Belgrade | 3Q 2013

Office Market & Trends Outlook

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Economy Outlook

3Q 2013

In the first three quarters of 2013, Serbia recorded a modest economic recovery after it slipped into the recession in 2012 when a downfall in GDP rate of -1.7% was recorded. The main Serbian economic issues, that influenced the latest Fitch rating as BB- with negative outlook, represents a continuous increase in budget deficit, increasing public debt, fragile economic recovery mostly depending on the automobile industry and high dependence on the international credit arrangements.

The economy slowdown was also driven by a decrease in loan instruments that became more expensive due to high interest rates, as a consequence of more cautious and restrictive measures instructed from the banks. Therefore, vast majority of public and private entities are facing a high level of illiquidity issues and credit repayment inabilities.

The restructured Serbian government has announced the adoption of several austerity measures in October 2013 in order to reduce budget deficits and improve the conditions for economic growth in 2014. Without implementation of strict and unpopular measures, including layoffs in the public sector and ending the long term process of restructuring companies, expected improvements will not be possible in the short term.

According to the official data, after the negative GDP growth rate of -1.7% in 2012, Serbian economy recorded a modest GDP growth of 0.2% in 2Q 2013, mostly affected by growth in information and communication sector (9.6%), electricity, gas and steam supply (3.2%), and mining and quarrying (2.8%). The most significant decline was recorded in the construction sector (-42.5%) as the most severely affected by the global crisis.

According to the preliminary data, GDP growth was strengthened in 3Q 2013 to 3.2%.

Industrial production recorded strong growth by 13.4% in September 2013 compared to September 2012, with growth in electricity, gas, steam and air conditioning supply sector by 19.8%, followed by manufacturing (12.2%) and mining (10.4%). During the period January – September 2013 it recorded an increase of 6.4% comparing to the same period last year.

In the 1H 2013, construction sector in Serbia was faced with continuous slump that started as a consequence of the global financial crisis in 2008. The value of construction works in the period January - June 2013 decreased by 34.9% compared to the same period 2012, also followed by the decrease in total number of issued building permits by 4.4%.

Serbia's FDI inflow reached its lowest level in relation to all the years of crisis. According to the National Bank of Serbia, net FDI inflow in the first three quarters of 2013 amounted to EUR 584 million, while expected inflow of EUR 800 million is 20% less than the year before.

In March 2013, Serbia started negotiations with the companies from UAE. The Al Dahra Company signed a preparatory agreement with the Serbian government that implies investing USD 400 million in Serbian agriculture sector. The Serbian government signed a strategic partnership agreement with the Etihad Company in August 2013, by which former air-transportation company "Jat Airways" will be restructured into a new company entitled "Air Serbia".

Total exports of goods in the period of January - August 2013 amounted to USD 9.237 billion, as a 28.1% increase comparing to the same period last year.

In 2012, Serbia recorded the highest level of annual inflation rate of 12.2%, while 1Q and 2Q 2013 reflected a gradual decrease in inflationary pressure. However, consumer prices in September 2013, compared to September 2012, increased by 4.9%, while compared with the previous month an increase of prices was noted in communication sector (0.7%), housing, water, electricity, gas and other fuels (0.5%), transport (0.4%), restaurants and hotels (0.3%), and food and non-alcoholic beverages (0.2%). The highest price decrease was noted in the group recreation and culture (-5.4%).

Serbian unemployment rate recorded a modest decrease from 1Q's 25% to 2Q's 24.1% in 2013. However, according to the latest predictions, 2013 will end with the highest rate of 26.5%. The announced reforms in 2014 will increase this rate, placing this issue as a top priority of any economic strategy.

The average net salary in September 2013 was RSD 42,866, which represents an increase of 1.5% in real terms, and an increase of 6.5% in nominal terms when compared to September 2012.

According to the IMF (International Monetary Fund) forecast, estimated GDP growth in 2013 has been revised to 2%. Due to a number of structural problems waiting to be solved, it is difficult to expect positive changes in the real estate and construction sector in 2014.

National Bank of Serbia is to succeed in bringing the rate to the level of 4.1% by 2015.

The announced austerity measures will also contribute to the economy slowdown, since it will influence the further decline in domestic demand and a possible increase in the unemployment rate. In 2013, the European Commission recommended that Serbia should be granted a date for the start of negotiation for accession to the EU, which should improve business climate in the country, attract new investments and enable access to the EU funds. However, the exact date will be provided at the beginning of 2014, as it was previously conditioned by progress in the Belgrade – Pristine negotiations.

A new privatization and restructuring cycle of the remaining large state owned companies is expected in the following period, as well as a new credit arrangement with the IMF.

Table 1

Macroeconomic indicators	2008	2009	2010	2011	2012	1Q 2013	2Q 2013	2013f*	2014f*
GDP (EUR bn)	32.6	28.9	28.0	31.4	29.9	7.4	8.1	32.3	33.5
GDP per capita (EUR)	4,456	3,945	3,981	4,288	4,800	n.a.	n.a.	4,537	4,708
GDP (constant prices y-o-y, %)	3.8	-3.5	1.0	1.6	-1.7	2.1	0.2	1.8	2.1
CPI (average y-o-y, %)	8.6	6.6	10.3	7.0	12.2	11.2	9.8	10.0	7.0
Central Bank reference rate	17.8	9.5	11.5	10.5	10.3	11.7	n.a	10	9.5
Monthly wage, nominal (EUR)	402.4	337.9	330.1	372.5	364.5	370.8	394.8	n.a.	n.a.
Unemployment rate, in %	13.6	16.1	19.2	23.0	23.9	25.0	24.1	26.5	25.7
Budget balance / GDP (%)	-1.7	-3.4	-3.7	-4.2	-5.7	-6.0	-5.2	-5.8	-4.5
Public debt (in % of GDP)	29.2	34.7	44.5	48.2	59.3	62.5	60.6	65.8	65.9
Current account balance (EUR mil)	-7,054	-1,910	-1,887	-2,870	-3,155	-622	-268	-2,754	-2,527
Current account balance (% of GDP)	-21.6	-6.6	-6.7	-9.1	-10.5	-8.4	-3,3	-8.5	-7.5
Net FDI (EUR mil)	1,824	1,373	860	1,827	1,006	155.3	n.a.	800	800
FDI (% of GDP)	5.5	4.8	3.1	5.6	3.4	4.4	n.a.	2.5	2.4
Gross foreign debt (EUR mil)	21,088	22,487	23,786	24,125	25,721	26,722	26,072	27,814	28,219
Exchange rate to EUR (avg)	81.4	94.0	103.0	102.0	113.1	111.7	112.2	116.0	120.0
Credit rating (Fitch)	BB- /negative	BB- /negative	BB- /stable	BB- /stable	BB- /negative	BB- /negative	BB- /negative	BB- /negative	n.a.

Source: National Bank of Serbia
Ministry of Finance and Economy
* Unicredit Bank; Hypo-Alpe-Adria Group

Forecast

It is expected that GDP growth during the 2013 will keep the positive rate. However, the latest predictions for the year-end results are below those initially forecasted, with a modest GDP growth of 1.8% y-o-y. This gradual recovery of Serbian economy mostly depends on external exports that recorded a strong increase of 26.4% in 1H 2013 compared to the same period last year, mostly due to higher exports of FIAT cars and good agricultural season.

Inflation continues to represent one of the biggest challenges with an estimated double digit rate of 10% y-o-y in 2013. The main goal of the

Office

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Following the economic downturn in 2012, Belgrade office market witnessed an improvement of occupier demand in 2013. The continued lack of new speculative office developments contributes to stabilization of the market rent levels, bringing vacancy to its lowest level since 2009.

The total volume of demand increased in the first 9 months of 2013, but lease renewals had a considerable share in total leasing activity. With a few deliveries announced for 2013/2014 and taking into account the current market absorption, we can expect a relatively stable decrease in vacancy in the coming quarters.

Supply

The Belgrade office market starts to witness an increase in supply with 25,000 sq m of gross leasable area (GLA) being introduced to the market over the last 12 months. This marginal addition to supply is a step forward after a long period of almost zero delivery, recorded during 21 consecutive months. However, 79% of the newly constructed office space is owner occupied, indicating very slow recovery of confidence among investors. Two largest deliveries in 2H 2012 were the headquarter building of Raiffeisen Bank (18,400 sq m of GLA) and Danube Business Center (5,300 sq m of GLA) located in New Belgrade.

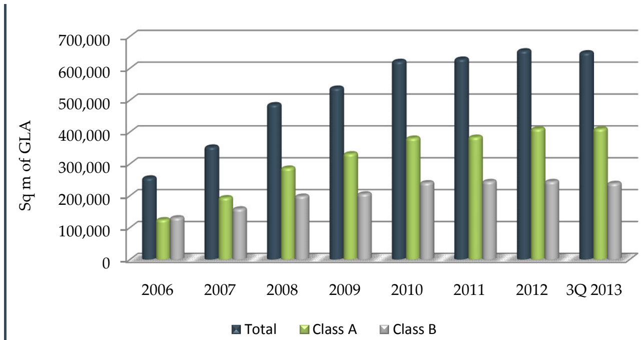
A few larger office deliveries scheduled for the second half of 2010 have been postponed and none of these projects have been activated yet. The postponed projects such as "Tri Lista Duvana" (8,500 sq m), "B-23" (35,000 sq m) and "Atlas office building" (3,600 sq m) will bring the additional 47,000 sq m of GLA of speculative space. However, it is still uncertain when these buildings will be introduced to the market.

A couple of small-scale projects that will bring new 15,000 sq m of GLA, are currently under construction and their completion is expected during 2013/2014 period.

Despite strong pipeline, supply has responded with net additions to stock falling well below pre-recession averages, while development completions are expected to be low over the next 12 months. With limited new supply and moderate demand we will see slow but steady absorption of the vacant space in the coming period.

Chart 1

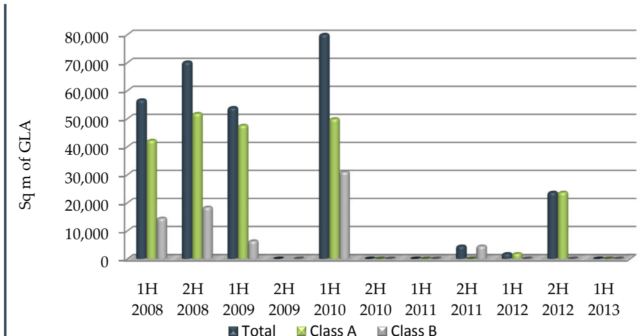
Belgrade office stock



Source: LeRoy Research

Chart 2

Belgrade office delivery, semiannual



Source: LeRoy Research

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Demand

Belgrade office market witnessed improvement of occupier demand in 2013, after last year's contraction caused by a new wave of recession. Serbia's economy recorded a growth in the first three quarters of 2013, but growing uncertainty about short term economic outlook prevented sustained upturn in demand, further delaying any substantial market recovery. The IMF (International Monetary Fund) has downgraded Serbia's mid-term growth forecast which is a warning sign of potential economic turbulence in the country. The fundamentals in the occupier market are weak, particularly because of the high unemployment rate and growing state debt.

The market activity in previous years was mainly supported by small to medium size transactions but unlike 2012, when recorded take-up decreased cca 15%, in 2013 we noticed a slight increase in expansionary led requirements. Relocation requirements and lease renegotiations are still the most active segment of demand, comprising almost 40% of total leasing activity in 2013, due to the fact that five-year lease agreements, concluded during the expansion period (2008), expire this year. New leases in three quarters of 2013 comprise app. 30,000 sq m which is an increase of 31% compared with the same period last year.

Since the most of contemporary office space is located in New Belgrade area, the highest number of office leases relate to New Belgrade office space, while only 25% of lease transactions are in the downtown area. Occupier activity was predominantly focused on grade A space. The structure of demand is similar and among most active occupiers in 2013 are IT companies, banking/insurance sector, professional services firms, etc.

The recovery in demand will be slow, and rising economy uncertainty does not contribute to strengthening business environment. At the local level, expectations for annual take-up in 2013 showing better prospects compared with last year and demand slowly shifting toward new leases, causing positive upturn in absorption of available space.

Vacancy

After a peak, vacancy of speculative stock has started to drop in 2011, but remain in double digits due to still a large amount of surplus space that needs to be absorbed. In 2013 office vacancy rate decreased below 20%, first time since 2009.

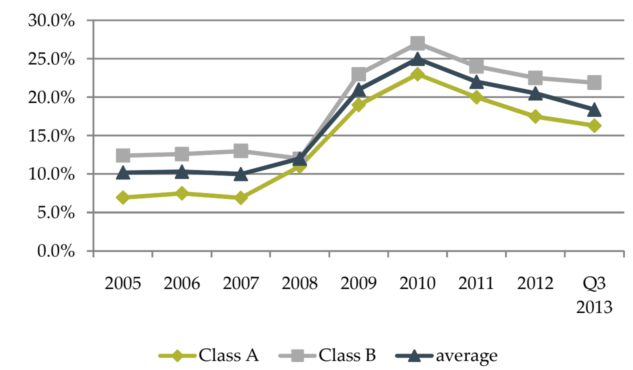
Low level of net absorption is mainly a result of number of relocations taking place despite growing element of take-up generated by new tenants. The majority of vacant space remains within new developments and the increased vacancy is recorded also within lower quality class B and C buildings and secondary locations.

Despite new deliveries in 2012, better absorption of the available office space in 2013 influenced the further decline in vacancy rates to average 18% in Q3 2013 (16% class A and 22% class B).

With a few deliveries announced for 2013/2014 and taking into account current market absorption, we can expect relatively stable decrease in vacancy in the coming quarters.

Chart 3

Office vacancy rates



Source: LeRoy Research

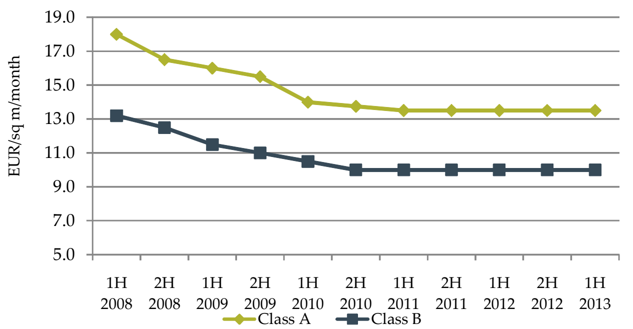
Rents

Moderate supply of new office space has kept prime rents stable since 2011. The prime class A rents are stabilized to EUR 14 - 15.5 per sq m/month, while the prime class B rents are EUR 11 - 12 per sq m/month. The rental levels in CBD area for the class A space is EUR 13 - 14 per sq m/month on average, while for the class B premises it is EUR 10.5 - 11 per sq m/month. The rents in the Wide Center area for the class A ranges from EUR 12 - 13 per sq/month, and for the class B from EUR 8 - 10 per sq m/month. Tenant incentives remain a feature of the market and can include fit-out contributions and rent free periods, particularly for existing class B buildings while landlords in prime locations can afford to be less flexible.

Office yields seem to have bottomed out in 2010, and we noticed stabilization since 2011 onwards. With few speculative developments that will not significantly affect the existing stock, average rents are not expected to decline further, especially in the prime office segment.

Chart 4

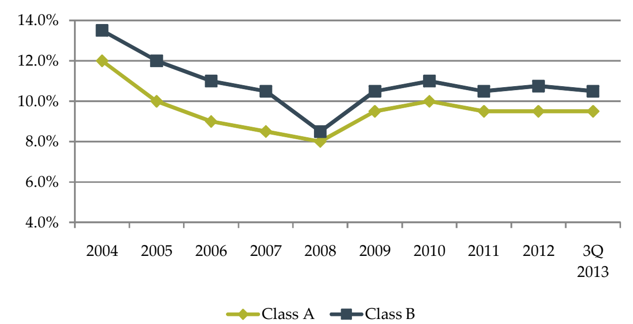
Average rent levels



Source: LeRoy Research

Chart 5

Office yields



Source: LeRoy Research

Pipeline

After a period of stagnation, a few small-scale projects should be delivered during 2013/2014 that will bring new 15,000 sq m of GLA. Large-scale developments (the office projects “Tri lista duvana”, “Atlas building” and “B-23”) are still on hold and their completion will bring new 47,000 sq m of speculative space to the market.

In terms of speculative developments, the project “Swiss build” (1,220 sq m of GLA) in Kralja Aleksandra Boulevard should be delivered by the end of 2013. By the end of 2014, the Austrian developer Soravia Group announced completion of construction of mixed-use complex “Old Mill” that will comprise 4* hotel and office building (3,200 sq m). The construction company Deneza announced delivery of a new office building in Tosin bunar Street (4,000 sq m) by the end of 2014.

The announced construction of Banca Intesa headquarter building (24,000 sq m) at the corner of Mihajla Pupina Boulevard and Tresnjinog cveta Street in New Belgrade (block 11a) is currently on hold.

Forecast

New speculative developments are rare and it will remain so until a sustained upturn in demand. Economic recovery has lost its momentum, compounded by very low level of foreign direct investments (FDI) and expected growth of unemployment in the coming year, which will possibly prevent a required level of expansionary demand.

The lack of new supply and modest short-term pipeline, together with slow demand recovery, influence the pace of office market activity through slow but steady absorption of available space. Headline rents are expected to remain stable in 2013. With the expected level of new completions, vacancy rate will decrease further in next 12 months, setting the scene for slight rental growth of class A office space. The overall impression is that Belgrade office market shows a good outlook in the medium run.

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