy rate for CE and SEE capital cities is substantially lower, at around 8.5%. Most of these markets are just above their natural vacancy rates. The level of this available supply is likely to put downward pressure on rents in the short term. Depending on how the demand side of the market unfolds in H1 2009, it will become apparent which markets will maintain strong fundamentals and which markets are becoming more favourable to occupiers.

Vacancy rates increased in 2008 in most of CEE's capital cities. Moscow's vacancy rate increased the most, moving from 5.9% to 15.1%. In Prague, Bucharest, Budapest, Belgrade and Bratislava vacancy rates also increased rapidly. Especially in the smaller markets this is likely to put pressure on rents, while in some of the larger markets in CE, future supply might dry up now that the lack of development financing is putting a brake on pipelines and if take-up remains strong. Meanwhile, vacancy rates fell in Warsaw and Zagreb.

Future Supply

Belgrade, Bucharest and Sofia continue to have substantial office pipelines relative to the size of their office markets. These markets are likely to enter a new property cycle in the foreseeable future. The combination of pressure on rents and the need for corporations to focus on costs could result in an extra reason to outsource business to CEE and help keep leasing markets active here. Meanwhile, other CEE cities, including Warsaw and Prague, have reasonable pipelines vis-à-vis current stocks. Across CEE, most office space arriving in 2009 and 2010 is to be delivered outside the prime locations in city centres. In Budapest, Prague, Sofia and Warsaw, about only 23% of it is located in central submarkets, showing that market conditions can differ strongly within cities.

Developers' and investors' willingness and ability to undertake new office projects have clearly been affected by illiquid market conditions. CEE will still welcome a substantial amount of new office space in 2009. Construction on much of this space began before the economy slowed down. With lower economic growth possibly causing important drivers of take-up to fall away, markets with significant confirmed pipelines face the possibility of supply/demand imbalances occurring in the short-to medium-term. As lending dried up and economic forecasts deteriorated over the course of 2008, mainly office projects were postponed or cancelled, especially those that were in the initial planning phases. The impact on future supply in 2010 is clearly visible.

This moment in time marks a turning point after years of continuous growth in CEE. The number of projects that are under construction and being cancelled has been limited thus far.

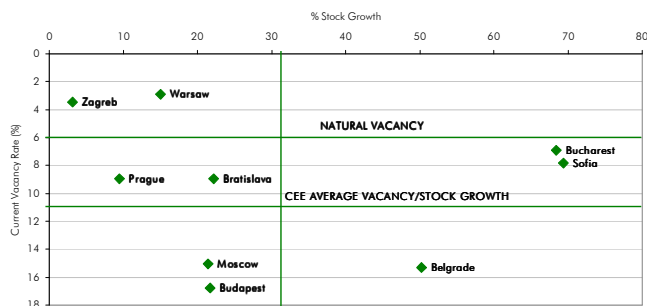
Rents

Prime rent levels increased in H1 2008 in certain CEE markets such as Warsaw, Prague, Moscow and Kyiv. Later in 2008, however, high levels of completions and economic difficulties removed upward pressure on rents. This meant that rental growth in the region for 2008 as a whole was minimal. Some markets saw corrections to prime rents in q4 2008 to more sustainable levels after climbing substantially in q1-q3 2008 (e.g., Warsaw, Kyiv and Moscow). Prague and Zagreb recorded higher y-o-y growth, while prime rents fell y-o-y in Belgrade and Sofia. Depending on demand, net effective rents are likely to come under pressure in 2009 as occupiers are offered increased incentives and fit-out costs, especially in largely vacant buildings in non-central locations.

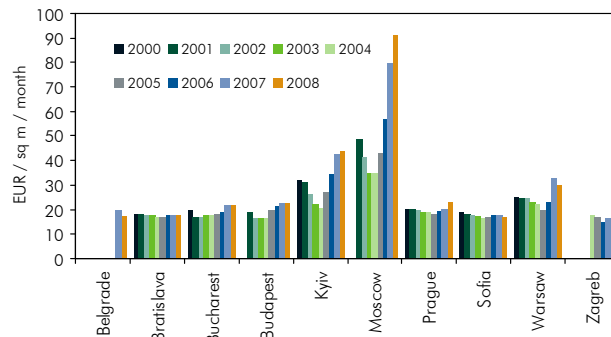
Outlooks

- **CEE Economies** have begun to feel the effects of the credit crisis and economic slowdown, leading to reduced growth forecasts and possible recessions in some CEE countries in 2009, including Hungary and Ukraine. Stronger growth is forecast in 2010 in most countries, however.
- **Development Completions** will remain high in 2009 as buildings already under construction are completed, but will fall in 2010 as developers and investors struggle to finance projects and recognise the more challenging market conditions. Some SEE countries have substantial pipelines relative to the size of their markets. Market fundamentals in Poland and the Czech Republic are stable, with Hungary and Slovakia being more vulnerable.
- Despite strong take-up in 2008, **Demand** is likely to fall in 2009 from current highs as occupiers process the effects of the current economic situation on their businesses and postpone expansion and relocation plans. Outsourcing is expected to soften the landing for some of the markets, but this will most likely take effect in H2 2009/2010.
- **Vacancy Rate** movement will depend strongly on the market in question. In markets with strong economies, lower vacancy rates and reasonable pipelines, vacancy rates will remain below or close to friction levels. Some markets have reached vacancy rates that are at levels potentially of concern and future movement hinges largely on demand. Markets with substantial pipelines are likely to struggle to absorb this space.
- With the exception of core Central European markets, **Prime Rents** are likely to come under pressure across CEE. The gap between effective rents for prime and secondary properties is likely to increase as tenants are offered increased incentives, especially for long-term vacant space. In markets where the gap between the two becomes too large, prime properties will face downward pressure too.

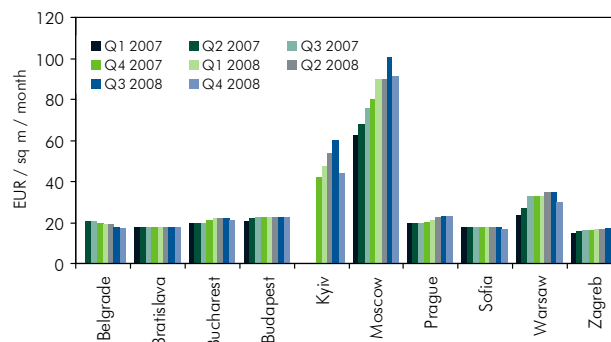
CEE Office Pipelines v Current Vacancy Rates



CEE Prime Rents by Year



CEE Prime Rents by Quarter



Top Recommendations

Investors

Monitor competition carefully

As take-up is likely to slow in H1 2009 and the amount of development completions stays high, occupiers will gain power in most of the office markets across CEE. Therefore, effective rents will come under pressure, especially in speculatively built offices in non-central locations. Even though competition will be limited in the short term for prime office buildings, corporations are analysing cost structures carefully with potential relocations as a result. Careful monitoring of competition will be key in 2009.

Developers

Look for development potential in core Central European cities

As a direct result of limited lending that is taking place, some of the markets in Central Europe might face supply drying up over the next one to two years. This will open up possibilities for equity backed developers / investors especially now that land prices are coming under pressure. As development potential is limited in the core areas of Prague and Warsaw, and vacancy is likely to increase in non-central locations, developers / investors need to apply a careful site selection policy.

Methodology Definitions

Prime Rent – Represents the top open-market tier of rent that could be expected for a unit of standard size commensurate with demand in each location, of the highest quality and specification and in the best location in a market at the survey date. The Prime Rent 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, the quoted figure will be more hypothetical, based on expert opinion of market conditions, but the same criteria on building size and specification will still apply. For offices, the Prime Rent should represent the typical “achievable” open market headline rent that a blue chip occupier would be expected to pay for:

- An office unit of standard size commensurate with demand in each location, typically 1,000 sq m (10,000 sq ft)
- An office unit of the highest quality and specification
- An office unit within the prime location (CBD, for example) of a market.

It is assumed that the occupier will also agree to a package of incentives that is typical for the market at the time.

Take-up – Represents the total net floor space known to have been let or pre-let, sold or pre-sold to tenants or owner-occupiers during the survey period. A property is deemed to be taken-up only when contracts are signed or a binding agreement exists. Pre-let refers to take-up that was signed either in the planning or construction phase.

Net Absorption – Represents the change in occupied stock within a market during a survey period.

Vacant Space Rate – Represents the percentage ratio of total Vacant Space to Stock, using the calculation Vacant Vacancy/Stock X 100. Rate is always expressed as a percentage figure.

Natural Vacancy Rate – Represents the generally accepted vacancy rate at which occupiers can move into/within an office market without putting significant upward/downward pressure on rents.

Total Stock – Represents the total completed space (occupied and vacant) in the private and public sector at the survey date. Includes owner occupied (OO) space except for Hungary and Serbia.

Space Under Construction – Represents the total amount of net rentable area of properties where construction has commenced on a new development or in existing properties where a major refurbishment/renovation (stripped back to shell and core) and is ongoing at the survey date.

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

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