

# Czech Investment Market ViewPoint

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## IS CZECH REPUBLIC NEXT ON INVESTORS AGENDA?

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### INTRODUCTION

The real estate investment market in the Czech Republic (CR) is still in its infancy but has already been through turbulent times. With the ups and downs hopefully behind us we are now seemingly in a period of stabilisation and moderate renewed growth. Most European real estate investment markets bottomed out sometime in 2009 and have been recovering steadily since. Although 2010 brought more optimism in the CR, we are only just seeing solid evidence of improved investors interest. With limited historical experience to fall back on we believe mature Western European (WE) investment markets as well as the fast developing Polish (PL) investment market can help point the way towards our own future. We attempt in this paper to examine the evidence; having once again reached long-term average levels for most market indicators, the question now is: will capital values increase and what will be the drivers? Furthermore will cross-border investors' interest fall upon the CR in the same way currently experienced by PL?

### Getting Back to 'Normal'

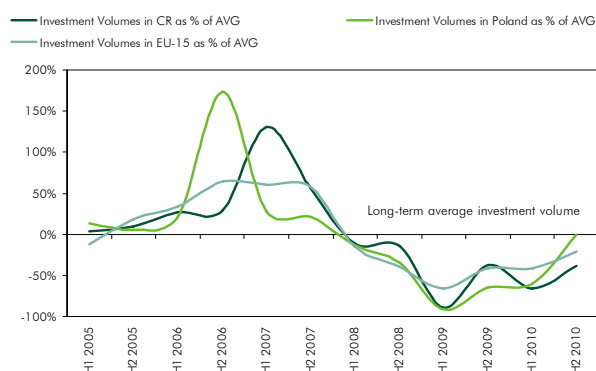
Comparing the biannual investment volumes with the long-term average (right), we can see that the trends in all markets are similar. Having reached the bottom in mid 2009, investment volumes have been increasing since. Whilst the CR volume is below the long term biannual average it did break through the quarterly average figure (€335 mln) in Q4 2010 reaching €374 mln; a trend which we expect to continue based on current levels of activity in the market.

### Increased Local Investor Activity

The importance of local buyers increased dramatically through the recession as evidenced by the graph on the right. Local investors took advantage of low competition levels and their own perception of less risk than cross-border investors in the domestic market. The relatively low level of investment volume also has an exaggerating effect on the appearance of local market share as a percentage. In general all markets saw an increase in local investment as a percentage of the total market.

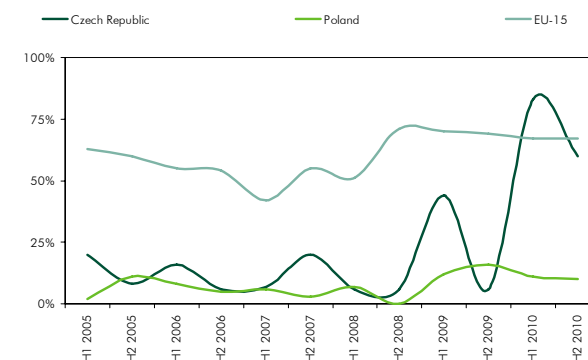
A recent survey by CBRE showed that investors consider economic performance as the main driver of future investment activity. This was demonstrated by the shift of focus from markets like the UK and France to strong performing Germany. The attractiveness of the CEE region also increased in 2011 (15% to 18.5% y-o-y) with CR of particular interest possibly as a result of Germany being its main trading partner. Economic growth in CR is estimated at 1.8% this year. Although lower than in some other CEE countries it is above both the EU-27 (1.7%) and the Euro Zone (1.4%). We expect therefore to see increased cross-border investment activity in 2011.

### Investment Volumes



Source: CB Richard Ellis

### Local Investment as % of Total Investment Activity



Source: CB Richard Ellis

2010 saw investors maintain interest mainly in prime assets in core markets, mainly offices. Based on the survey the office sector will remain important but as many office markets saw re-pricing the retail and industrial sectors are becoming increasingly attractive.

## Direct Market

When considering investment volumes it is interesting to look at the direct market versus the "represented" market in CR and PL against mature WE markets. While in the CR and PL about 50% of investment transactions concluded directly, in WE the direct market is much smaller. On the sellers side especially the frequency of agents representing the client in WE is considerably higher.

## Prime Yields Under Downward Pressure

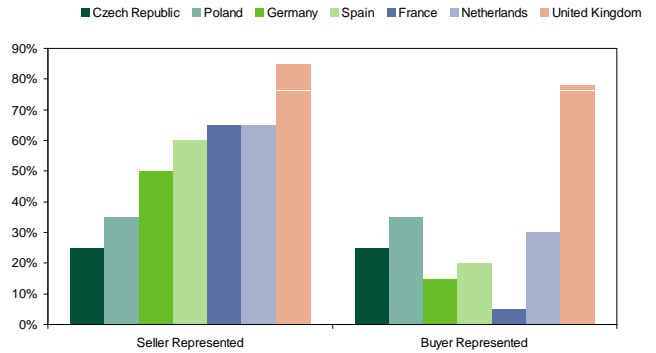
Higher levels of interest and therefore competition for prime quality office assets in core markets pushed yields down in the EU-15 with prime yield compression having already started in Q2 2009 and continued since. Compression in CEE markets has been more gentle with the PL market more recently becoming more expensive and CR perhaps representing a positive opportunity. Interest in the CEE region focussed mainly on PL throughout 2010. PL was the only CEE economy with positive GDP growth during the global economic downturn and recorded faster GDP growth (3.8%) compared to CR in 2010 (2.2%).

Investors active in PL are expected to look to the CR market for diversification opportunities with pricing levels still some 50 basis points above PL. With strengthening tenant demand and relative income stability the CR stands out as an attractive opportunity. Furthermore yields in CR are currently close to the cyclical peak and we therefore expect to see continued yield compression in all sectors throughout 2011 and continued into 2012.

## Occupier Market

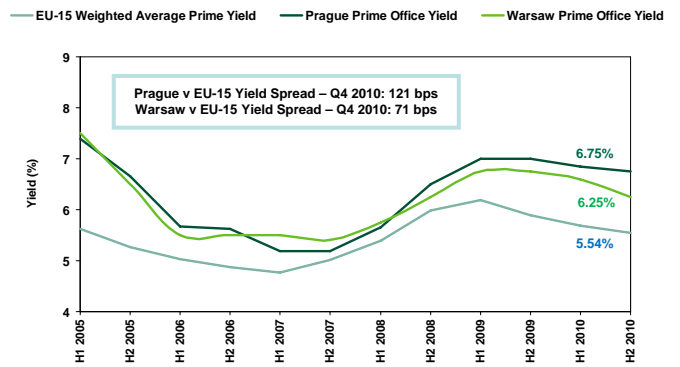
Strong economic performance had a positive impact on the PL occupier market with demand picking up already by the end of 2009, whereas the CR office demand reached the bottom of the cycle only in mid 2010. As a result vacancy stood at 7% in Warsaw at the end of 2010 and at 13% in Prague in spite of significantly reduced Prague office supply. With demand in the CR picking up during the second half of 2010 there is the prospect of rental growth from 2011-12 onwards. Development activity has resumed and several large-scale projects are due to be completed in 2011-12.

## Agents Representation



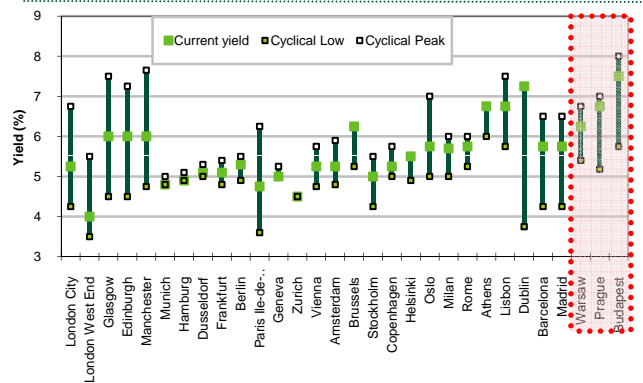
Source: CB Richard Ellis

## Prime Office Yields



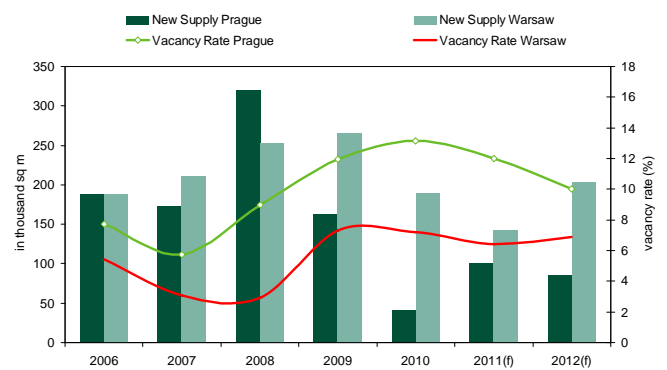
Source: CB Richard Ellis

## European Prime Office Yields Q4 2010



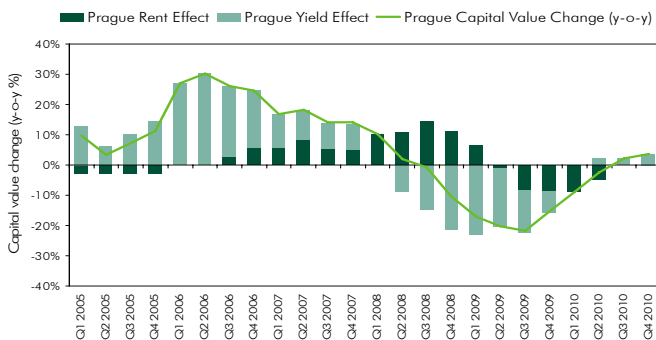
Source: CB Richard Ellis

## Prague v. Warsaw Office Supply and Vacancy



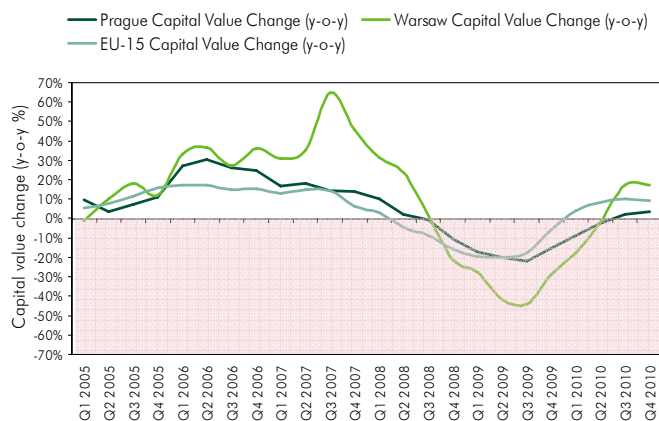
Source: CB Richard Ellis

## Prague Prime Office Capital Value Movement



Source: CB Richard Ellis

## Prime Office Capital Value Movement



Source: CB Richard Ellis

## Capital Values

The combined result of the above is that after two years of prime office capital values falling, Prague finally saw a break to this trend in 2010. Prime capital values are influenced both by prime rental and prime yield development. With prime rental volatility in Prague being traditionally low, prime yield development typically has more effect on prime capital values.

Looking at both the EU-15 and Warsaw office market capital value changes y-o-y, we can see that the growth of capital value in these markets was much steeper. This was caused both by yield compression being more aggressive and by prime rents being more volatile, resulting in a strong combined effect on final capital value.

The effect of prime rent on capital values is especially strong in the Warsaw office market as prime rents are very sensitive to current market developments. During the growth years the prime rent in Warsaw went as high as EUR 35/sq m/month with a consequent fall to EUR 23/sq m/month. In comparison to this Prague office rents offer relative stability of future income to investors.

As the chart shows, the growth of capital values in the EU-15 and Warsaw has already slowed in Q4 2010, which indicates that the markets started to stabilise and future growth of capital values will be more moderate. In the CR we believe that capital value growth can still accelerate with an expected increase in investors interest and the consequent effect on yields. Furthermore we have noted incentives on office leases, specifically in good quality assets around Prague, having stabilised through 2010 and in some Prague locations we expect renewed upward pressure on rents, which will further support the growth of capital values.

## CONCLUSIONS & FORECASTS

- With all the main investment indicators returning back to long-term averages and occupier markets resuming activity again, investors appear to perceive the CR market as less risky and furthermore offering an opportunity for diversification of investor portfolios. This is reflected by the shift in their attention from core European markets.
- Based on the CBRE Investors Intentions Survey economic performance appears to be the future driver of investments. Focus has shifted more towards Germany and CEE countries, especially those linked to the German economy. As a result investment volumes in the CR should increase. We believe investment activity in 2011 could exceed EUR 1 billion.
- The main focus in 2011 will remain on prime property with secondary assets seeing minimal yield corrections.
- The office sector will remain the centre of investors attentions but we expect investments in the retail and industrial sectors to rise significantly from a low base level. We believe that the retail sector may even exceed the office sector in terms of volume.
- Prime yields compression in the CR has been slower than in the EU-15 and PL and prime yields are still close to their cyclical peak.
- Occupier markets are resuming their activity and are expected to strengthen further. In addition, several new high quality products are to be completed in 2011-12 and a number of established properties are on offer.
- Based on the above we believe prime yields will compress through 2011 and most of 2012.
- Capital Values started to rise again in 2010 and are mostly driven by changes in prime yield, as prime rents are relatively stable in the Prague office market. As opposed to the EU-15 and PL, where capital value growth has already slowed, we believe CR growth can still accelerate due to compressing yields and expected renewed upward pressure on rents.

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