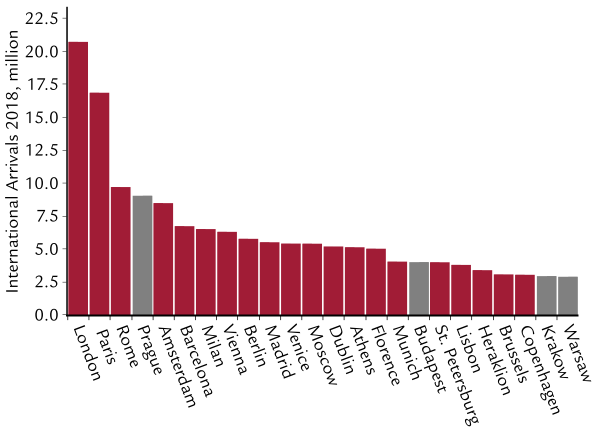
Real Estate House View
Hungary, Poland, Czech Republic

Second half-year 2019

Key takeaways

- As the real estate markets in Central and Eastern Europe benefited from the good economic situation in recent years, it is mainly the sectors that depend on domestic demand that might weaken as economic growth is expected to ease. Due to offshoring from Western Europe, the office and logistics sector will certainly remain attractive.
- In the office sector, the letting markets performed very well last year on the demand side, but there is evidence of a strong reaction on the supply side, which significantly limits the prospects for rental growth.
- E-commerce is now picking up speed in Central Europe as well, but growth in store-based retail sales is likely to remain considerable for the medium term, thus maintaining potential for some rental growth.
- Yields may continue to fall in the short term due to substantial yield spreads to many markets in Western Europe.
- The economic and interest rate environment need to be monitored, as yields are likely to pick up earlier or more rapidly than in Europe's core markets. Political trends in the individual countries should also be kept in mind.

Chart in focus



Source: Euromonitor International

The capitals of Central Europe may not be among the leading European tourist destinations, but surveys on international tourist arrivals indicate that Prague in particular is one of the most popular cities in Europe. In addition, Budapest and Warsaw also chalk up considerable visitor numbers. The positive effects of tourism are visible not only in the hotel but also in the retail sector – especially in the luxury goods segment but also in gastronomy.

With a delay to trends in export-oriented economies in Western Europe, business sentiment has started to deteriorate in CEE. The manufacturing Purchasing Managers' Index for the Czech Republic dropped below the 50 points mark for the first time since July 2016. Currently at 45.9 points, the indicator has reached its lowest level since July 2009. In all three countries, annual headline inflation accelerated through the first half of 2019, reaching its highest level since 2012. Therefore, the central banks have limited room for manoeuvre to stimulate the economy any time soon. The deteriorating growth/inflation mix weighs on consumer confidence, which has dropped from the multi-year record levels reached in 2018. Adding to economic tailwinds, the political climate is uncertain, with discontent intensifying in the Czech Republic as of late.

Investment markets perform well

The CEE markets saw a sharp increase in investor demand and transaction volumes in recent years due mainly to strong economic growth plus high initial yields in the European context. In 2018, PMA calculated the transaction volume for commercial real estate at around EUR 11.5 bn. While offices ranked first and logistics is gaining in relevance, the retail sector, at just under 35%, retained its above-average importance. A lot of international capital is flowing into the markets, but domestic capital is also playing an increasingly prominent role. In the first months of 2019, investment in the region weakened similarly to Europe overall, mainly due to a strong decline in Poland.

Will it be different for offices?

The CEE office markets continue to experience dynamic growth, but we see them as among Europe's most challenging markets due to high completions, especially in Warsaw. With office employment rising, net absorption reached record levels in 2018. Thus vacancy rates continued to fall in the major markets. Prime rents in Prague and Budapest picked up considerably in 2018, and even Warsaw saw some growth. The upward trend, but also the differences between the markets, are underlined by PMA's analysis of incentives: in Budapest, incentives – measured as a percentage of headline rents – dropped sharply to below 15%, and Prague too saw a slight decrease to 15%, while incentives in Warsaw remained at 25% of headline rent. The major concern remains the ongoing construction activity: as of end-2018, space under construction accounted for more than 12% of total stock in Warsaw and 10% in Prague, of which the majority was speculative. Current building starts, however, point to a slowdown in both cities, thus brightening the prospects for these markets. Unless this trend becomes more pronounced, there are grounds to remain sceptical. We assume that rents in Prague and Budapest will continue to edge up thanks to the current good momentum while in Warsaw they are set to remain stable.

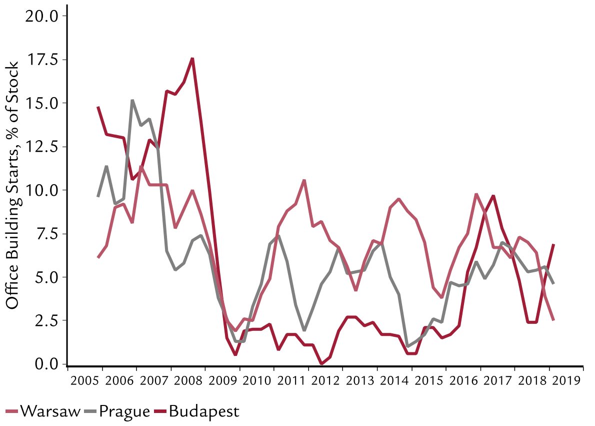
Retail still in good shape

Even if e-commerce is picking up momentum, store-based retail in the CEE countries is still able to generate sales growth thanks to low unemployment and rising salaries. In the capitals and some major cities, tourism also comes into play, leading to rising rents in the high streets and prime inner-city shopping centres. Thus strong growth is reported for Budapest and Prague over the last 12 months as vacancies have continued to decrease, while rent levels in Warsaw – which lacks a proper high street – have remained unchanged. Such growth is likely to wain in the future, but Budapest and Prague are expected to grow by roughly 2% on average over the next few years. With increasing saturation in the major markets, developers are turning to smaller cities, where retail parks are often becoming local anchor points for retailers.

Yields continue to fall

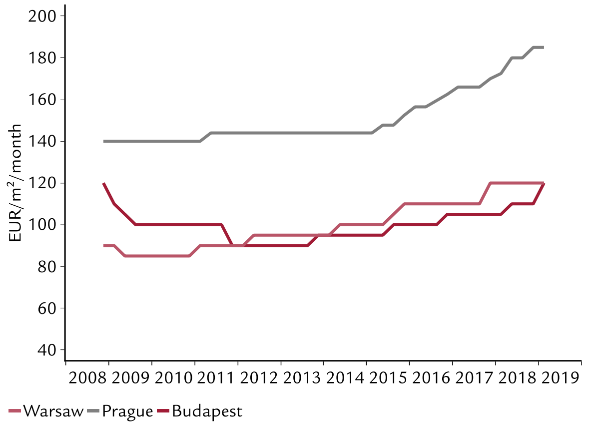
Yields remained under stronger pressure in 2018 than had been expected, falling by about 30 basis points in the major markets and segments. The yield compression impacted the performance of real estate investments: according to MSCI, investments in the CEE region achieved a total return of 10.1% in 2018, well above the 10-year average of approx. 5% and the previous year's 7%. In 2019, total returns are unlikely to increase as much due to the slowing momentum in both rental and price growth. However, in today's low interest rate environment there is still some room for a further slight decline in yields in 2019/2020.

Chart 1: Office building starts in % of stock



Source: PMA

Chart 2: Prime high street rents in major CEE markets



Source: PMA

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