



RISK, RETURN & REALITY - CEE OFFICE PROPERTY

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Introduction

Considerable negative sentiment has surrounded CEE as a region since fall 2008. While this sentiment has probably been justified with regard to certain parts of the region, other parts of CEE have been unfairly swept up by it. It has become clear that certain CEE property markets will have to go through a phase of restructuring before resuming sustainable growth. On the other hand, based on the structure and outlooks of their economies and property markets, certain Central European office* markets are likely to be among the property markets that outperform for institutional investors in the short- to medium term. There are still legitimate concerns for investors thinking about re-entering CEE property investment markets. Despite more positive economic outlooks for 2010 and beyond, CEE economies are not yet out of the woods. Furthermore, property values have probably not yet reached bottom in some CEE markets. Nonetheless, there is a case to be made for investment in CEE property at this time, based on fundamental reasons for investing in property. It should be remembered that property markets are international, especially in CEE, and many trends affecting the region are also evident in Western Europe, at least to some extent.

Risk and Perception

The tendency to view CEE as a uniform region economically has spilled over to perception of its property market risks in the last year. The reality is different, however; there is substantial variation in

economic and property market fundamentals and supply/demand balances by sub-region, market and even sub-location. This means that risk in property is not evenly spread across the region, as rents and values are expected to hold up better in certain markets than others, even if compared to the EU-15 average.

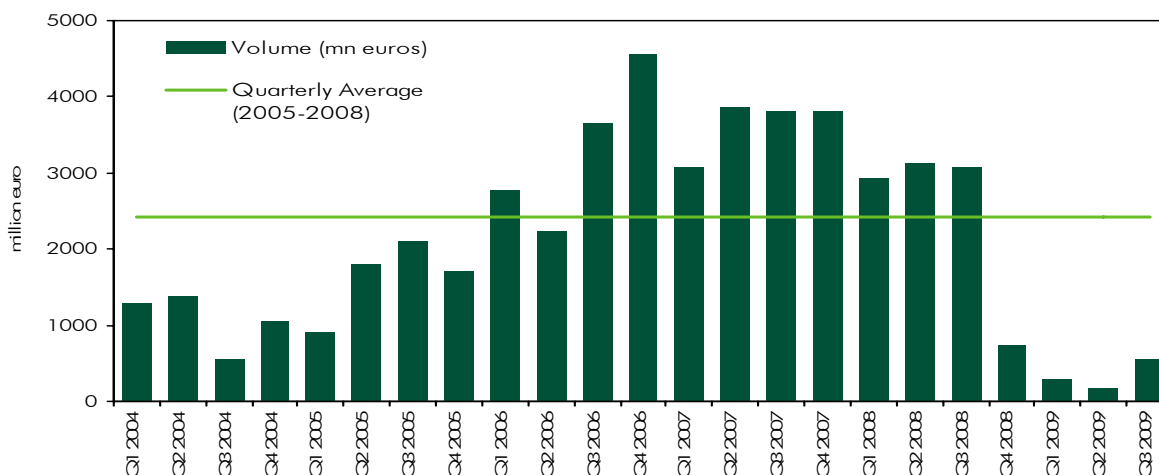
Economy

Although all CEE economies have been affected by the downturn, the impact has not been uniform. The Polish economy continues to defy expectations of recession and is forecast to record growth in 2009 - one of only a few European countries forecast to do so. Additionally, prospects for recovery in 2010 are generally brighter in CEE than in Western Europe. The most recent IMF forecasts**, for example, predict economic growth in 2010 in Slovakia and Poland at 3.7% and 2.2%, respectively. This is well above forecast growth on average of 0.3% in the Eurozone. Even CEE countries that have been hit hard by recession this year such as Ukraine and Russia are expected to see positive economic growth in 2010. A return to economic growth should have positive effects on office markets across CEE, as it should help to ease upward pressure on unemployment and limit further downward pressure on rents.

* In this paper we focus on the office segment across the region. Similar analyses can be made for other commercial sectors, however.

** Economic growth forecast numbers from IMF World Economic Outlook (October 2009).

CEE Property Investment Volume by Quarter



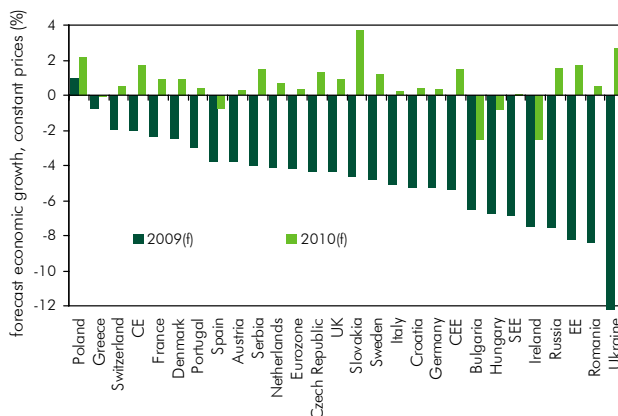
OCCUPIER MARKET FUNDAMENTALS

After a period of rapid growth, the CEE office market is moving to a more sustainable growth pattern. Like the investment market, cheap money helped propel development markets across CEE. Projects started during the boom years are being delivered and especially the smaller markets in the region may suffer from considerable supply / demand imbalances in the short- and even medium-term. The financial crisis has made obtaining financing more difficult, which is already bringing down future confirmed pipelines. In addition, higher vacancy rates and still substantial pipelines in some markets are affecting developers' strategies in CEE. Ultimately this may lead to a situation of tight supply in the medium-term in some markets.

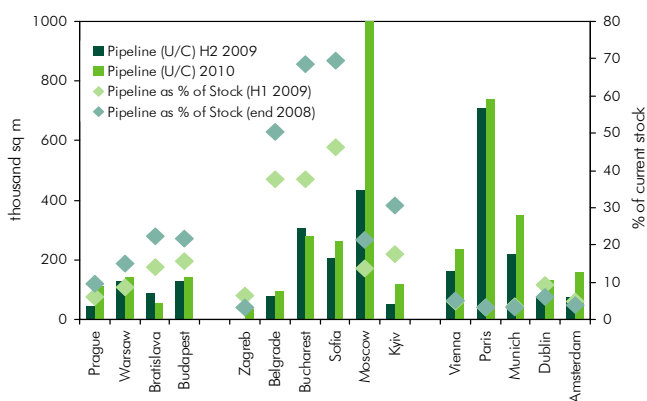
In general, core investment product will be better positioned to weather the storm than non-core properties. Rental declines in the core segment of the market are expected to remain more limited than for non-core properties. Tenants are still willing to pay for quality in terms of location, amenities, transport connections, etc. As vacancy increases in many markets, however, and more alternatives become available, landlords will face more difficult negotiations. Prime locations that offer property at significantly higher rental levels than good alternative locations somewhat less centrally located may see more significant rental corrections – as has occurred in Warsaw in recent quarters. On the other hand, the amount of true prime office stock is limited in almost all CEE markets, meaning that it is often not easy to find the right alternatives for tenants.

Based on current market fundamentals, the Warsaw and Prague office markets appear most likely to become more favorable to investors in the short- to medium term. The IMF forecasts that Poland's economy will continue to outperform EU-15 averages. Combined with already low levels of vacancy and a relatively low development pipeline versus current stock, this positions Warsaw's office market to outperform not only in CEE, but also in Europe. Prague also looks likely to become more investor friendly. Despite a somewhat higher current vacancy rate of around 10%, pipeline under construction is limited. The Czech Republic's economic growth outlook is moderate, but higher growth is forecast than for major Western European economies such as the UK and Germany. Despite Slovakia's positive economic outlook (>2010), the office market outlook for Bratislava is somewhat more challenging. Higher vacancy and a relatively large pipeline under construction are likely to keep vacancy at a higher level. Hungary is likely to see renewed economic growth in 2011 according to the IMF, after a minimal decline in 2010. Considerable pipeline in Budapest is expected to be delivered before the end of 2010, though, which is likely to push vacancy up further.

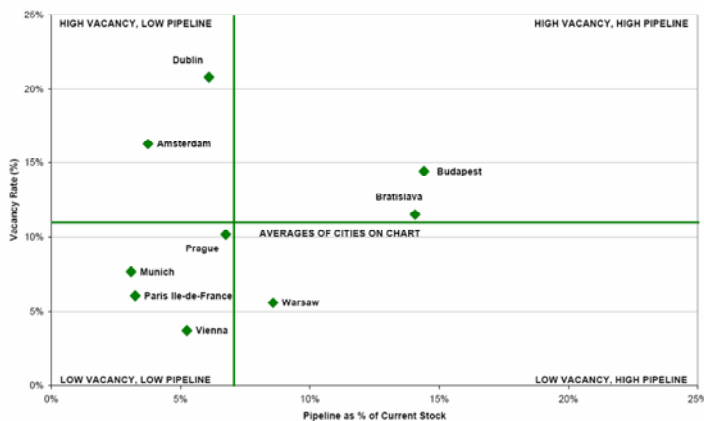
Forecast Economic Growth by Country – 2009-2010



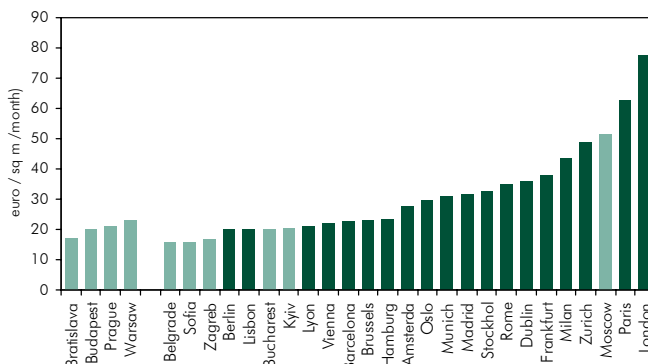
CEE Development Pipelines v Current Stock



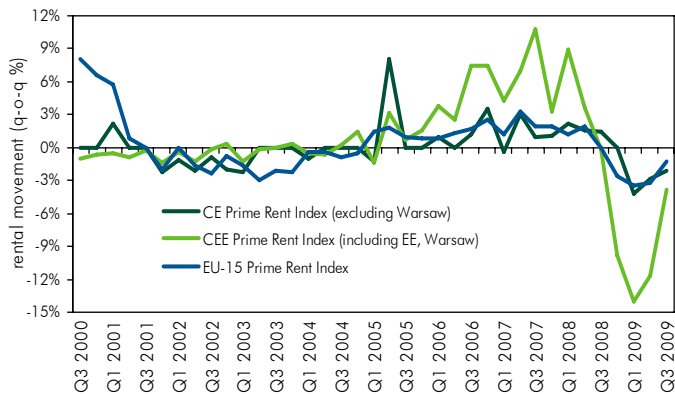
CE Vacancy and Pipeline



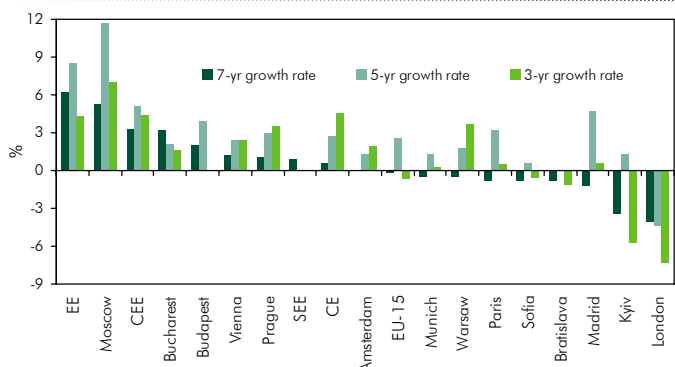
EMEA Office Prime Rents – Q3 2009



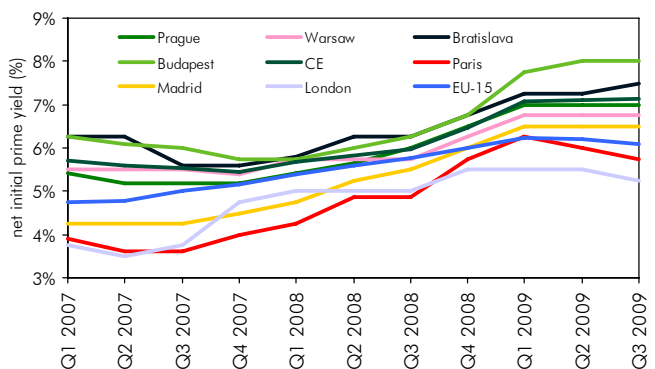
Prime Office Rental Movement



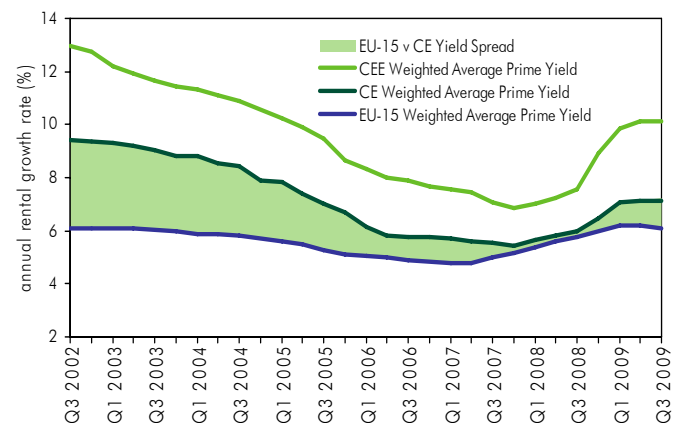
Rental Growth Rates



Prime Office Yield Movement CE v Western Europe



CE Prime Office Yield Risk Premium v EU-15



RENTS

Prime office rents across CE are relatively low compared to most counterparts in Western Europe. This has helped to keep rents across CE less volatile – with the exception of Warsaw – compared to such markets as London, Paris and Madrid.

Despite this lack of volatility, many CEE office markets have recorded solid rental growth in recent years compared to EU-15 averages. Even the relatively muted rental growth rates in CE office markets such as Prague and Budapest compare favorably to EU-15 averages or growth rates recorded in key Western European office markets over the last three, five and seven years. Rental growth in CEE matches up particularly well against EU-15 markets over a full seven-year period, demonstrating the longer-term growth to rents that has occurred in many CEE markets.

While the cumulative effect the crisis has had on property in CEE remains unclear, structural characteristics of markets can help explain how property market fundamentals are likely to develop. Key trends for the near future include more bankruptcies and higher unemployment as companies restructure. Incentives are increasing in most markets and rental growth is negative across the board. These trends are global, however, and will have their effects on property outside CEE too.

YIELDS & RISK PREMIUMS

The availability of significant amounts of cheap money pushed yields down quickly across CEE in recent years. Risk premiums for investing in CEE property that existed prior to 2005 largely disappeared. By Q2 2008, investors secured only a 25 basis points (bps) premium for investing in Central European (CE) office property compared to the EU-15 average. Property yields across CEE have moved out significantly in the last year. Currently, a risk premium of over 100 bps again exists, which has returned risk and return in CEE to a more sustainable level.

In recent months, the spread between the CE weighted average prime office yield and 10-year German government bond – widely considered to be a “safe” investment – has reached levels not seen since early 2005, making real estate more interesting as an asset class. This has occurred in the context of outward movement of yields (CE yield +170 bps since Q4 2007, CEE + 330 bps) and investors’ retreat to the security of government bonds, which has driven down bond yields.

Based on the re-establishment of the risk premium and the fact that yields are bottoming out in Western Europe, there are indications that CEE is close to reaching a situation where buyers and sellers can again meet each others’ expectations.

Conclusions

Economic growth likely to outperform EU-15: CE's economic outlook is more positive than the EU-15's. Especially Poland and Slovakia are expected to have significantly higher growth rates than major Western European economies such as Germany and the UK in 2010 and 2011. This is likely to have positive spin-off effects on office property, meaning less unemployment in the services sector and less downward pressure on rents.

Relatively stable and high income returns: Based on a historic analysis of three-, five- and seven-year income returns – based on prime rents – Central Europe outperformed the EU-15. Moreover, CE's office markets have proved to be less volatile over this period compared to the EU-15 – with the exception of Warsaw. The fact that rents are indexed, which is not the case in London for example, is of additional benefit to investors.

Warsaw and Prague expected to be among Europe's outperformers: Based on current and forecast market fundamentals, Warsaw and Prague look most likely to become outperformers from the perspective of institutional investors. Relatively low vacancy rates, limited pipelines under construction and absolute levels of rents at or below levels in most Western European markets will continue to make these CE capitals interesting targets in the upcoming years.

Property investment in CEE is unlikely to return to levels seen in 2006-2007 anytime soon. Nonetheless, the quiet seen on the market so far in 2009 does not reflect the value to be found in some markets and properties across the region. Certain properties in CEE now possess the income generating characteristics that investors seek at relatively low risk levels, and at prices that are significantly more sustainable than one year ago. Despite the fact that a critical approach is needed, the next several quarters will present interesting opportunities for investors to (re-)enter CEE property markets.

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Page 4

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