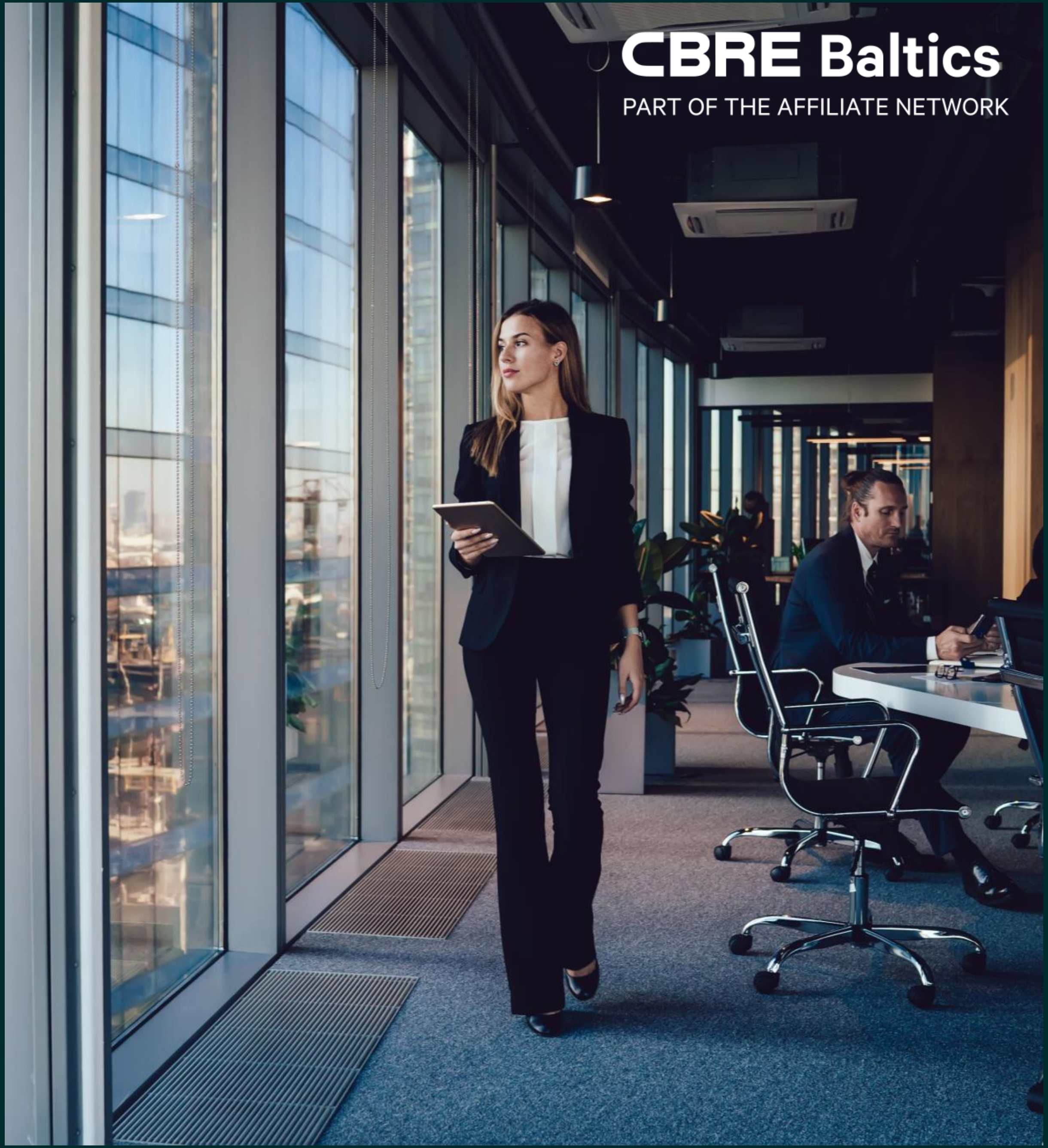
All Sectors

Market Outlook H2 2023

REPORT

BALTIC
REAL ESTATE



Trends to Watch

01

INVESTMENT

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02

OFFICE

Return-to-office rates remain mild across the Baltics. However, corporate policies are tightening and becoming more prescriptive. The optimal return-to-office policy largely depends on the size and sector of the company.

03

RETAIL

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04

INDUSTRIAL & LOGISTICS

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05

HOTELS

Regional tourism will significantly benefit the Baltic hotel sector in the short term. Sustainability, wellness, and personalized experiences will be key drivers of conscious consumer demand in the long term.

06

PURPOSE-BUILT RENTAL RESIDENTIAL

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01

Investment

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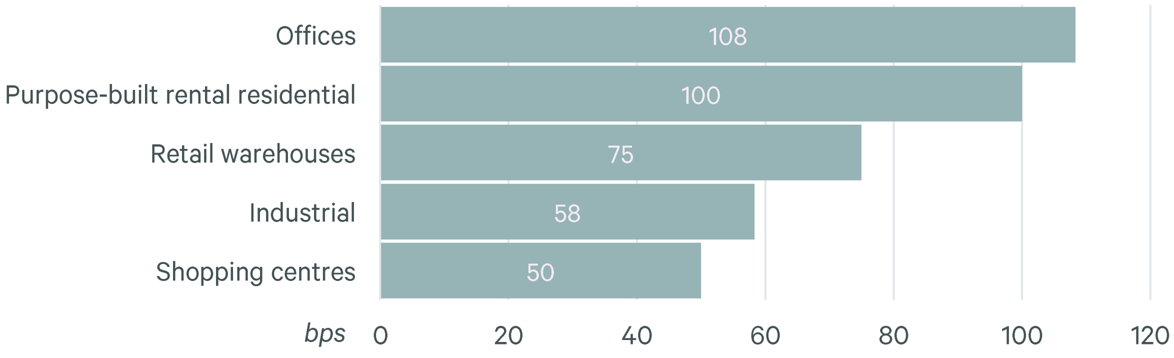
> Increased interest rates have triggered a widespread repricing of commercial properties. Although long-term rates may have peaked, further asset repricing may occur as property yields continue adjusting to the increases that have already occurred.
>
> We expect that inflation is likely to decline over H2 2023 as commodity prices continue to fall, and demand cools under pressure from high interest rates. Similarly, the asset repricing rally should be nearing its end in H2 2023.

- Lately, the European Central Bank (ECB) has raised its main refinancing rate by 25bps to 4.00% and deposit rate by 25bps to 3.50%, both reaching their highest levels since 2008.
- While ECB's rates are still increasing, there are tentative signs that core inflation is abating, and economic activity is slowing. However, the effects will probably be delayed to next year.
- The ECB rate increases are already reflected in long-term interest rates. A further gradual decline in long rates is expected, provided that inflation continues to fall as expected.
- Greater certainty on the interest rate outlook is expected to provide a foundation for recovery in H2 2023, particularly for capital markets activity.

Figure 1: Annual Prime Yield Change across the Baltics, June 2022 - June 2023



Source: CBRE Baltics Research

Equity-like returns for debt-like risk?

Rapidly rising interest rates have forced market participants to recalculate their expected cash flows. This applies to both potential owners and financiers of commercial real estate. The tightening conditions of senior debt, predominantly provided by local Nordic-originated banks in the Baltics, include a higher portion of equity, shorter debt amortization periods, and more conservative loan covenants. Furthermore, the diminishing banks' loan books, coupled with stagnant GDPs and filled RE allocation limits, is resulting in a disappearing supply of senior financing. On the other hand, equity holders still require more favorably priced debt to meet their required returns.

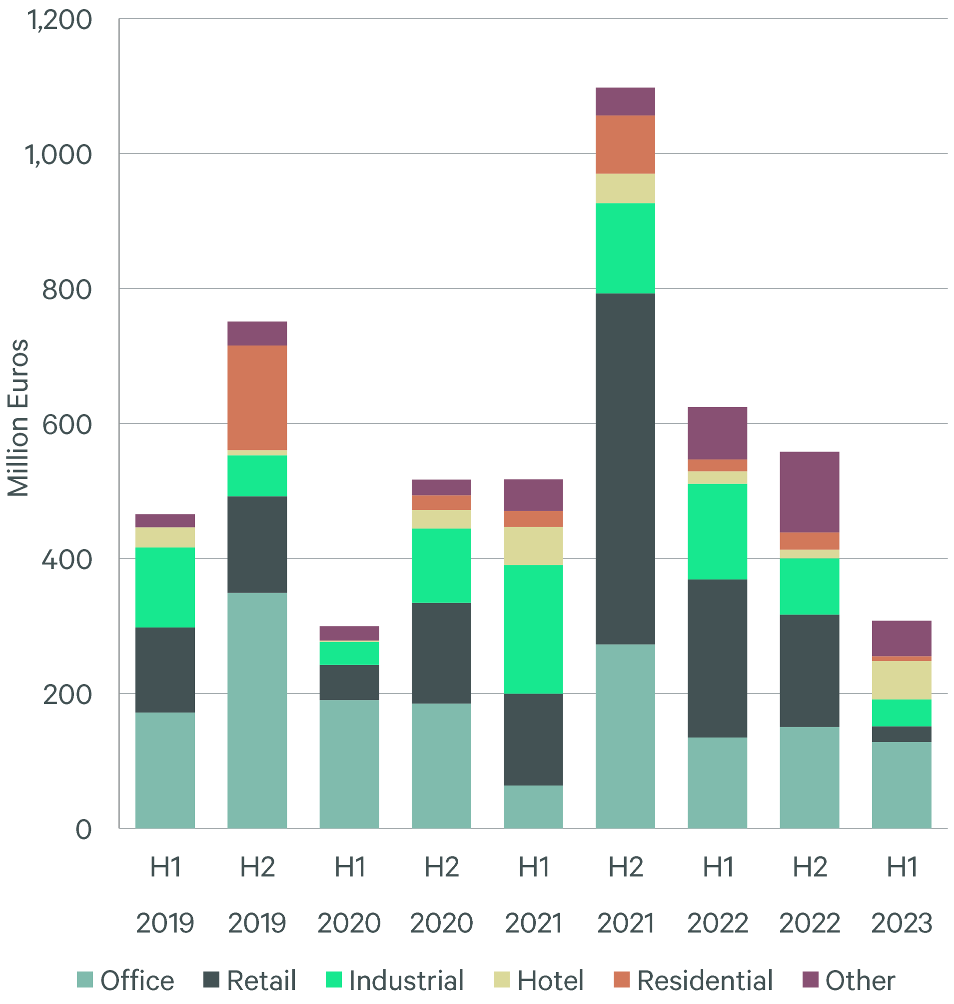
This situation creates opportunities for intermediate layers of financing, such as preferred equity or mezzanine debt, which have historically "bridged" the capital needs. First public announcements have already been made about launching such new vehicles in the Baltics to fill the financing gap in the Baltic real estate.

Investment market slowdown

The slowdown will continue in the number of completed transactions and the volume of investments. The ongoing geopolitical situation in Ukraine does not favor the decision to enter the Baltic region for potential investors. The main asset class targeted is offices. Yet, after the pandemic recovery, the Baltic hotel sector has become increasingly attractive.

Investors will focus on the performance of existing portfolios, and even if the value decreases in the valuation reports, we do not anticipate forced sales for large discounts over H2 2023. Sellers continue to hold their target price higher than what investors are willing to pay, and this is the main reason some investors are exploring opportunities outside the Baltic capitals, where yields are higher and opportunities are broader. Therefore, Baltic investors will continue searching for commercial real estate in the CEE region.

Figure 2: Investment Volumes by Sector, Baltics, H1 2019-H1 2023



Source: CBRE Baltics Research

02

Office

Return-to-office rates remain mild across the Baltics. However, corporate policies are tightening and becoming more prescriptive. The optimal return-to-office policy largely depends on the size and sector of the company.

The larger the company, the more frequent the visits

Office return rates across the Baltics still remain low. However, following the set example across European occupiers, policies are tightening and becoming more prescriptive. Optimal policy largely depends on the size and sector of the company. For example, across CEE, 58% of Financial and Professional Services companies are communicating to employees about the importance of returning to the office for company success, while only 25% of firms among the Tech, Media and Telecoms sectors are doing so.

Changing workstyles are driving office design elements, too. Desk sharing and technology have come to the forefront of office fit-out. These shifts are extreme for large corporates: 83% are reducing dedicated or assigned seating and 81% are increasing activity-based work environments. As a direct consequence of these changes, desk sharing ratios are changing.

Lease structures change, too

The results from the CEE Office Occupier Sentiment Survey dictate that 55% of respondents are seeking more flexible expansion and contraction options on both new and renewed spaces. In the meantime, as many as 42% of surveyed office tenants are in search of shorter lease terms on both new and renewed spaces.

When selecting the location for a future office, public transportation access seems to be the most important factor, with progressively rising selection based on sustainability. Green leases are also expected to enter the picture more actively in the periods ahead.

Figure 3: Current Return-to-Office Guidance

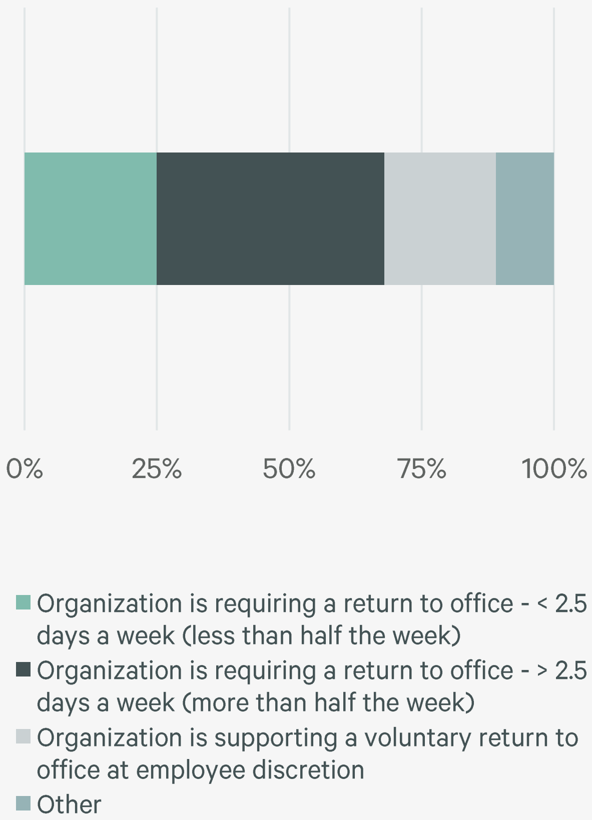
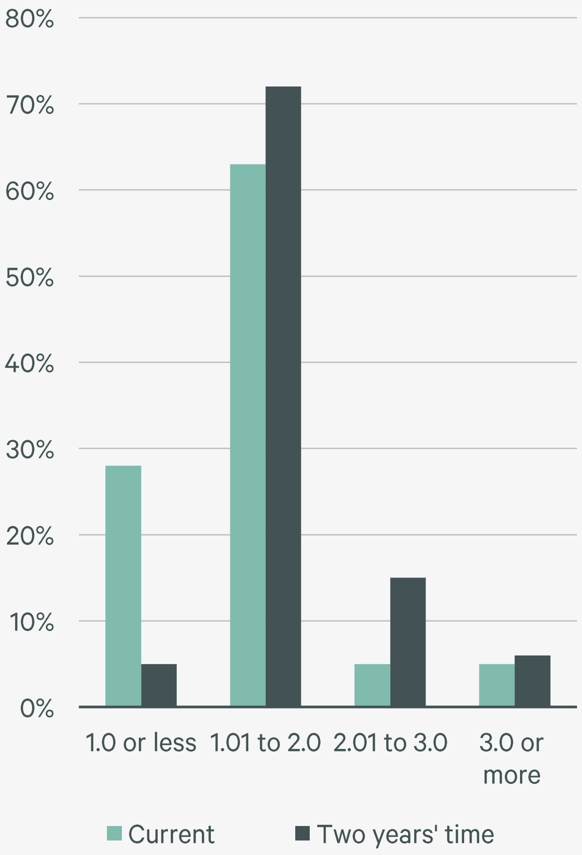


Figure 4: Typical Employee-to-Desk Ratios



Source: CEE Office Occupier Sentiment Survey 2023

48%

Experiencing attendance rate of 40% or lower

72%

Reducing dedicated or assigned seating

90%

Aiming for employees to be at the office at least half the time

Source: European Office Occupier Sentiment Survey, 2023

Who will be in the forefront of the Baltic demand?

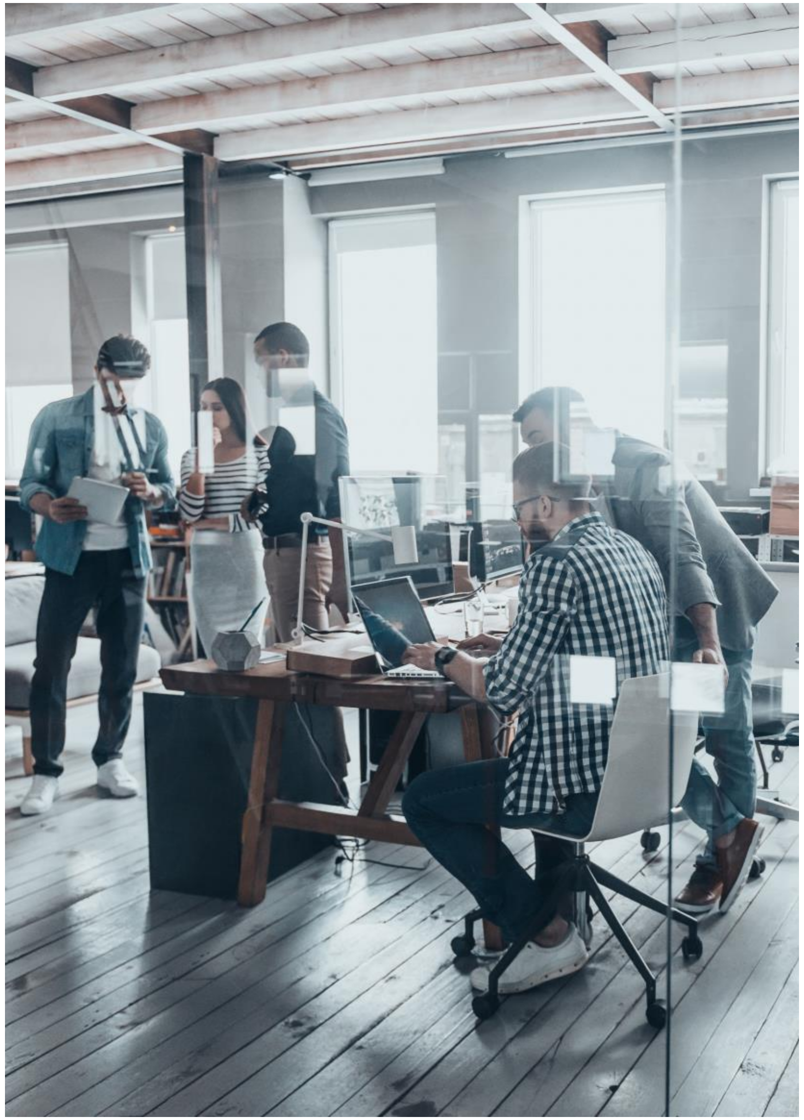
Historically, local occupiers have, on average, absorbed more than half of the office market space in the Baltic capitals. As a rule of thumb, the remaining space has been leased to FDIs and, more recently, to companies relocating due to ongoing geopolitical tensions in the region. While the latter has boosted demand in the short term, overall regional tensions create uncertainty for new entrants to the region. Consequently, Baltic take-up is expected to be more conservative in 2023, driven primarily by local relocations.

When it comes to the size of transactions, the average deal size has decreased over the last few years. The most significant change can be observed in the Vilnius market, where the average leased office size has reduced by over 50% (from 1,950 to 900 sqm) between 2019 and 2022. This trend is expected to continue into 2023, with the average office lease currently around 700 sqm year-to-date. In Riga and Tallinn, the average leased office size is also expected to remain predominantly lower.

Combined with the decreasing take-up and the implementation of somewhat flexible return-to-office policies, the long-term structural vacancy is likely to reach approximately 10-15%.

Currently, the office market in the Baltics seems to favor the tenants' side, and higher incentives can now be achieved. The office market generally tracks growth in the job market. However, under the current economic circumstances, tenants have learned to use space more efficiently, sometimes even expanding their headcount.

The prevailing trend of the so-called hidden vacancy (arising from non-optimal utilization of space and stalled expansion plans) might also push the construction market to slow. A fully fitted-out office space offers a competitive advantage over standard landlord offerings, especially considering the rising costs of fit-outs and significant expenses associated with capital investments. As a result, tenants are expected to become more discerning when evaluating existing market offerings.



03

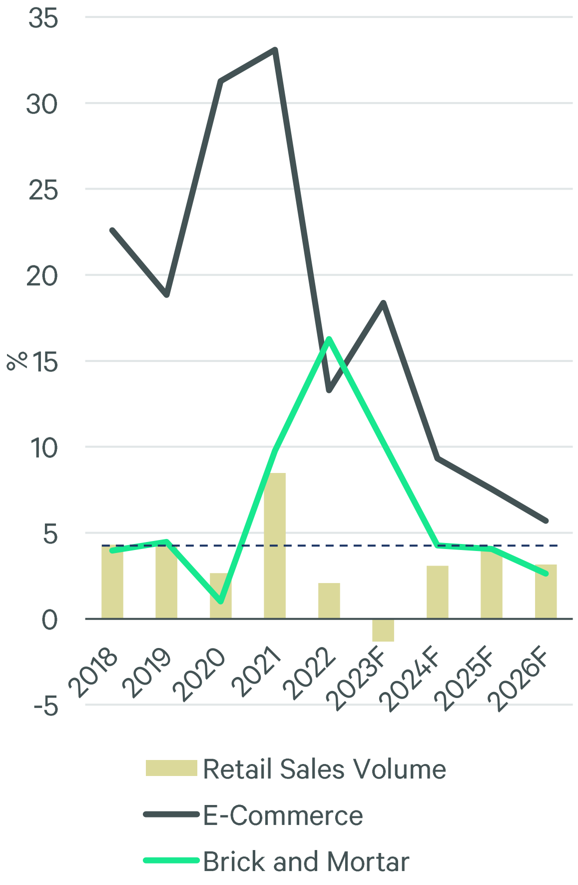
Retail

The proportion of multifunctional projects dedicated to retail continues to rise. An increase is also expected in redevelopment activity. Investments in automating the shopping experience continue.

Investments in innovations

Refurbishment and improvement of public space amenities are becoming increasingly important in landlords' investment programs. Investors in retail space are competing to capture the attention of both consumers and retailers. Furthermore, there is a growing focus on multifunctional spaces, and the term "retailer" is expanding rapidly to include various providers of catering, services, and amenities that contribute to a seamless shopping and leisure experience. Additionally, the proportion of multifunctional projects dedicated to retail continues to rise, accounting for over 30% of the project pipeline in 2023/2024. Moreover, there is an increase in the redevelopment of historically significant market areas. Investment programs have been announced for two functioning marketplaces: Keskturg in Tallinn and Urmas in Kaunas.

Figure 5: Retail Sales in Current Prices and Retail Volume, Annual Growth, Baltics, %, 2018 – 2026F



Source: Euromonitor, Oxford Economics

Evolution of channels

Under the economic slowdown, retailers are once again facing changes in consumer behavior and slower sales in H2 2023. To effectively navigate these market conditions, retailers and landlords are prioritizing ease of access through various channels.

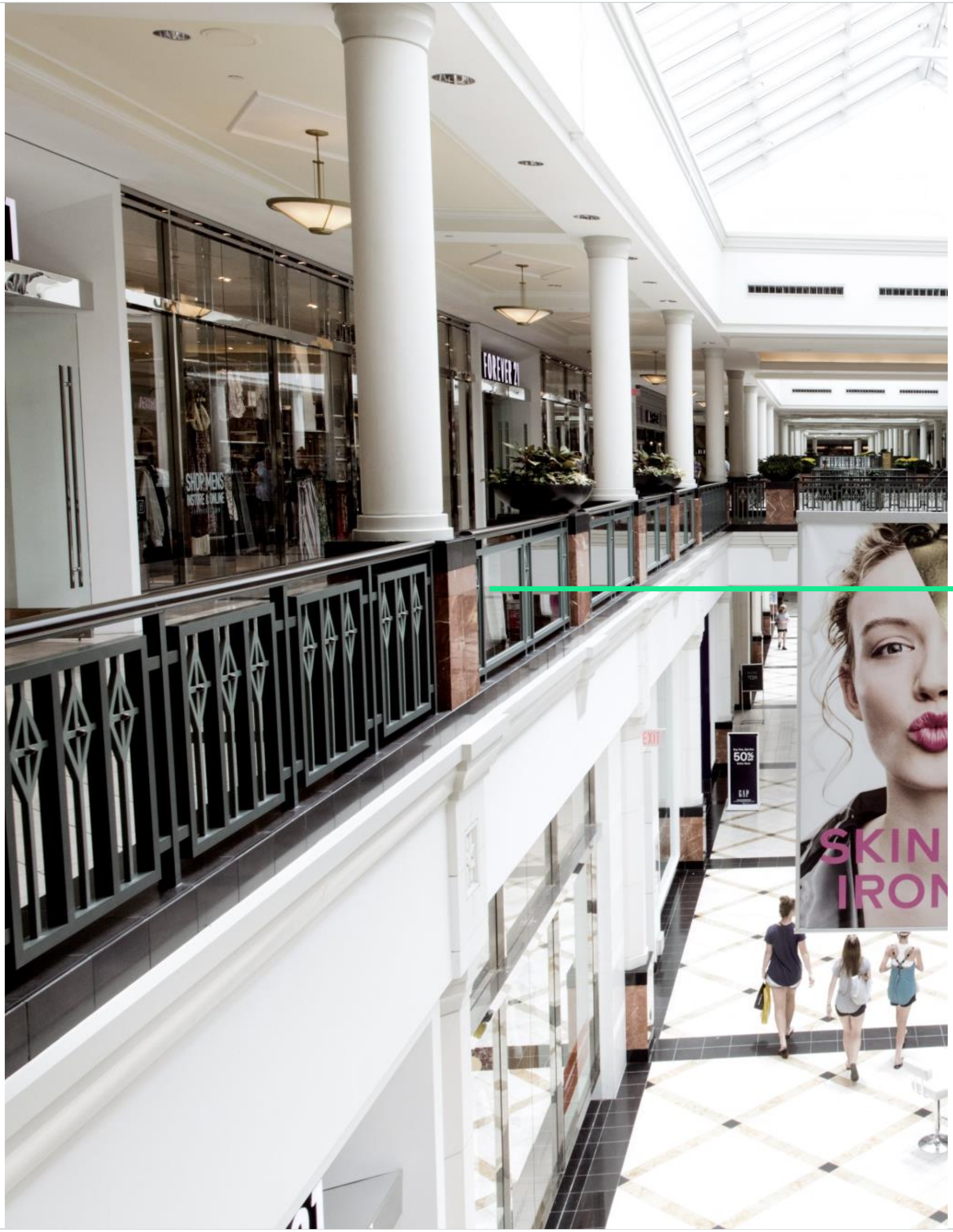
Investments in automating the shopping experience continue. From a brick-and-mortar perspective, the network of IKI autonomous stores in Vilnius has expanded, with the opening of a third store that operates without salespeople. The e-commerce ecosystem is also keeping up with the advancements. Clevon, an Estonian developer of autonomous vehicle technology, and the Lithuanian grocery store chain IKI have expanded their collaboration by introducing three autonomous robot carriers. These carriers deliver goods in lockable compartments for online grocery orders.

In the medium-to-long term, positive growth expectations for retail are supported by both e-commerce and brick-and-mortar channels (Figure 5). However, sales numbers have not yet fully recovered to pre-pandemic levels due to inflationary pressures and monetary tightening.

Although the preference for e-commerce has accelerated significantly in recent years, its impact is now slowing down, and physical retail will continue to play an important role. Most customers perceive physical and online retail channels as interconnected. Footfall and tenant sales across European retail assets have largely recovered within CBRE's managed portfolio of European retail assets. As a result, retail occupiers must focus on building an omnichannel offering for customers across online and offline platforms.

High inflation rates have a direct impact on the cost of goods and services, leading to higher refurbishment and operating expenses, as well as personnel costs for retail landlords and tenants.

The rising prices of raw materials, supplies, and utilities, coupled with a wage increase of approximately 9% in the Baltics, are placing additional strain on profit margins. Consequently, landlords are encountering growing property maintenance and improvement costs, while tenants cope with covering increasing operational expenses. Furthermore, tenants must navigate the application of indexation to their rent, all while ensuring that consumers are not excessively burdened. This complex environment requires careful management and strategic decision-making to strike a balance between sustainability and affordability for all stakeholders involved.



Navigating rising expenses has been placed high on landlords' agenda.

04

Industrial & Logistics

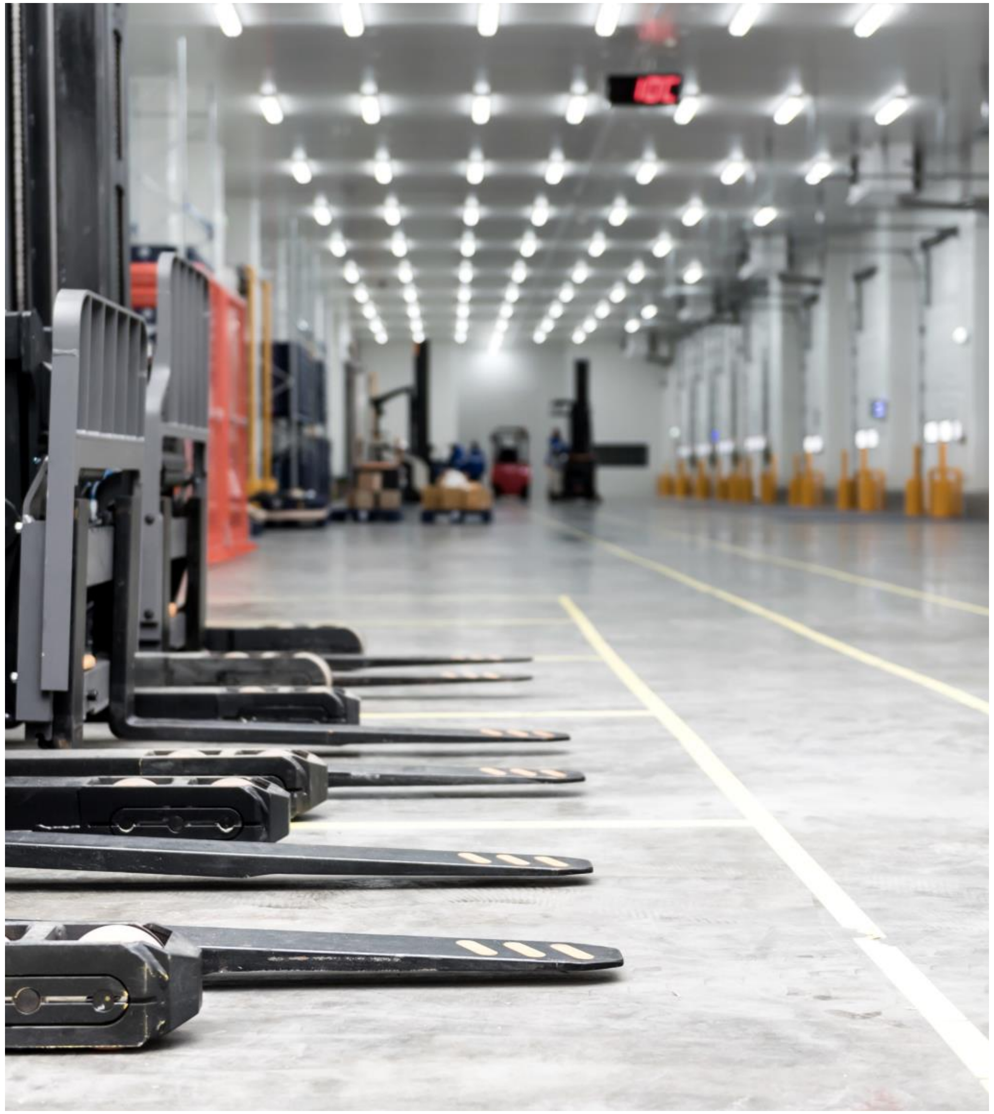
As the region's infrastructure continues to develop, with transforming transportation networks and expanding intermodal hubs, the potential for international companies to establish a presence in the region is expected to grow.

Manufacturing and nearshoring trends – will it reach the Baltics?

It is important to underline that many production companies in CEE countries choose to invest in their own production facilities rather than lease space from logistics developers, so the nearshoring occurrence is in fact higher than presented.

Manufacturing companies are increasingly taking industrial and logistics units throughout Europe, with a similar trend being observed in CEE. Taking into account sectoral distribution, in Q1 2023 a significant increase of sqm leased by manufacturing companies in CEE was observed – 34% of take-up. Compared to 2022, it is an increase by 11%. This trend is set to continue.

- The sentiment on manufacturing transactions in the Baltics is cautiously optimistic. The manufacturing industry in the Baltics has been experiencing steady growth in recent years, with an increasing number of companies considering operations in the region. The countries' skilled workforce, favorable business environment, and strategic location have all contributed to its growing popularity as a manufacturing hub. The Baltics' expanding network of free economic zones is also a key factor driving growth in the region's manufacturing sector (offering tax incentives, streamlined regulations, and other benefits).
- However, the availability of manufacturing lease transactions remains limited, with built-to-own projects being the more prevalent option. As the region's infrastructure continues to develop, with initiatives such as Rail Baltica and expanding intermodal hubs, the potential for international companies to establish a presence in the region is expected to grow further.



(Non)traditional formats

Historically, the majority of the logistics and industrial pipeline in the Baltics has been comprised of built-to-suit developments, while speculative projects have been relatively rare. However, with the growth of e-commerce, developers are showing increased interest in speculative storage facilities, particularly in the format of stock offices.

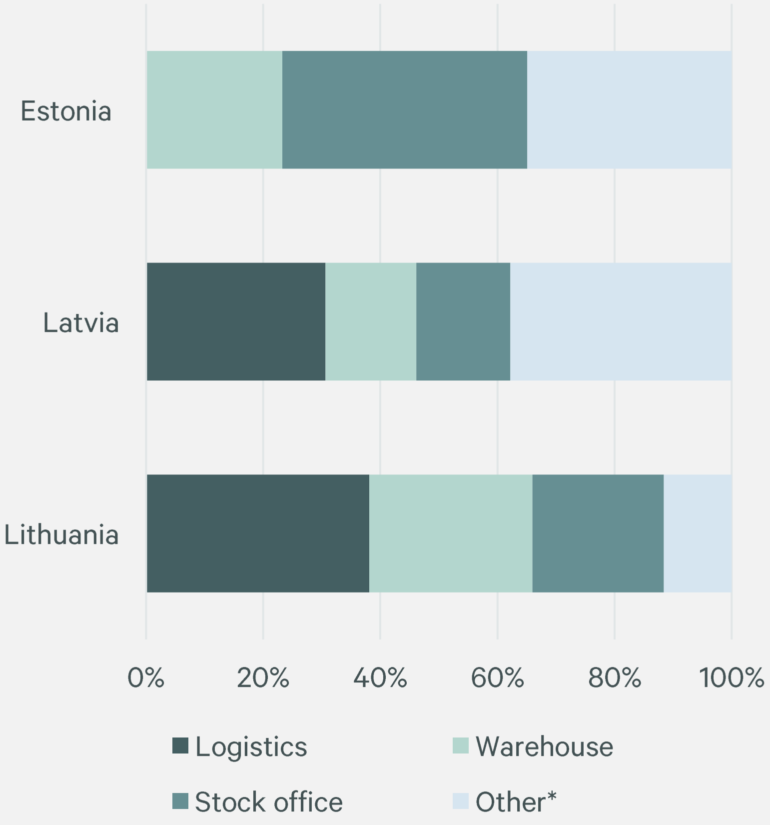
Stock offices have experienced significant growth recently and continue to be important landmarks with a substantial pipeline of projects. Several of these projects have already secured pre-leased spaces, indicating strong demand in the market. Existing stock offices maintain low vacancy rates and demonstrate robust performance. Due to their more flexible lease terms, such spaces tend to attract companies involved in e-commerce, wholesale, or retail trade. With a positive outlook, the stock office sector in the Baltics is expected to continue its upward trajectory.

Regional patterns

Over the past year, the CEE countries have been impacted by high levels of inflation, which have affected purchasing power and retail sales. These general weaker economic conditions have also had a negative impact on the real estate markets, including the industrial and logistics sectors. However, manufacturing companies are increasing their demand for warehouse space as a result of the nearshoring trend, opting to locate in attractive CEE countries.

Vacancy rates remain low in the majority of CEE countries. However, an increase in vacancies is expected to be recorded in 2023, as tenants are not expanding as eagerly as in previous years.

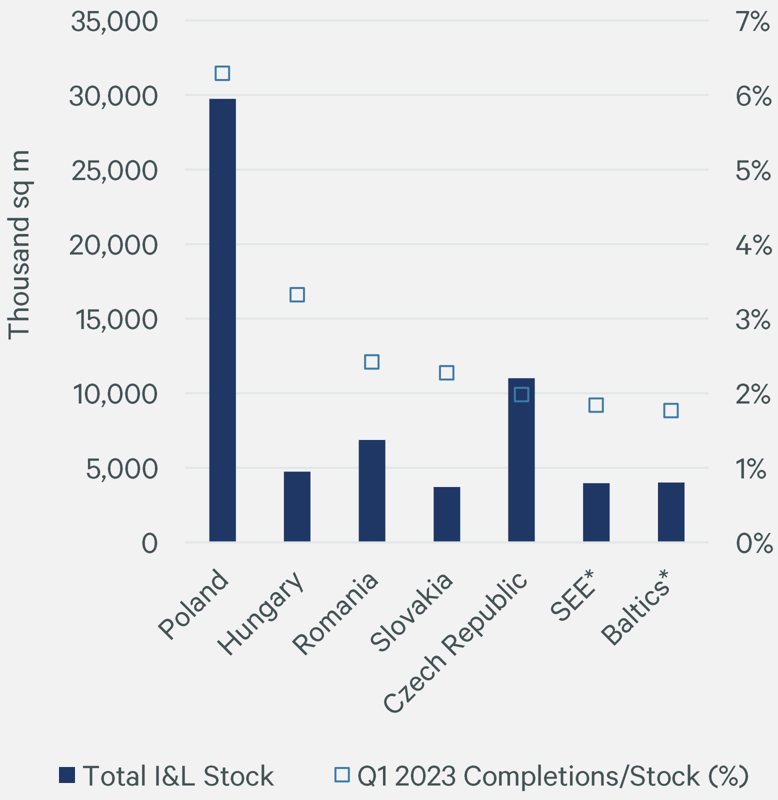
Figure 6: Under-Construction Industrial Stock



Source: CBRE Baltics Research

* - including production, laboratory and business parks types

Figure 7: Total Stock & Completions to Stock Ratio (%)



Source: CBRE, 2023

*SEE: Bulgaria, Croatia, Serbia, Slovenia

**Baltics: Estonia, Latvia, Lithuania

05

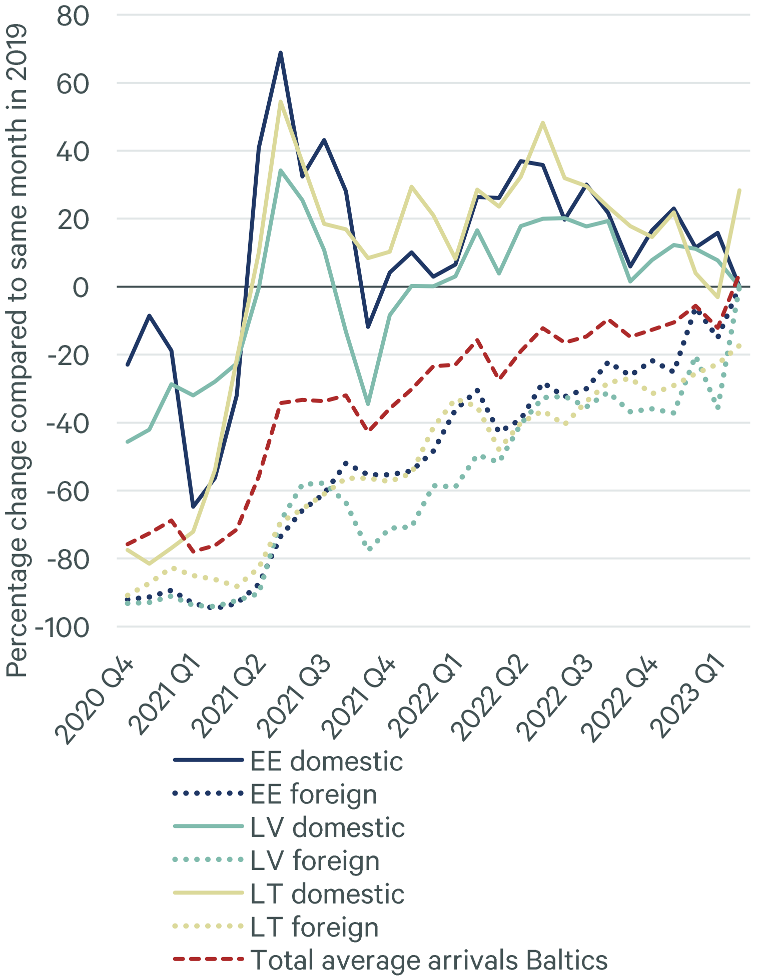
Hotels

Regional tourism will significantly benefit the Baltic hotel sector in the short term. Sustainability, wellness, and personalized experiences will be key drivers of conscious consumer demand in the long term.

Revival & restructuring

Alongside the economic uncertainty, an opportunity for Baltic hotels arises. By embracing innovation, financial restructuring, and adopting sustainable practices, the hotel sector can enter the blue ocean strategy.

Figure 8: Arrivals at Tourist Accommodation Establishments



Source: Eurostat, CBRE Baltics Research

Customers are now favoring regional travel routes, opting for land journeys over air travel. This trend has been accelerated by the increase in plane fuel prices, leading to higher ticket costs that consequently impact on hotel prices. Alongside budget constraints, travellers are becoming more conscious of the carbon footprint and overall sustainability impact of their trips. Reduced affordability, coupled with changing consumer behavior, has driven domestic Baltic tourism.

Globally, people are prioritizing travel spending, allowing prices to rise for both hotels and means of travel. Leisure travel has returned to 2019 levels, while business travel still lags. Additionally, rising travel costs and budget constraints remain concerns for European tourists. Climate change is already impacting the tourism industry, as well, with Europe experiencing its second warmest year in 2022, resulting in disruptive summer travel conditions. Cooler destinations are now leveraging this advantage as rising temperatures reduce the appeal of southern European-Mediterranean regions, causing tourism to shift towards the Baltics and Nordics as more attractive destinations.

In the short term, domestic and regional tourism will significantly benefit the Baltic economies, generating revenue and boosting the performance of the hospitality sector. Sustainability, wellness and personalized experiences will be key drivers of conscious consumer demand in the long-term.

06

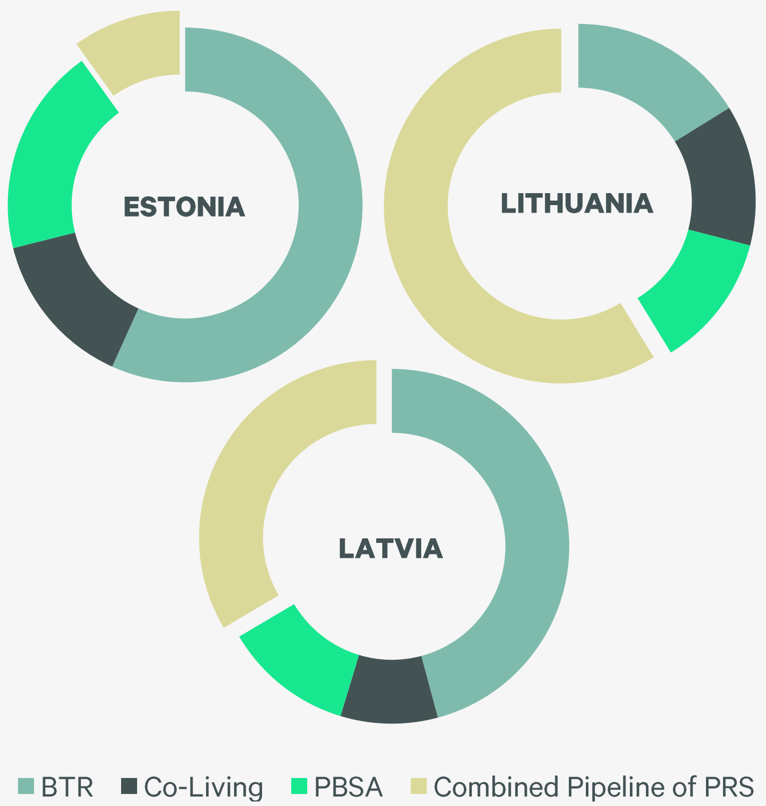
Purpose-Built Rental Residential

The rental residential market in the Baltics has become more concentrated in the hands of institutional investors, who often have more substantial capital availability to initiate and pursue the development of new projects, while smaller market players wait for more favorable conditions.

Rent or buy?

- The increase in mortgage rates has reduced housing affordability, in turn fueling growth in the rental residential sector. Markets expect household purchase lending rates to rise, approaching 4% by the autumn. Rising financing costs are impacting both landlords/investors which are having to pay higher costs to service loans and renters are impacted by inflationary pressure boosting communal costs and rental payments.
- While a decrease in newly built dwelling sales across the Baltics has been evident, the sales of older dwellings gained momentum in late 2022 pushing into 2023. Given the current decline in residential transaction volumes, it is anticipated that the market demand for apartment purchases may only fully recover in 2024.
- CBRE Baltics forecasts a minor shift in bargaining power from property owners to renters as a vivid trend in the rental market next year. Due to the already steeper apartment sales pricing as well as high costs of loans, it is believed that leasing will return as a more active alternative to owned housing.

Figure 9: Current Situation in Private Rented Sector in the Baltics, Number of Apartments



Source: CBRE Baltics Research
Note: BTR refers to Build-to-Rent; PBSA – Purpose-Built Student Accommodation.

The rental residential market in the Baltics has become more concentrated in the hands of institutional investors, often having more substantial cash availability to initiate and pursue the development of new projects while less substantial market players wait for less troubling conditions. This trend is set so continue.

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