

Briefing note

CEE investment markets

Expanding and attractive

March 2018



SUMMARY

CEE investment volumes have been rising since 2012 by 25% pa

■ All CEE economies are growing at above EU average rates. The average unemployment rate has halved over the past decade to 4.5%.

■ Technology (ICT) and Transport & Storage sectors are expanding fast due to low wages and skilled labour. Demand for offices and logistics are driven by this growth. Poland, Czech Republic and Romania are the largest markets.

■ Supply of quality office space is falling; the average vacancy rate dropped to 8.7% in Q4 2017 from 11.1% a year before.

■ Prime office rents increased by 3.0% pa last year and we predict that they will rise by another 3.0% on average this year.

■ Strong fundamentals have underpinned investor demand. Last year the total investment volume was close to €12bn, 7% higher yoy. The markets are becoming more diversified in terms of investor profile and sectors targeted.

■ Prime yields in the CEE markets are at historic lows but still higher than the rest of Europe. Further yield compression is anticipated.

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“Positive market fundamentals and attractive yields bring new capital in the CEE markets.” Eri Mitsostergiou, Savills European Research

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→ Economic expansion above EU average

The CEE economies had the strongest year in a decade in 2017, with GDP estimated to have expanded by an average of 4.7%. This is up from 3.1% the year before and higher than the 2.4% average growth of the European Union (EU28). The region is benefiting from export demand from the Eurozone, accommodating fiscal policies and growing domestic demand.

The country with the fastest GDP growth last year was Romania (6.8%), followed by Poland and the Czech Republic (4.5%). All economies were underpinned by growing wages and buoyant household consumption.

The average unemployment rate was at 4.9% in 2017, the lowest in a decade at compared to 7.7% across the EU28. Rising wages support private consumption, which expanded by 5.4% last year, compared to 1.8% in the EU28.

The factors that drove economic expansion last year will continue to support activity in 2018, with the regional GDP forecast to expand by 4.0%, compared to 2.2% in the rest of the European Union (Oxford Economics).

The main risk to the outlook is the political uncertainty with rising Euroscepticism in the Czech Republic, protests against the government in Slovakia and Romania and Poland's clash with the EU.

Investment activity is rising

Investors showed confidence in the CEE markets last year with the total investment volume close to €12bn, 7.0% up from 2016 and almost 80% above the 10 year average. Activity has picked up, particularly in the smaller markets, as investors are moving up the yield curve in search for less competitive markets in Europe and better returns.

Investment turnover in the five countries we monitor is already 19% above the past peak and its share over the total European activity surged to 5.2% in 2017 from 3.5% in 2015 and 4.9% in 2016. This is above the 4.5% 10 year average and in line with the share achieved in the past peak.

The largest market was Poland accounting for 42% of the investment turnover, followed by Czech Republic at 30%. Hungary and Romania accounted for 15% and 10% respectively, however they showed the highest annual upward trend last year, Romania grew by 54% and Hungary by 14%, confirming investor confidence in their future prospects.

The markets have become more diversified

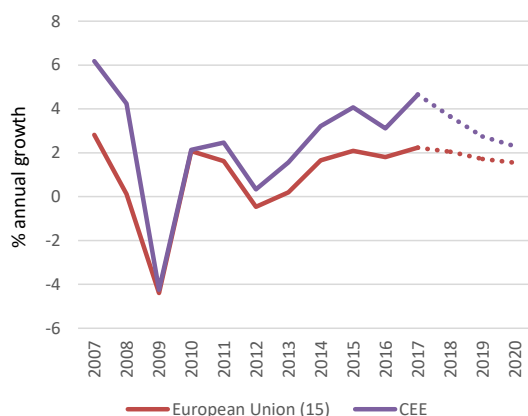
Retail captured the highest share of activity in 2017 (46%) followed by offices (30%). The market has become much more diversified compared to ten years ago, when offices and retail were capturing over 90% share of the total investment. Last year industrial

space accounted for 15% of the turnover compared to 4% ten years ago, while hotels increased their share from 2% to 9% over the decade.

Investor composition in terms of origin has also become more diversified. In 2017 the largest group of investors, in terms of capital deployed in the region, came from South Africa (18%) followed by Germany (11%) and the US (10%). The share of intraregional investors remained significant at 18% of the total activity. This breakdown looks very different compared to ten years ago, when European investors from Austria, UK, Germany and France accounted for over half of the activity. The market has been maturing over the years in line with growing economies offering attractive opportunities for developers and investors that were prepared to invest in these smaller but growing markets.

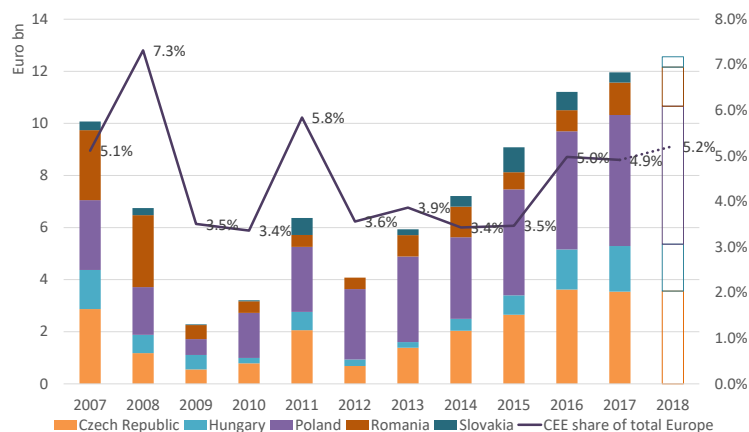
South African and US capital in particular have contributed to the rising liquidity of the less mature markets in particular, with more than €6.5bn investments over the past five years, almost a quarter of the total turnover. Capital inflows from Asia have also been on the rise, especially Chinese and Singaporean players who invested almost €1.9bn over the past two years in the region (Source: RCA).

GRAPH 1
CEE vs EU15 GDP growth Above average rates in the region



Source: Oxford Economics

GRAPH 2
Investment volume Record high turnover in CEE markets



Source: Savills, RCA

Strong market fundamentals across sectors

Rising investment volumes in the CEE region are justified by strong market fundamentals.

■ Offices

The office sector has enjoyed a steady growth in demand for modern stock. Last year take-up went up by 8% pa and was 22% above its 10 year average. Demand was driven by shared services and ICT companies, which are expanding in the region.

Overall, the ICT sector output expanded by 4.7% last year, well above the EU15 average of 3.6%. Impressive growth rates were noted in Romania (9.2% pa) and Hungary (5.7% pa). Poland was the largest market for ICT accounting for 44% of the regional output. The Czech Republic came second with 21% share in the region's ICT output. Lower labour costs and a skilled multilingual workforce have been the key reasons for the attractiveness of the region.

The markets experienced a drop in vacancy rates (-20%), which have fallen below their high levels three or four years ago, at 8.7%. In Prague and Budapest the vacancy rate was at 7.5% in Q4 2017, spurring developers to propose new schemes. There are about 300,000sqm of new office space in the pipeline in Prague and over 400,000sqm in Budapest and Bucharest respectively, for 2018-19. Warsaw also saw its vacancy rate

falling to 11.7% last year compared to 14.2% in 2016. Development activity has slowed down, with about 485,000sqm of new space set to be delivered in 2018 and 2019. Generally, low interest rates, rental growth, yield compression and healthy demand drive development activity in the region.

Indeed, prime office rents increased last year, in line with rising take-up and falling availability of quality space. Last year prime CBD office rents increased by 3% on average, the highest rises noted in Warsaw and Prague at 5% respectively.

■ Logistics

Logistics is a sector of particular importance in the CEE markets. The geographical position of the region and the competitive labour costs have supported demand for industrial space and regional logistics hubs, even more so since the infrastructure in these countries has been improving. Demand has also been underpinned by the growing share of ecommerce and rising consumer spending locally and across Europe.

The Transport and Storage sector output expanded by 4.9% compared to 2.5% in the EU15 in 2017. Impressive growth rates were noted in Romania (8.1% pa), and Poland (6.5% pa). Poland was the largest player in the market accounting for 44% of regional output, followed by Romania with a 22% share.

■ Retail

Since this region has been lacking historically in high street space, shopping centres are the main destination for shopping and leisure. With wages and retail spending growing there is need for captive retail destinations. Average wages increased last year by 7.8% in Czech Republic 11.1% in Poland, 12.3% in Romania and 13.5% in Hungary. This had a positive impact on consumer sentiment and retail sales, which were on average 6.3% up from the previous year across the region, compared to 2.8% in EU28.

The average shopping centre density in the CEE markets we analyse was at 222sqm per 1,000 population in 2017, which compares to 315sqm in Europe (EU28), implying that the region is still undersupplied. Although there are still new and successful retail schemes being delivered in these markets, the scope for further supply may be challenged from the fast rise of ecommerce in the future.

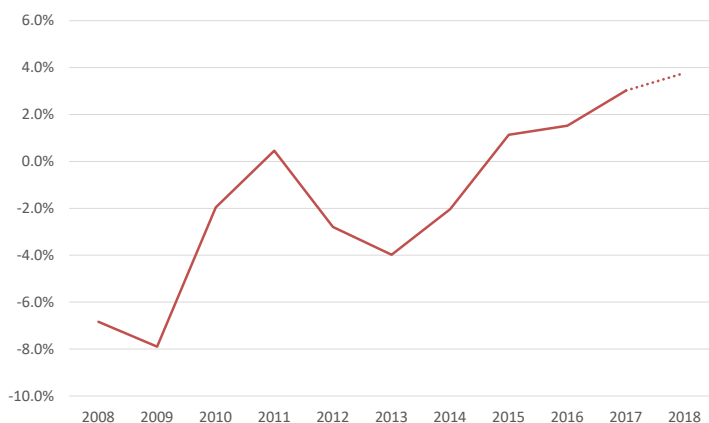
■ Hotels

Hotels last year captured 9% of the activity, a 72% rise from the year before and 161% above the 10 year average.

The number of tourist arrivals has been going up consistently across all the countries, in 2016 the region experienced a 9% increase yoy. The strength of the tourism sector and its positive impact on hotel performance, has attracted international capital, which targets good quality assets and benefits from positive income returns.

GRAPH 3

Average* CEE prime office rental growth Rents are rising for the best buildings in the best locations



Source: Savills, *Average of Prague, Budapest, Warsaw and Bucharest

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 “The ICT and Logistics sectors are key for the performance of the property market. The availability of quality space can attract the best companies and retain talent” Eri Mitsostergiou, European Research

Prime yields are compressing

Average prime office yields in CEE were at 6.2% on average in Q4 2017, 40bps below the previous year. Yields have been compressing since 2009, but they remain the highest in Europe, as the average prime office yield for the rest of the European markets was at 3.7% at the end of last year.

The highest yields for prime office space at the end of last year were achievable in Bucharest (7.25%). Budapest followed at 6.0%, while the more established markets of Prague and Warsaw were at 4.85% and 5.0% respectively. The steepest annual yield

compression was noted in Budapest, by -80bps.

Prime shopping centre yields were at 7.0% in Romania, 6.0% in Hungary, 5.0% in the Czech Republic and 5.0% in Poland. Yield compression was between 0 and 30bps pa.

Prime logistics yields are higher, at 8.5% in Romania, 7.7% in Hungary, 6.25% in Poland and 5.75% in the Czech Republic.

We forecast further yield compression across all sectors in 2018, between 10bps and 25bps. We believe that the logistics sector has the best prospects.

OUTLOOK

Good yield compression prospects across CEE markets

■ The region's GDP is forecast to continue to grow above the EU average in 2018. Romania and Poland are expected once again to be the top performers with 4.8% and 4.2% annual GDP growth respectively.

■ Our evidence shows that investor confidence in the CEE region continues to strengthen, supported by positive fundamentals and attractive yields. We expect Asian inflows of capital to rise further and new sources of capital to emerge.

■ The development of the occupier markets has improved the demand and supply balance leading to positive prime rental growth. We forecast that prime office rents will grow by 3% on average this year.

■ The growth of ecommerce will continue to drive the demand for medium size warehouse space, as well as large scale European logistics platforms.

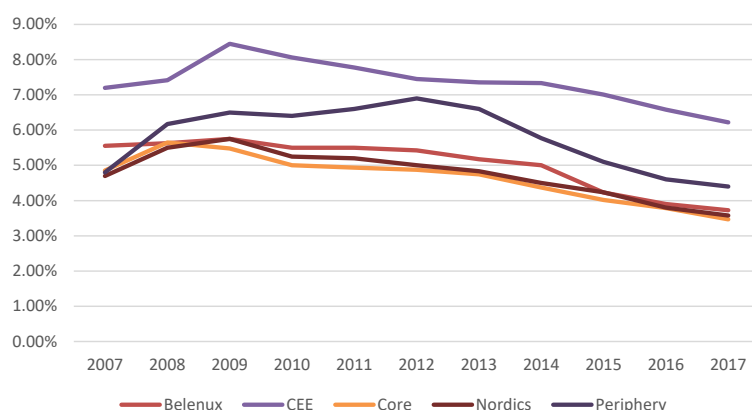
■ Despite rising labour costs, the CEE markets remain the cheapest in Europe and will maintain their attractiveness as shared services, manufacturing and distribution destinations.

■ Yields still have room to compress further. This year we predict that prime yields in Hungary may move in by 20-25bps and in Poland by 10-25bps across all sectors. The Czech Republic is likely to see a 35bps yield shift for prime offices and Romania a 50bps yield shift for prime logistics, while the rest of the sectors may stabilise.

■ As the traditional asset classes grow, investors will turn their focus to alternative asset classes where there is less competition. We anticipate the total investment volume to exceed €12.5bn this year.

GRAPH 4

CEE prime office yields in context Still considerably higher despite compression

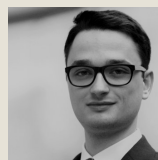


Source: Savills

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