

Real Estate House View

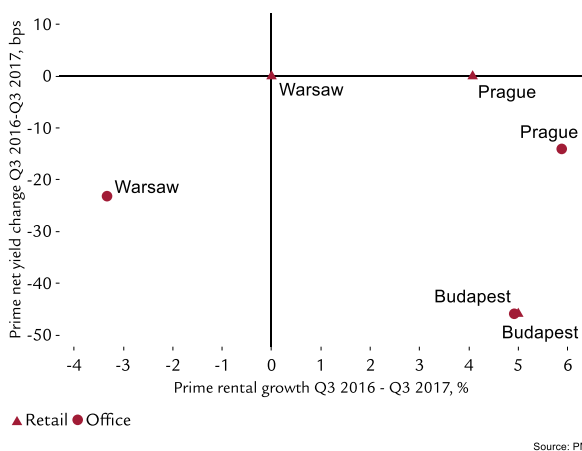
Hungary, Poland, Czech Republic

First half of 2018

Key takeaways

- The real estate markets in Central Eastern Europe (CEE) gained maturity over the past two decades but still feature some differences in market structures and cycles compared to Western European markets.
- Strong economic growth is fuelling the property markets but the letting markets are suffering from a strong expansion of supply, which is dampening rental growth, especially in the office sector.
- Warsaw remains a challenging office market due to oversupply and ongoing development activities, but there are signs of some improvements in the medium term.
- Strong consumer spending is creating space for rental growth in prime high streets and major shopping centres.
- In the residential sector, letting markets hardly improved but should provide investment opportunities in the future as immigration to the major cities and aging of the property stock boost demand for additional housing.
- Investment performance has been modest in recent years. Investors have returned to the CEE markets due to above-average initial yields since 2015, leading to notable yield compression.
- Yields have fallen in Budapest in particular, with rental growth visible in the office and retail sectors. In addition, the yield premium is attracting investors who are willing to accept the political uncertainties.

Chart in focus



The commercial real estate markets in Central Europe saw a significant decline in office yields in the past 12 months, though this was not accompanied by rental growth in every market. In 2018 we anticipate a stronger convergence in rent and yield trends: while yield compression is likely to weaken noticeably, slight rental growth in the office sector and a considerable gain in the retail sector is expected.

With their exposure to manufacturing, Poland and the Czech Republic are benefiting from the continued upswing in the Eurozone. Unemployment rates have been falling sharply across the entire region since 2015. Wage growth in the Czech Republic exceeds 4%, adding to decent growth in disposable incomes. Domestic politics, which are not compliant with EU standards, do not bode well in Brussels, with Poland's reform of the judiciary still being the largest obstacle. These disputes may limit foreign direct investments into the region going forward. In regards to the monetary policy, the Czech National Bank is one of the few central banks which has embarked on a tightening cycle.

Office markets still difficult

The major CEE office markets have seen increasing demand and take-up since 2015, reflecting the strong economic growth in these countries. Positive momentum was recorded especially in Warsaw in terms of letting activities in general and net absorption in particular (due to increasing expansion of space). In contrast, Prague is still characterised by a high level of relocations and far less by demand for additional space. The CEE office markets are seeing a lot of construction activity as developers usually react promptly to positive signs in the letting markets. Warsaw serves as an example: net additions are high despite high vacancies (above 13% as of Q3 2017). In contrast, availability in Budapest and Prague decreased in 2017 as a result of low completions. High vacancies has limited rental growth in the past. We expect very subdued rental growth in Prague and Budapest but ongoing short term pressure in Warsaw. In Warsaw, however, the situation could improve in the future since new builds are outperforming the quality of existing properties only slightly. This might soften tenants' movement to higher quality space. Large companies are also increasingly focusing their staff in the CBD in order to attract high skilled young employees. This is consequently stabilising the office market, especially in central areas, which should be supported by a gradual decline in construction activity.

Economic growth pushes retail

The economic fundamentals provide good prospects for the CEE countries, which enjoy the highest consumer and retail spending forecasts in Europe for the

coming years. However, online sales are significantly lower in CEE compared to Western Europe. Against this background, the high street areas in the capitals, especially in Prague and Budapest, offer further potential for rental growth. In the medium term, an annual increase in rents of circa 2% seems realistic in prime locations. In the shopping centre segment there are major retail schemes in many CEE cities. Retail demand focuses on large, well located and easily accessible centres with a strong tenant mix, whereas smaller schemes tend to suffer. As a result of strong consumer spending and continued expansion of retail chains, rents in the prime shopping centres are expected to rise in the short and medium term.

Residential markets emerging

Due to the high home ownership rate, neither considerable letting nor institutional investment markets have emerged in the CEE countries. However, some transactions by institutional investors have taken place recently. In the medium term, however, changes are to be expected. Overall, Central Europe has the same main drivers as those in the Western countries: strong migration from the hinterland to the large cities and hence the need for additional housing, including apartments for rent. Moreover, many buildings from the socialist era need to be refurbished or replaced. As a result, rents and house prices are rising not only in the capitals but also elsewhere, leading to investment opportunities in the medium and long run.

Strong investments figures

Transaction volumes in CEE increased strongly in 2016, and the region saw ongoing strong demand in the first quarters of 2017. Yields compressed significantly in this context but look set to bottom out in the course of the year in both the Czech Republic and Poland. Due to political uncertainties, Hungary has still high initial yields in the European context, so investors are continuing to compress values further down. Overall, yields are likely to remain under pressure in 2018, resulting in slightly lower levels.

Chart 1: Net addition of office stock in CEE's main office markets

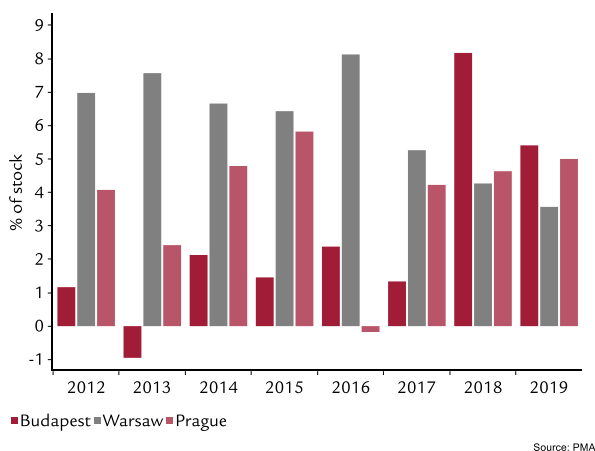
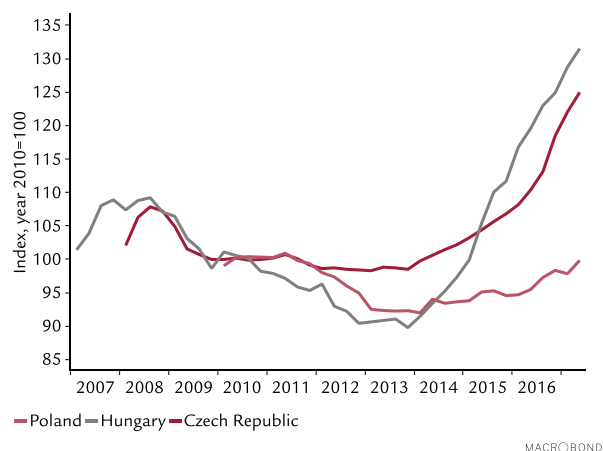


Chart 2: House price index for the major CEE countries



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