CB RICHARD ELLIS

# MarketView

# CEE Office Investment

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## Hot Topics

- Development completions at lowest level on record in CEE
- Vacancy trending down in most of CE and SEE with Warsaw standing out
- Prime capital value growth mainly driven by EE
- Occupational recovery in Warsaw and Moscow driving office investment volumes

## OVERVIEW

### • Development completions at lowest level on record in CEE

Central & Eastern Europe's (CEE) office stock has grown very modestly during H1 2011. Most markets reached the bottom of the development curve early this year. Looking further ahead, pipelines under construction (U/C) are slowly building up in the Central European (CE) capitals and Kyiv. Moscow's pipeline has remained limited due to new planning regulations under way. Some markets in South Eastern Europe (SEE) are still facing high pipelines as a result of projects being delayed. Weak occupational fundamentals here, coupled with continued challenges in securing financing mean developers are reluctant to launch new projects. Despite a recent increase in development starts across CEE, relatively low levels of completions are expected over the next 12-18 months.

### • Vacancy trending down in most of CE and SEE with Warsaw standing out

Despite solid and increasing take-up figures in H1 2011, net absorption fell back on 2010 mainly as a result of a significant number of relocations taking place. Apart from Warsaw, most markets in CE and South Eastern Europe (SEE) have remained rather tenant-favoured. Take-up in CEE (excluding Moscow) surpassed the 5-year average of 600,000 sq m in H1 2011 with Prague and Warsaw marking the highest growth compared to the same period last year. Vacancy in the region is generally trending down now. Significant declines in vacancy levels have been registered in Belgrade and Warsaw, two markets with more restricted pipelines for now. A decline in vacancy of around three percentage points was registered in Eastern Europe (EE) since end of 2010.

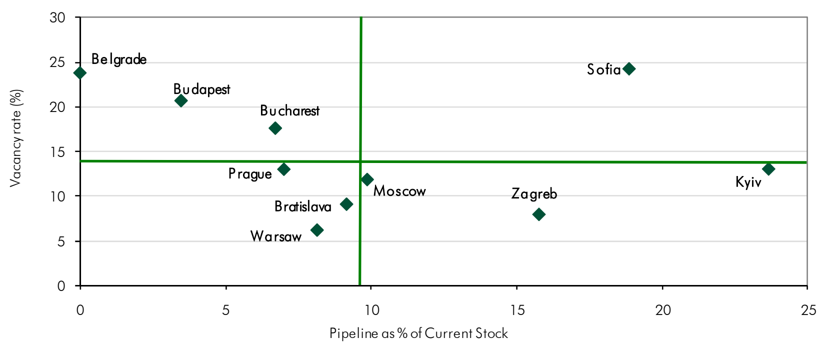
### • Prime capital value growth mainly driven by EE

The weighted average prime yield for CEE (including Russia & Ukraine) reached 8.8% at the end of Q2 2011 after compressing by 52 bps since Q4 2010. Prime yields compressed significantly in EE, and with that the yield premium narrowed to 275 bps between Moscow and Warsaw. On top of prime yield compression, prime rental growth also positively impacted on prime capital values across EE although this effect was almost offset by the rise of the USD/EUR rate before the recent Eurozone crisis started to take effect on rates. Most other CEE markets saw little change to capital values. Prime rents increased considerably in Warsaw only outside EE. The most significant prime yield movement was registered in Sofia where yields have moved 50 basis points (bps) lower since the end of last year.

### • Occupational recovery in Warsaw and Moscow driving office investment volumes

In total €2.2 billion of office investment turnover was registered in the first half of 2011. Most markets in CEE have seen increased liquidity but around 75% of the volume was closed in Russia and Poland alone. Purchasers maintain their focus on the prime end of the market despite low availability of new and high quality product. Instead of turning towards second tier property in the core markets, investment activity has been slowly increasing for core product in countries being perceived as riskier from a macro-economic point of view such as Croatia and Bulgaria.

**Vacancy and Pipeline Relative to Stock in CEE Capital Cities**



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## OFFICE OCCUPIER MARKET TRENDS

### Stock and Completions

Growth to office stock decelerated further in CEE in H1 2011. In fact, new supply has never been as low in CEE as in the first half of 2011. Only 460,000 sq m of office space was completed in the ten CEE capitals covered in this report. More than 60% of this space was handed over in Moscow. Office completions fell across all markets and reached all-time lows in many of them.

Despite the low level of completions, the development market has been picking up recently. Pipelines U/C have been increasing in all capital cities in CE. Despite the fact that most lenders still require pre-leases in order to finance, some speculative projects have already started. Since pre-leases are uncommon in some of CEEs markets and market fundamentals have not been particularly strong, construction starts have, despite the increase, remained limited. As a result completions in SEE, currently still at considerable levels in Sofia, are expected to decrease further into 2012. An additional factor having an influence on pipelines in SEE is the importance of the Greek banking industry which could pose a risk in unlocking new growth. On the back of stronger occupational fundamentals, EE is expected to see increasing construction activity. Pipeline U/C in Kyiv has been picking-up significantly and reflects a change in sentiment towards the improving state of the economy. New planning regulation under way in Moscow has caused a temporary brake on development.

After 2.1 million sq m of new space was completed in 2010, annual completions are likely to amount to 1.7 million sq m in 2011. For 2012 the volume is likely to decline further to below 1.5 million sq m , despite the recent increase in development starts. Even with these reduced pipelines U/C, office stock in CEE is expected to keep growing by 5% per annum which is clearly above the growth rate expected for the EU-15.

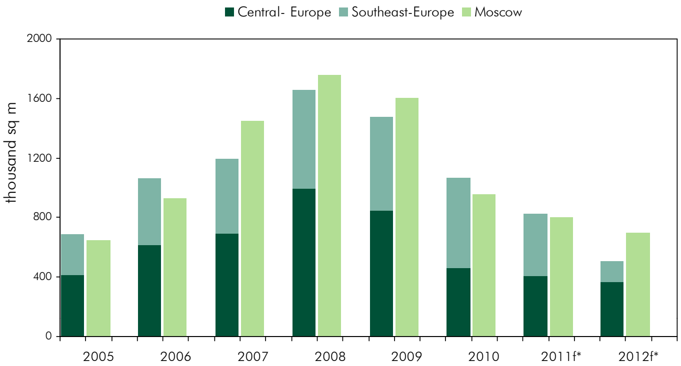
#### New Master Plan in Moscow

The primary goal of the plan is to allow for the continued development of the city without further increasing the density of the CBD. At the same time, the city is focused on developing further the city's transportation infrastructure to relieve congestion and improve the living and business environment. We expect the project to help develop some of the outlying regions economically, including the appearance of additional suburban office markets, while making the current CBD more attractive to residents and businesses.

### Take-up and Absorption

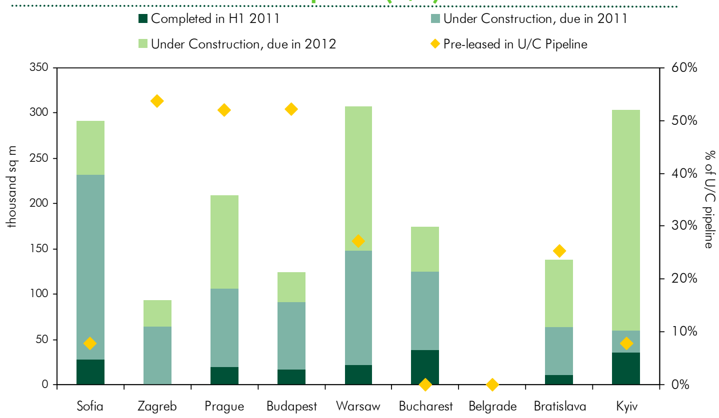
Take-up in all other markets in CEE, excluding Moscow, has shown a steady growth since early 2009. Moscow take-up fell back by 40% compared to H1 2010. Leaving out Moscow, CEE's long-term average take-up of 600,000 sq m was surpassed for the first time since the recent crisis started affecting demand. Compared to H2 2010, Bucharest and Prague have experienced increasing take-up from already strong levels whilst other key markets such as Budapest and Warsaw registered stable and high levels of take-up.

#### CEE Office Completions and Pipeline (U/C)

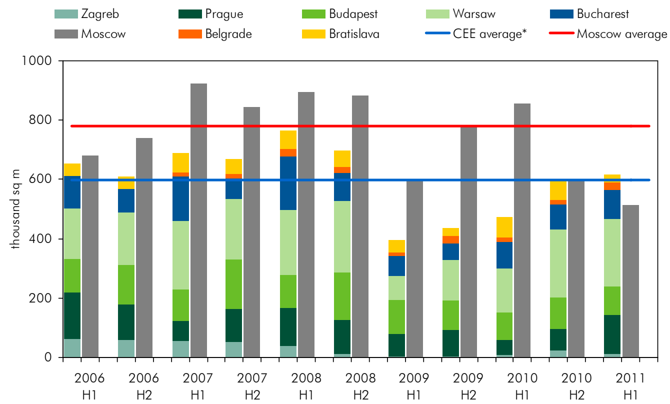



* Outlook includes projects under construction only.

#### CEE Office Deliveries and Pipeline (U/C)

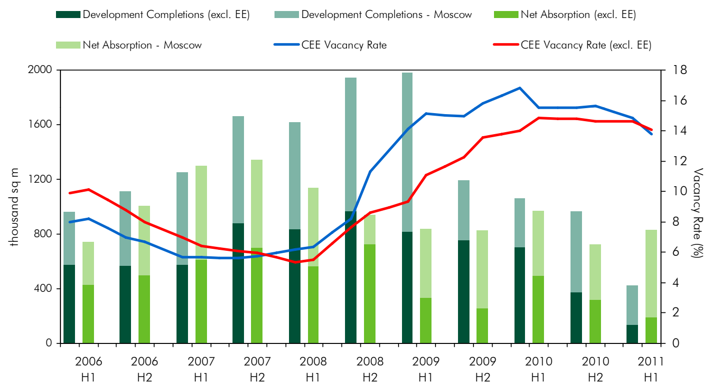



#### CEE Take-up




* CEE average excludes Moscow. Averages are calculated based on 2006-2010 figures.

#### CEE Development Completions v Net Absorption* & Vacancy




* Net absorption = occupied stock (t=1) – occupied stock (t=0)

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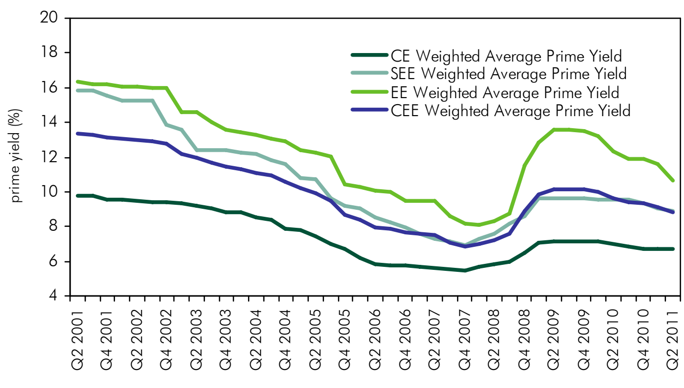
High levels of take-up in Moscow in 2010 have resulted in strong net absorption this year as a result of the time gap between signing the lease agreement and the physical move. Despite the low take-up in H1 2011, Moscow registered the highest net absorption since 2007. Other CEE markets experienced a reverse trend. Although take-up has been on the rise in most markets, net absorption has remained rather weak or has even turned negative in some cases. These low levels of net absorption can be explained by the increasing share of pre-leases, mostly in Prague and Warsaw. Another reason is the limited "new demand" as a growing element of take-up is generated by relocations.

### CEE Prime Office Rents and Prime Yields

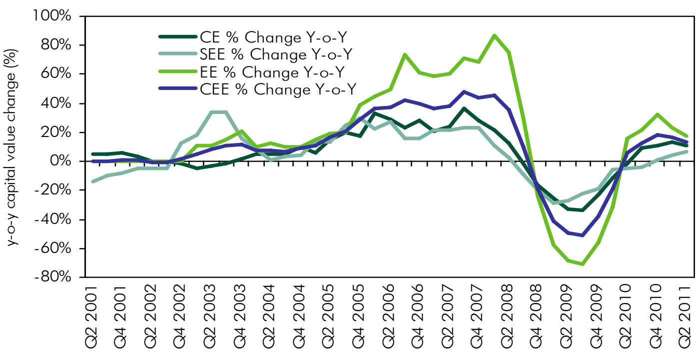
| Market | Prime rent (€ / sq p.a.) | q-o-q change (%) | y-o-y change (%) | Prime yield (%) |
|---|---|---|---|---|
| Belgrade | 177 | 2% | -2% | 9.50 |
| Bratislava | 204 | 0% | 0% | 7.25 |
| Bucharest | 234 | 0% | 0% | 8.50 |
| Budapest | 240 | 0% | 0% | 7.50 |
| Kyiv* | 290 | 3% | 25% | 13.00 |
| Moscow* | 724 | 11% | 20% | 9.00 |
| Prague | 252 | 0% | 0% | 6.50 |
| Sofia | 168 | 0% | -3% | 9.35 |
| Warsaw | 312 | 0% | 13% | 6.25 |
| Zagreb | 191 | -1% | -4% | 8.30 |
| CEE | n/a | 2% | 3% | 8.80 |
| CE | n/a | 0% | 6% | 6.67 |

* Changes to rents Moscow and Kyiv measured based on USD rents.

### CEE Weighted Average Prime Office Yields (%)




### CEE Weighted Average Prime Capital Value (% pa)




## Vacancy

The average vacancy rate in CEE (including EE) currently stands at 13.8% compared to 15.7% in Q4 2010. The majority of this decline of almost two percentage points is the result of changes positively affecting the EE capitals. Excluding EE, the average vacancy rate in CEE moved down more moderately from 14.6% in H2 2010 to the current level of 14.1%.

A clear decline in vacancy was registered in Belgrade and Warsaw only, although coming from very different levels. Warsaw has the lowest vacancy rate in the region - slightly above 6% - which has been working as a signal for developers to launch new projects. Belgrade, at the other end of the spectrum, is still struggling with a vacant stock level of close to 24%. On a positive note, vacancy in Belgrade has been on a decline for four quarters now and is expected to move down further with currently no development U/C and several projects on-hold. Sofia is part of the same tier as Belgrade, however, the trend here is the opposite as a significant volume of space is expected to be completed in H2 2011.

The group in between, contains cities such as Bratislava or Prague where vacancy rates are at 9% and 13% respectively. Despite limited absorption in recent quarters, and vacancy at around 10% developers have started some new developments. Vacancy rates in Bucharest (16%) and Budapest (21%) keep the amount of new construction low. In Although the pipeline is slowly building up in Budapest as well, some concerns are being raised about the levels of vacancy in some pockets of the market.

## RENTS, YIELDS & CAPITAL VALUES

Diverging trends in vacancy have resulted in different prospects for rental growth across the region. Solid rental growth has emerged in Moscow and Kyiv where prime rents increased by 20-25% in USD terms. Increases in EUR terms have remained moderate. Prime rents in Warsaw were up by 13% compared to H1 2010 although increases have been slowing down recently. Most other markets have not seen any rental growth over the last 12 months. In fact some SEE capitals are still coping with downward rental pressure.

The CB Richard Ellis CEE weighted average prime office yield (including EE) compressed further in H1 2011 to 8.8%. This is 52 bps lower when compared to the end of Q4 2010 and is 85 bps down on Q2 2010. Compression was mainly driven by prime yield movement in EE, while prime yields have remained mostly stable in CE during Q2 2011. The risk premium between Moscow and Warsaw, the two most liquid markets, has halved in two years. This change reflects increased liquidity on the back of increasing oil prices as well as a more healthy state of the property market in Moscow.

Warsaw still generates the largest investment turnover in CE, however, more and more investors have started investigating opportunities in other markets in the region as well. Potential investors are hesitant with regards to moving up the risk spectrum - in terms of property quality - in CEE and keep focused on the best properties. Prague already has seen an increase of investment activity as a result and markets such as Budapest are likely to follow suit in H2 2011 on the back of this trend. This increase of activity could lead to some prime yield compression in a wider number of markets in the coming quarters.

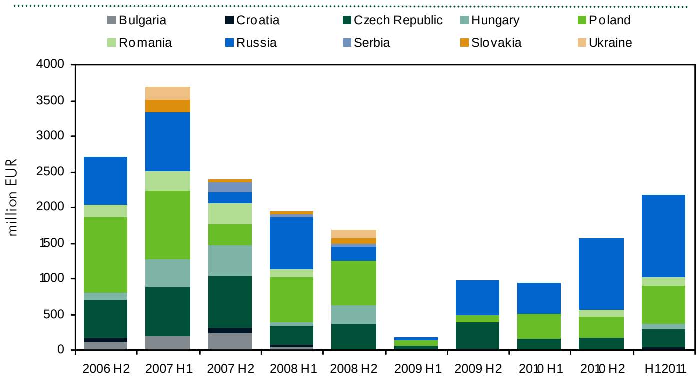
## INVESTMENT ACTIVITY

The total office investment turnover in H1 2011 amounted to €2.2 billion, just slightly lower than the €2.5 billion achieved in the whole of 2010. This figure includes the office part of the CA Immo purchase of Europolis. Russia in particular, but also Poland drove investment volumes this far in 2011. Together, these countries accounted for over 75% of the volume achieved.

After increased local activity in recent years, cross-border investment is on the rise again. Still, over 50% of the market is dominated by local investors. One of the most active local purchasers has been Czech Property Invest (CPI) in the Czech and Slovakia Republic. Increased cross-border activity is partly the result of funds returning to the market after announcing increased allocations for CEE earlier this year. German Open Ended Funds (GOEFs) have remained less active. At least equally important has been an increase in disposal activity by GOEFs which was recorded in H1 2011. Total volume reached around Euro 100 million as a result of sales taking place in the Czech Republic. Sales are expected to increase in H2 2011 on the back of a restructuring underway in the GOEF-sector. Activity from Closed Ended Funds has increased in 2011, a trend expected as a result of turbulence in the GOEF-sector.

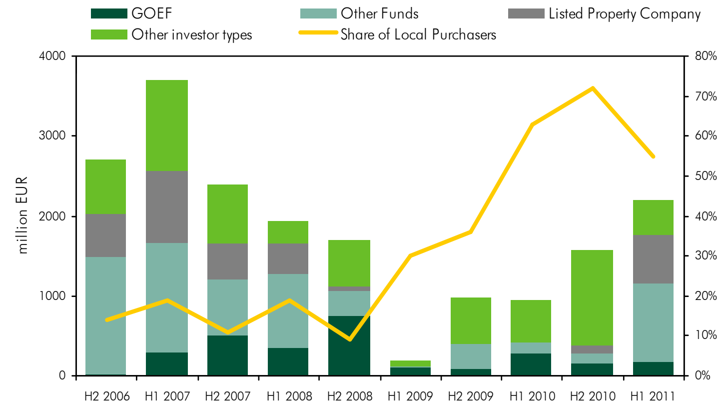
Investment market liquidity has been on the rise in CEE for some quarters in a row now. Recovery in investment volumes is one of the strongest in Europe, helped by coming from the low levels achieved at the bottom of the market in 2009. On the one hand, recovery is mainly visible in the top-tier of the market, whilst the so-called secondary segment has remained mostly illiquid in most countries. On the one hand Russia and Poland have re-emerged strongly whilst Ukraine and Serbia are still waiting for the first transaction to close on the open market.

### Total Office Investment Turnover in CEE (€ million)*

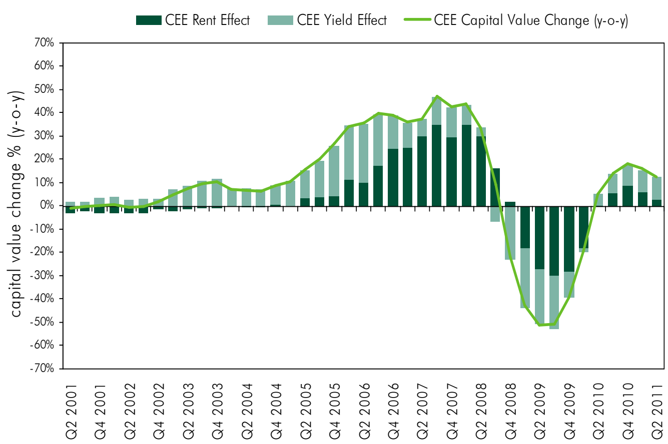



* Excluding Mixed-use projects

### CEE Office Investment by Type of Investor




### CEE Office Prime Capital Value Movement




### Top-5 Largest Single Asset CEE Office Transactions in 2011 H1

| Country | City | Name | Size (sq m) | Purchaser | Price (€) | Indicative Yield |
|---|---|---|---|---|---|---|
| Russia | Moscow | Alfa Arbat Center | 47,000 | Promsvyaz'nedvizhimost | 161 million | N/a |
| Russia | Moscow | Classic Business Center | 45,000 | Lenmar Capital Inc | 98 million | N/a |
| Poland | Warsaw | North Gate | 30,000 | WestInvest Interselect | 103 million | 7.1% |
| Poland | Warsaw | Zebra Tower | 16,000 | Union Investment | 73 million | 6.6% |
| Poland | Warsaw | Crowne Square | 17,000 | Invesco | 64 million | 6.6% |

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## CEE OFFICE MARKET ANALYSES

**Belgrade** office stock did not grow in H1 2011. With a steady take up, vacant space started to decrease and the vacancy rate has returned to 2009 levels standing at around 24% at the end of H1 2011. This positive change is due to new market entrants leasing prime office premises in the CBD and so impacting positively the prime rent figures. The delivery of the postponed 50,000 sq m of planned pipeline (not U/C) before the end of 2012 is unlikely right now. Without new deliveries, market absorption should continue at a steady pace, taking into account the potential interest from new entries to the market.

**Bratislava** office market registered an increase in total leasing activity (TLA) after a weak Q1. However, a large share of TLA consisted of renegotiations (48%), with another 15% attributed to pre-lets. At the end of the first half of 2011 vacancy stood at 9.1% following a steady decline from 13.6% a year ago. The fall in vacancy was rather due to the low new supply as only 11,000 sq m of new office space was delivered in H1 2011. Net absorption has been sufficient to drive the vacancy rate down so far, although its level is down by 60% compared to last year.

Office deliveries in **Bucharest** in H1 2011 reached an historical low with just 52,700 sq m, a decrease of 65% y-o-y. The completion level in H2 2011 will be close to 100,000 sq m. Take-up in H1 2011 registered a healthy increase totaling 125,000 sq m. While pre-leases now account for 30% of take-up, renegotiation and renewal activity is down by almost 60% compared to last year. The vacancy rate stands at 16.1%, continuing its downward trend from end 2010, as fewer and fewer buildings are delivered. Prime rents are stable at EUR 19.5/sq m/month. Incentives are less typical for prime office buildings while still dominating the mass market.

The level of new completions in **Budapest** fell further to 16,500 sq m in H1 2011. Looking ahead, the pipeline remains limited until 2013 at least with speculative developments reaching only 52,000 sq m in the coming 18 months. Demand is stable with a positive outlook for the rest of the year. Take-up in H1 was 5% up on the same period last year, however, most of the new demand did not result in net absorption on the market. The vacancy rate seems to be stable at 20.6% with diverging trends across the submarkets. Effective rents have stopped declining in general but rental growth remains sporadic.

**Kyiv**'s office market seems to have reached a temporary improvement before an increase in vacancy levels may again appear on the back of the significant speculative pipeline under construction - more than 200,000 sq m scheduled to enter the market in 2012. Because there has not been enough new supply to compensate for the increased activity of occupiers over the last 18 months, the vacancy rate fell significantly and reached 13.0% by the end of June 2011. Net absorption in 2010 was strongly positive and reached almost twice the level of annual new completions but in H1 2011 the growth rate slowed down. The absence of new class A premises in 2011 will continue to drive prime rents up for the rest of the year.

In the first half of 2011 the **Moscow** market has seen continuing evidence of a return to growth regarding rental levels in class 'A' properties. At the end of 2010 an annual rental rate of US$ 900 per sq m was registered, although by the end of H1 2011 this level was up to US$ 1,050 per sq m. However take-up remained lower in this half compared to H1 2010, but net absorption was robust. Overall vacancy is registered at 13.5% at the end of H1 2011, down from 20% a year ago. The rate fell particularly sharply in class 'A' properties. The prime end of the market is expected to witness a further recovery while growth in class 'B' will be flatter.

Total leasing activity in **Prague** increased further and was up by 8% in H1 2011 compared to the same period last year. A further positive indicator is that renegotiations decreased to 13% in Q2. On the back of stronger demand, vacancy has been declining from its peak of 13.8% last June to the current level of 11.9%. The positive vacancy trend is helped by very low completion levels as merely 20,000 sq m was handed over in H1 2011. The supply pipeline is picking up in the coming two years. Vacancy rates may increase especially towards the end of 2011 as we expect 86,000 sq m to be completed with about half of it being built on a speculative basis. Another 100,000 sq m is scheduled for 2012, although half of that is already pre-let. Prime rents have been stable since Q3 2009 and remain at 21 EUR/sq m/month.

In **Sofia** new office deliveries fell back to 27,500 sq m in H1 2011. This is far from signalling the end of the development wave as volumes under construction amount to over 300,000 sq m despite the lack of new project starts. The overall vacancy rate decreased for the first time in three years, but is still at 24.1%. Demand was fairly strong in the first half of the year. Although net absorption surpassed the volume of new deliveries on a quarterly basis for a first time in 3 years, demand is still far from balancing out the oversupply accumulated in the past couple of years. Rental rates have somewhat stabilized in Q2 2011 in all submarkets. However, landlords remain aggressive when it comes to securing new tenants and provide various incentives.

**Warsaw**'s office market has continued to perform well in H1 2011. Take-up in the first half of 2011 was up by 55% on the same period last year. Although net absorption fell back on last year, vacancy decreased further to the level of 6.4% by the end of June 2011. Only a few new office schemes, mostly strongly pre-leased, are expected for completion in 2011. However, a number of new developments have been launched to be delivered in 2013 - 2014. Strong demand and decreasing vacancy should put upward pressure on the rental level towards the end of the year. Prime rents have already started to increase and are 13% above the level of a year ago.

Despite the lack of new completions in **Zagreb**, vacancy increased further although it is still at the second lowest in CEE with a rate of below 8%. However, demand remains weak and the majority of the take-up generated continues to stem from occupiers looking to reduce costs. Generally landlords are under increasing pressure as many leases are expiring during the next 6 to 18 months. This situation could turn quite challenging for owners given the 93,000 sq m of new deliveries coming to the market until end of 2012.

## 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.

**Take-up** – Represents the total net floor space, not including renewals, 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.

**Total Leasing Activity (TLA)** – Represents the total floor space, including renewals, known to have been let or pre-let, sold or pre-sold to tenants or owner-occupiers during the survey period.

**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.

**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 Serbia.

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

**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.

**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 the light of market conditions, but the same criteria on building location and specification still apply.

**Prime Capital Values** - represent 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.

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