

# Prague Offices

FIRST QUARTER 2008

## ECONOMIC OVERVIEW

The Czech economy performed well in Q4 2007 with real GDP growing by 6.6% y-o-y. In total for 2007, output increased by 6.5% on average, which is 3.9 p.p. higher than the western European level (EU15). With regards to the structure of the GDP from the demand side, the main drivers in Q4 2007 were gross capital formation accelerating to 8.0% growth y-o-y (2.0 p.p. contribution to GDP) together with final consumption expenditure increasing by 4.0% y-o-y (+2.6 p.p.) and strong net exports up by 15% y-o-y (+2.0%). For 2008, an output slowdown is forecasted to ca. 4.9%. However, GDP growth is forecasted to refresh in 2009. As far as FDI inflow into the Czech Republic is concerned, the 2007 level exceeded the 10 year average. For the coming years, a structural shift is expected in FDI from capital intensive industrial inflows towards lower capital intensive service activities.

The labour market within the Greater Prague area, in terms of labour availability, witnessed a continuing downward movement with unemployment in the Prague market decreasing to 2.1%, which is 3.5 p.p. lower than the national average. As a result, average wages in Prague further increased to 28,531 CZK p.m. in Q4 2007, ca. 5,000 CZK above the Czech average.

Inflation at the end of Q1 2008 increased by 7.1% y-o-y converging down from 7.5% in the first two months of 2008. Speculation that the Central bank could uplift its key 2W repo rate from the current rate of 3.75% as a reaction to the rising inflation level did not come to pass. There were two reasons for this. Firstly, consumer prices are currently perceived to be at a peak with decrease replacing increase. Secondly, the appreciation of the Czech crown (in Q1 2007 the EUR was traded on average for 28.04 CZK whereas in Q1 2008 for 25.55 CZK). A stable mid term monetary policy is manifested on the inter-bank credit market with increased (+1.48 b.p. compared to Q1 2007) but stable rates. The higher cost of credit supported by construction cost growth (+10.9% since 2005) may negatively influence debt financing development opportunities, or alternatively act as a rental growth engine.

Take-up for office space remained strong and in line with the previous quarter. Gross take-up in Q1 2008 reached 71,444 sq m.

Approximately 64,800 sq m of modern office space was completed in Q1 2008. Of the new supply, ca. 76% had already been pre-leased.

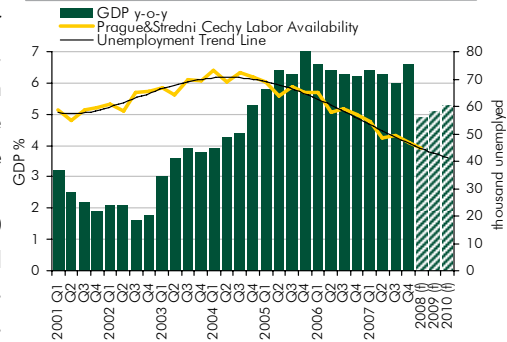
Prague prime office rents within the prime city centre locations in Q1 2008 reached € 21.50 sq m/month. From a market perspective, this growth is rational when taking into account a constantly low vacancy rate in the city centre and a limited pipeline of good quality space.

Due to the yield shift and concerns regarding capital value growth, as compensation we expect pressure on rents.

### Q1 2008 AT A GLANCE (q-o-q)

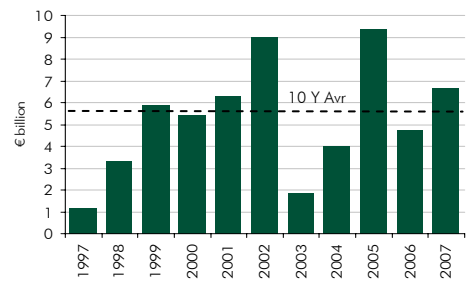
- Take-up →
- Vacancy Rate ↑
- Prime Rents ↑
- Prime Yields ↑

### ECONOMIC OUTPUT & LABOUR MARKET



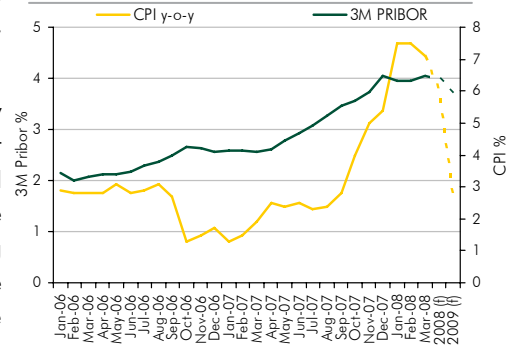
Source: CSO, MPSV, MFCR

### FDI INFLOW



Source: CNB

### INFLATION & INTERBANK MARKET RATES



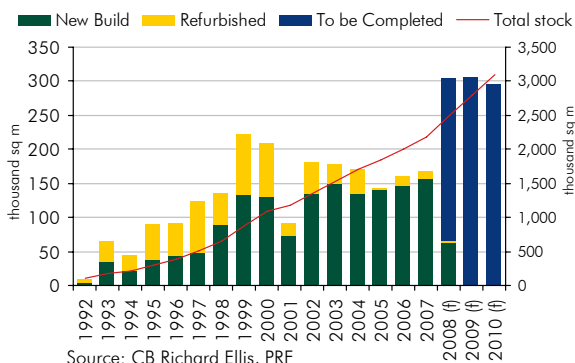
Source: CNB, CSO, MFCR

### TAXES AND FEES

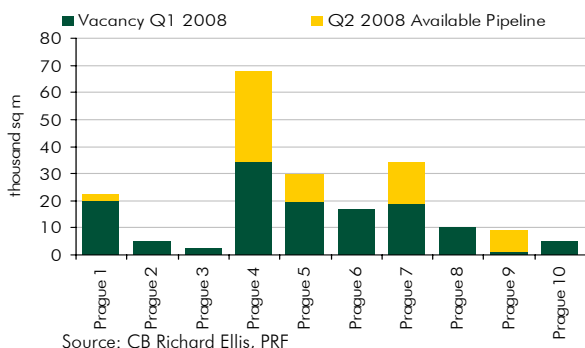
Corporate Tax	21%
VAT	19% / 9%
Transfer Tax	3% of the selling price
Property Tax	Nominal
Agent's Fees (Leasing)	12-15% of first year's rent

Source: CB Richard Ellis

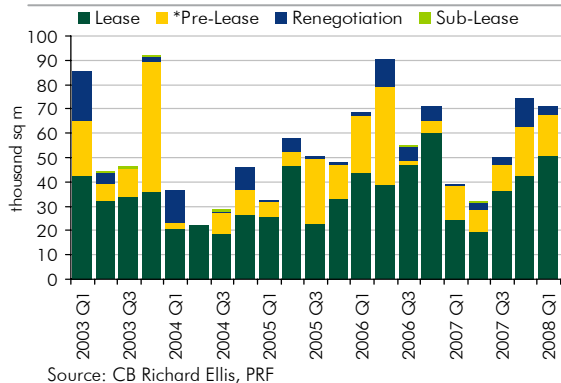
### OFFICE DEVELOPMENT IN PRAGUE



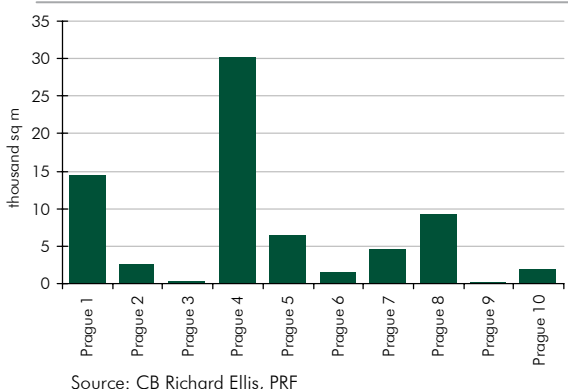
### AVAILABLE SUPPLY IN PRAGUE DISTRICTS



### PRAGUE OFFICE TAKE-UP



### TAKE-UP IN PRAGUE DISTRICTS Q1 2008



### OFFICE STOCK

The amount of modern office space in Prague currently totals ca. 2,254,000 million sq m. The locational distribution of modern office stock as of Q1 2008 was as follows:

- 49.9% in the Inner City submarket of which 7.5% was vacant;
- 29.3% in the Outer City submarket of which 4.2% was vacant;
- 20.8% in the City Centre submarket of which 4.7% was vacant.

### NEW SUPPLY

Approximately 64,800 sq m of modern office space was completed in Q1 2008 (City Tower in Prague 4, Palladium in Prague 1 and the refurbishment of office building Na Prikope 6 in Prague 1). The impact of new supply on the market was limited due to pre-leasing activity, though represented an increase in vacancy by 15,800 sq m. In other words, of the new supply, ca. 76% had already been pre-leased. Looking ahead at Q2 2008 (chart 2), the majority of available space will be located in the Prague 4, 7, 5 and 1 districts. Thus, Pankrac-Budejovicka, City Centre, Butovice-Stodulky and Karlín are locations where take-up levels will dominate.

### DEMAND

On the back of a strong economy creating employment and further generating business opportunities, demand for office space shows no signs of easing. For the third consecutive year, the Prague economy showed positive job creation figures with evidence of growth increasing (19,336 jobs created in 2007 / 16% increase y-o-y). Take-up for office space remained strong and in line with the previous quarter. Gross take-up in Q1 2008 (including leases, renegotiations, pre-leases and sub-leases) reached 71,444 sq m. As chart 3 demonstrates, the letting market is restructuring and we see more pre-leasing activity taking place again. It is not a new trend and the leasing market operated under the same structure during the second half of 2005 and the first half of 2006. During 2005 and 2006, pre-letting was fuelled by a few big tenants and consequently, the average size of a pre-lease deal stood at ca. 3,950 sq m. However, in 2007 and Q1 2008 the average size of a pre-lease deal reached only 1,970 sq m. In our opinion, the 2007/2008 trend is likely to continue in terms of the pre-let deals share being strong. We expect to witness more pre-letting due to a significant pipeline being actively marketed in an increasingly competitive environment and also due to a requirement condition in order to secure development financing.

The flagship deals signed in Q1 2008 were:

- Raiffeisenbank (17,500 sq m) in the City Tower, Prague 4;
- Wustenrot (5,500 sq m) in Kavčí Hory Office Park, Prague 4;
- NetCentrum (3,630 sq m) Classic 7, Prague 7.

In Q1 2008, the proportion of deals and pre-lets signed in newly completed buildings amounted to 90% of the total Q1 take-up. With regards to take-up within districts, winners in Q1 were Prague 4 and Prague 1, with combined share of 59%.

## VACANCY

The vacancy rate continued drifting up for the second consecutive quarter and reached a level of 5.95%. This represents an increase of 0.7 p.p. since its historical minimum in Q3 2007 (5.25%) and confirms our earlier prediction from mid 2007 when we forecasted Q1 2008 vacancy to reach 6.0%. The area producing vacancy growth from a y-o-y perspective was the Inner City submarket. Despite this overall increase, the vacancy rate varies significantly among particular office hubs, and in some districts it operates below the average level for Prague - City Centre, Andel and Karlín. An interesting situation emerged in the Karlín office hub where vacancy experienced an opposite trend compared to Prague, and in Q1 2008 dropped down to 5.32% after hovering around the 10% level during 2007. We expect the Karlín hub to attract more tenants as the demand unable to find space within the City Centre or the Andel area retargets to the available substitute – Karlín.

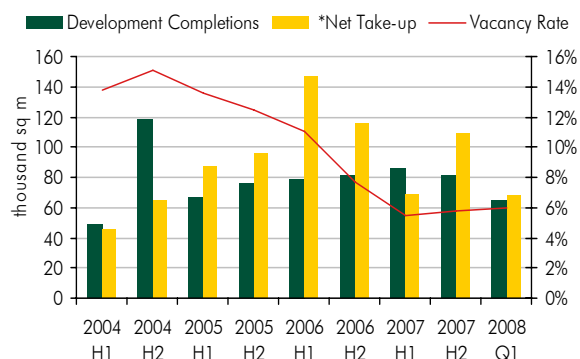
## RENTS

Prague prime office rents within prime city centre locations in Q1 2008 reached €21.50 sq m/month. From a market perspective, this growth is rational when taking into account a constantly low vacancy rate in the city centre and a limited pipeline of good quality space. However, we see a limited response from landlords to city centre market fundamentals relative to its rental pricing potential. Simply, rents can be higher. We also witnessed a rental increase in some adjacent city centre locations and in inner city locations as well as shortening of rent free periods. Despite the size of the pipeline, rental growth was also registered in the Pankrac-Budejovicka hub. Recently, as a result of the CZK appreciation, some landlords have started to denominate rents in CZK instead of the Euro. Subsequently, rental growth would be as a result of a conversion from CZK back to Euro. Another strategy to secure the income flow level is to denominate rents in Euro with a fixed exchange rate. This situation is an interesting example of how strategies used to raise rental income are to a substantial extent externally stimulated. These drivers would include the development cost growth and a movement of the Euro relative to the CZK. Certainly, the demand-supply balance plays an important role, however, we are of the opinion that rental pricing showed signs of being insufficient over the mid term – particularly in Prague 4 - with rents lagging behind market fundamentals. Service charges are standing at around € 3.00 /sq m/month. However, in some Outer City locations, downward pressure on leasing conditions was recorded.

## OUTLOOK

We expect 305,000 sq m of office space to be completed in 2008 and 300,000 sq m in 2009. In light of the pipeline dimension, vacancy is expected to continue in an upward movement with an increasing pace and at the end of 2008 to reach ca. 8.5%. On the other hand, interest rate uplifts in relation to development financing is likely to reduce the pipeline. Aside from the above mentioned aspects, we expect the revaluation of risk on the property investment market to stimulate pressure on rents. Due to the yield shift and concerns regarding capital value growth, as compensation we expect upward pressure on rents. We are of the opinion that prime locations have the potential to generate rental growth.

## PRAGUE'S OFFICE VACANCY TREND



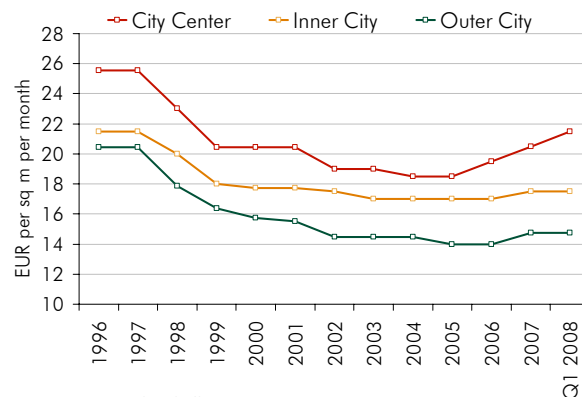
Source: CB Richard Ellis, PRF

## PRAGUE PRIME OFFICE RENTS

	€ per sq m per month	
	Minimum	Maximum
City Center	20.00	21.50
Inner City	16.00	17.50
Outer City	13.00	14.90

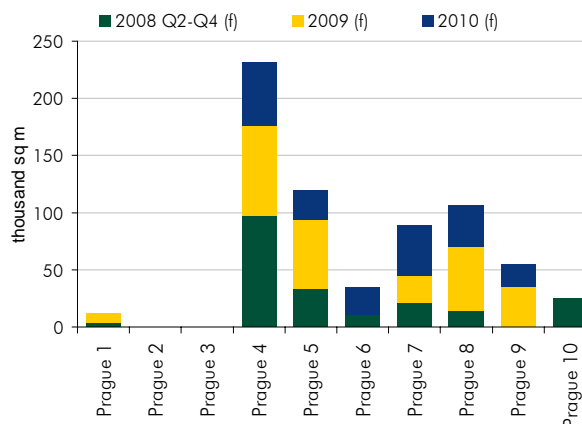
Source: CB Richard Ellis

## PRAGUE PRIME RENTS



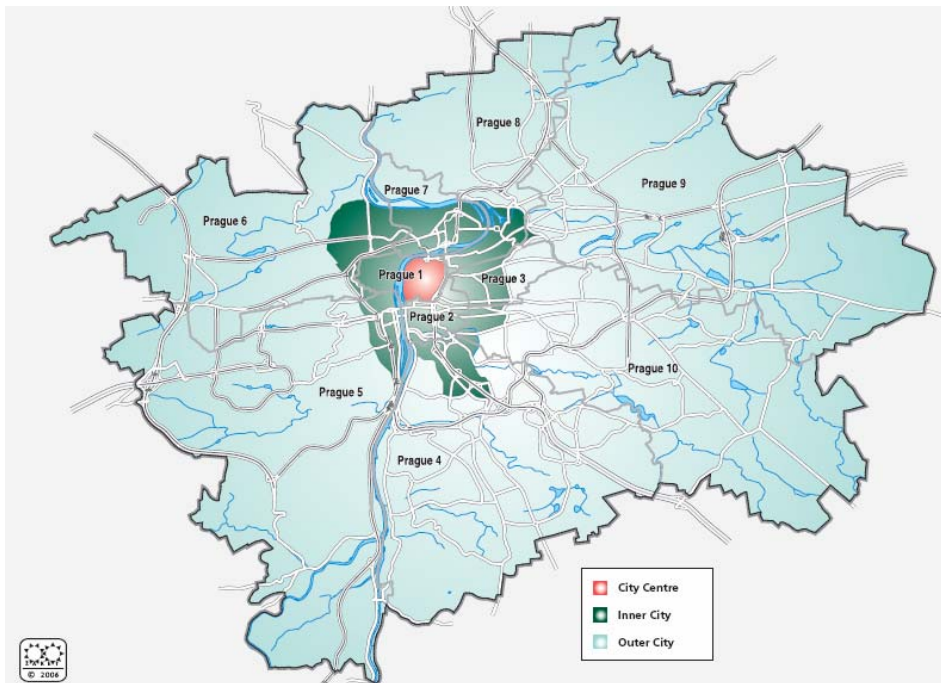
Source: CB Richard Ellis

## PRAGUE DISTRICTS SUPPLY PIPELINE



Source: CB Richard Ellis

## Prague Office Submarkets



Source: CB Richard Ellis

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