Intelligent Investment

Baltic Real Estate Market Outlook
2024

REPORT

REAL ESTATE

CBRE Baltics Research

Introduction

2023 has been a challenging year

due to persistent inflation and a 15-year high in interest rates, both of which negatively impacted economic growth and real estate markets. Across Europe, investment volumes have plummeted, mainly due to diverging expectations between buyers and sellers and increased financing costs.

Although the Baltics have remained relatively more resilient, the growth was fueled mainly by local investment and lease activity. We enter 2024 with normalizing inflation and expectations for the ECB base rate to reach a sustainable level.

What can we expect from 2024?

It will be another year of weak growth, although somewhat more robust than the previous one. Occupier markets will present a mixed picture, with growing polarization between the best assets and the rest. Sustainability will be a growing influence on real estate decisions across all sectors. Different players in the market will be looking harder for alignment in their ESG agendas, and the quest for better data on the costs and benefits of sustainability decisions will accelerate.

Continue reading to learn more about the Baltic real estate prospects in 2024 – how similar and different they are across Estonia, Latvia, and Lithuania.

Contents

01

Capital Markets

As property yields decompress further, the mismatch between buyers and sellers will close. Improved capital market conditions will create transaction opportunities. However, the upturn will be gradual as the financing environment is expected to remain tight. Equity buyers may benefit from some discounted values.

Key Takeaways

01 Although the number of transactions has decreased, the investment market is still active, with multiple smaller-size projects being executed. For larger portfolios, investors adopt a cautious approach.

02 Equity investors see market opportunities to acquire properties at a competitive advantage. Most of this capital is destined for value-add and opportunistic strategies. In 2024, numerous commercial bond redemptions and refinancings are anticipated.

03 Although yields have risen and stabilized at a certain level, pricing misalignment continues to exist, leading to reduced market activity and lowered investment volumes.

04 In H2 2023, investment activity in Europe and the Baltics rebounded, offering cautiously optimistic prospects for 2024 as interest rates and the market overall are expected to stabilize.

List of Abbreviations

CEE-5 – Czechia, Hungary, Poland, Romania and Slovakia
ECB – European Central Bank
LTV– Loan-to-Value
PBSA – Purpose-built student accommodation
PRS – Private rental scheme
WAULT – Weighted Average Unexpired Lease Term

Banks Are Following Case-by-case Approach For Financing

While interest rates are considered to have peaked in late 2023, earlier rate rises will continue to affect property yields as markets adjust to higher rates. Banks are now adopting a case-by-case approach and evaluating project fundamentals before financing. More products will come to market, as a combination of lower values and higher financing costs can make it difficult for investors to refinance, incentivizing some to sell.

RECORD HIGH INTEREST RATES

The ECB is expected to maintain the base interest rate at a record high of 4% during Q1 2024. This level has been achieved through 10 consecutive hikes, which have reversed rates from a historic low of minus 0.50% in just over a year. In its autumn statements, the ECB strongly hinted that rates had reached their peak. However, the forecast now anticipates that the ECB will initiate rate cuts by mid-2024, which should ease financing conditions.

SHIFTING FINANCING CONDITIONS

Financing conditions for commercial real estate in Europe have changed significantly during the first half of 2023. LTV across the Nordic region has dropped by 1,000 bps to reach 50% on average. In contrast, local banks in the Baltics have always been conservative, setting us apart from the CEE. Low LTVs limit the impact of value decline for banks. As a result, smaller developers may find it more challenging to finance their projects.

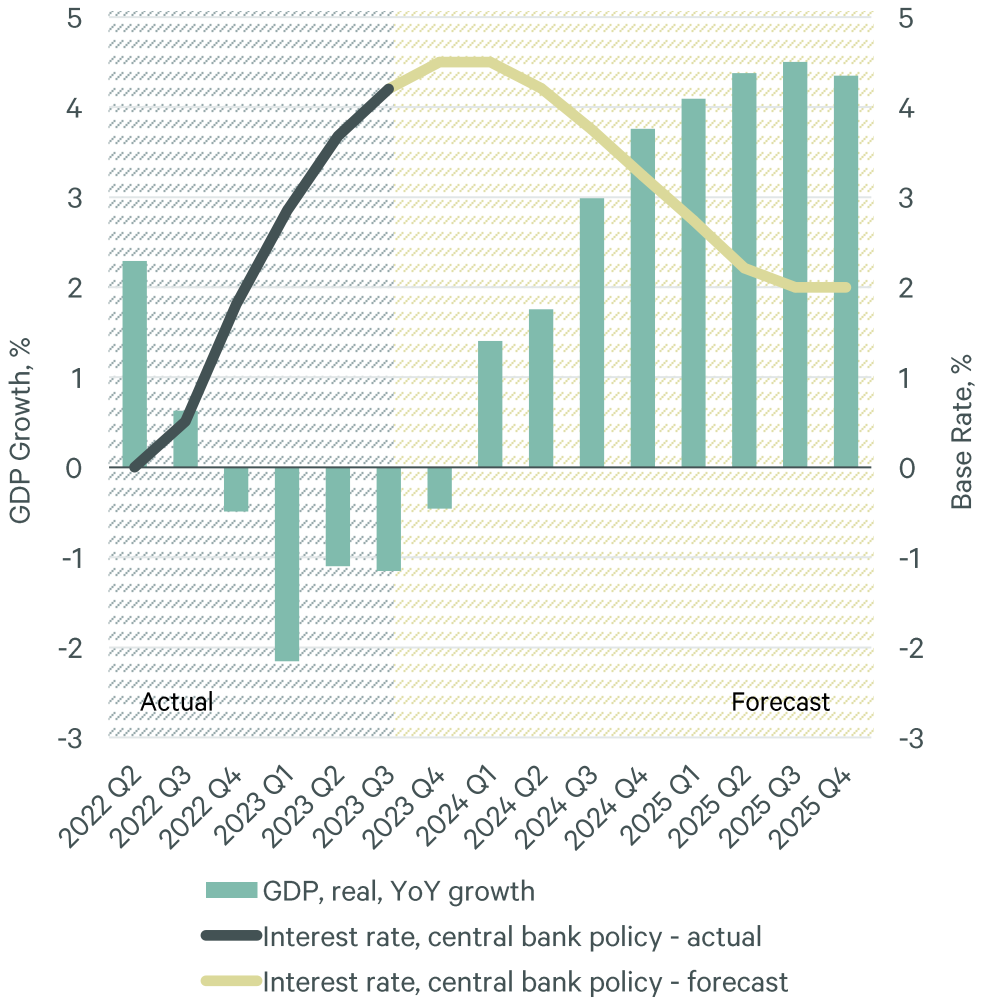
REFINANCING BOOM

Record refinancing numbers in EMEA and the Baltics will dictate future rhythm. Currently, banks examine the client as thoroughly as their real estate projects when assessing refinancing applications. Investment funds primarily focus on refinancing, which may lead them to sell off low-liquidity assets. Companies seeking refinancing face several challenges due to such factors as lower LTVs, reduced property values, and significant refurbishment costs. Consequently, additional equity injection might be required, which may not be readily available, forcing them to consider selling the assets.

ACTIVATION OF BOND MARKET

The Baltic bond market has experienced significant growth in recent years, with many Baltic developers and funds announcing their bond issues. As of the end of 2023, there were 70 active corporate bond issues on the Nasdaq Baltic Bond List, of which 10 are related to real estate market players. The activation of the bond market can be attributed to several factors, one of the most significant being the limited availability of bank financing for business development. Banks have become more conservative, and their risk appetite is notably lower than the market demand. While some banks provide financing more cautiously, others offer assistance in issuing bonds. Notably, bond yields in the Baltics are higher than those in Western Europe, and bonds with a reasonable level of risk, trading at 8-13% yield, were the most issued in 2023.

Figure 1: GDP and Interest Rates, Baltics, Actual and Forecast



Source: Oxford Economics, CBRE Baltics Research

Most Available Capital Targeting Value-Add and Opportunistic Strategies

As investors lean towards a neutral or positive sentiment on Euribor, it will signal a potential turning point.

MARKET PLAYERS

Investors are increasingly moving to value-add and opportunistic strategies, likely in an attempt to capture yield and discounts amid the backdrop of high risk-free rates.

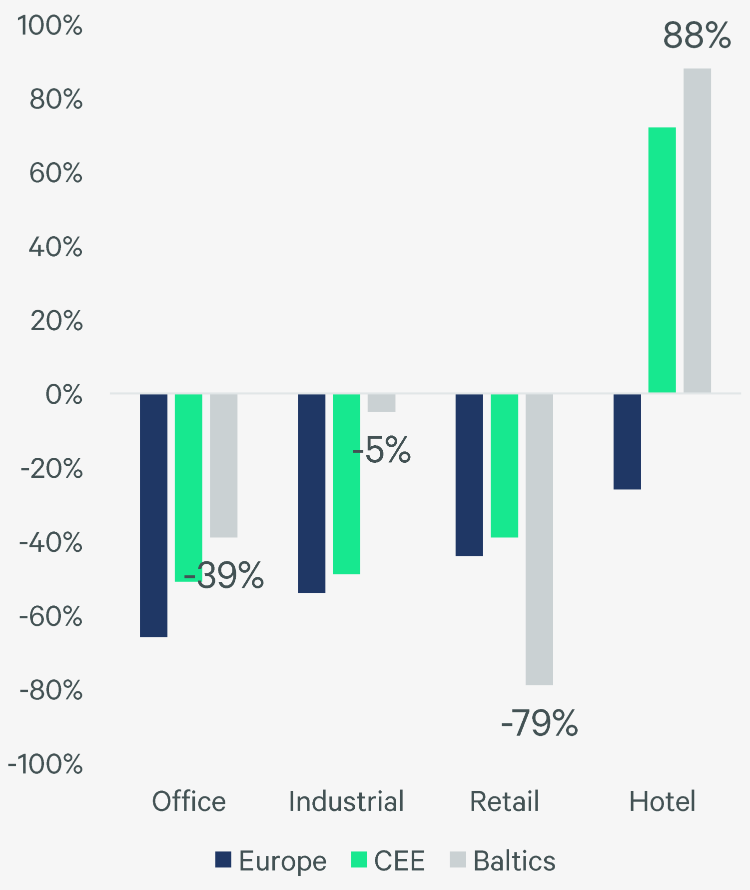
Investment activity in the Baltic region has decreased due to uncertain economic conditions. However, a few significant transactions towards the end of the year boosted confidence in the market. Local Baltic and some Scandinavian investors are still active, while many other foreign investors who were previously involved in the region have adopted a cautious approach and are waiting for new data to emerge before making decisions. This has reduced competition, allowing local investors to take advantage of opportunities. Investors are comparing local projects to opportunities in other parts of the CEE region, which is causing decision-making delays.

OBSOLESCENCE REMAINS A THREAT FOR OLDER ASSETS

Assets that are no longer attractive to occupiers or investors or do not meet regulatory requirements due to their physical condition, location, or specification must be repositioned through conversion or redevelopment. However, such spending can only be justified if the expected returns outweigh the costs at a reasonable margin.

Several factors have combined to make the conditions more challenging for such transactions. Reduced or stable valuations pose a risk of lower returns from redevelopment and increasing construction costs along with the high interest rates have put such opportunities under pressure.

Figure 2: 2023 vs. 2022 Investment Volume by Asset Class



Source: CBRE Research

However, these same factors should benefit existing, high-quality assets. We could see the value differences increase between higher and lower-quality assets until market conditions allow more stock to be redeveloped or converted into more profitable uses.

VALUES EXPECTED TO BOTTOM OUT IN 2024 AS LONG RATES PEAK

Although there are practically no distressed sales in the Baltic region currently, we anticipate they will emerge, with the market being potentially 6-9 months behind more mature markets, such as the United States. Some individuals or companies are struggling to meet the demands of the future market or struggle obtaining refinancing opportunities. This may spark the volumes of forced sales. Investors eagerly await such opportunities and have even created special funds for this purpose. Banks try their best to avoid adding clients to their non-performing lists due to capital allocation requirements and direct impact on the bottom line.

Investors remain keen on value-add investments, focusing on smaller neighborhood retail schemes. This demand surge is due to limited supply, and the smaller ticket sizes make transactions faster. While the smaller ticket sizes reflect the current market conditions, beginning 2024 should be started with already imitated large-scale transactions in the office and retail markets. However, the general market activity in 2024 is expected to remain slower, especially if transactions continue trading among local players.

Land transactions have garnered significant interest from investors lately. Development cases have become more common, too. However, the increased construction costs indicate a challenge or fluctuations in this aspect of the real estate sector.

In Times of Market Uncertainty, Investors Focus on Long and Stable Income

High inflation and interest rates make financing more expensive and less available. Yet, there is still a market for prime properties with 10+ year leases in any asset class, as well as for value-add projects. However, there is currently a limited supply of such properties in the Baltic market.

In Europe, the residential sector received a slight uptick in interest, while Logistics saw a marked increase. Investments into Retail, Hotel, and other sectors stayed nearly identical over the year. In the Baltics, occupier demand for Residential and Logistics is expected to increase in the coming years, too.

The main drivers for strengthening retail and industrial yields will be a recovering economy, consumer demand, and income growth; for offices – shallow unemployment; while for residential – strong rental growth caused by high borrowing and construction costs.

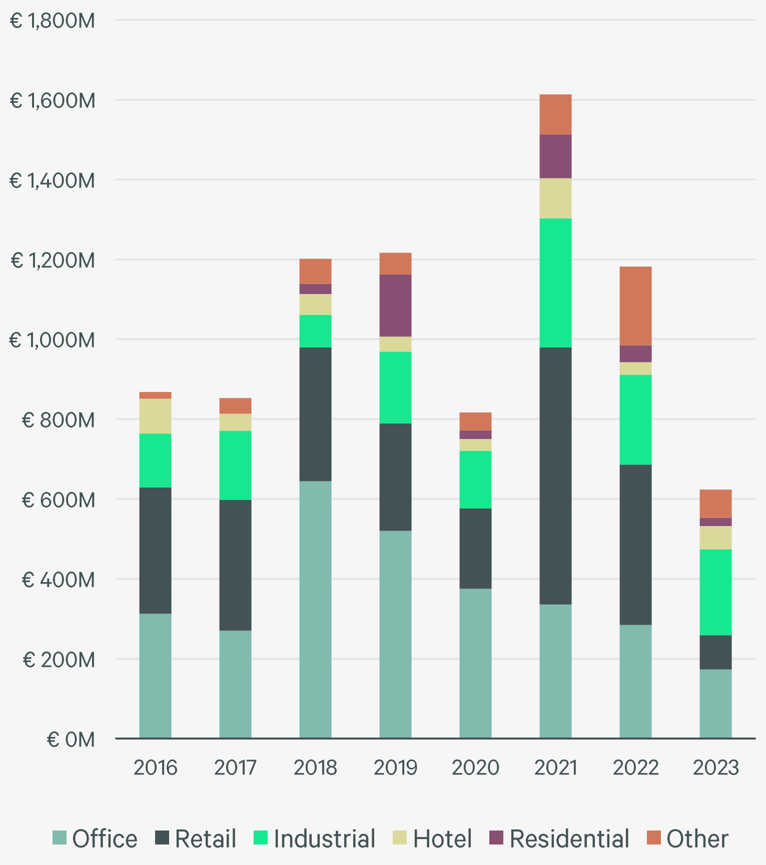
OFFICE

The prime office market has exhibited resilience due to strong tenancies, sustained rents, and employee-centric spaces. However, riskier transactions featured by lower quality or peripheral locations are slugging. Yet, as construction costs remain high and the availability of central land for development becomes increasingly scarce (especially in Vilnius and Tallinn), older office properties may become more attractive to value-add investors.

INDUSTRIAL

In 2023, industrial and logistics assets were the most highly sought-after assets worldwide due to their strong fundamentals. CBRE European Investor Intentions Survey, dated December 2023, also implies that the highest share of investors (34%) expect to primarily target this property sector for investments in 2024.

Figure 3. Investment Volumes* into the Baltics by Asset Type



Source: CBRE Baltics Research
*Cash flow generating assets over 1 mEUR

The changing pricing dynamics have encouraged some developers to consider older asset acquisitions as a more viable alternative to constructing new assets. However, the pricing for prime buildings remains above the construction costs.

RETAIL

Although retail sales have not surpassed 2019 levels, grocery sales have increased, and basket size is up by 25%. Many grocery chains have enjoyed double-digit revenue growth in 2023. However, electronics, household, furniture, and fashion retailers record more sluggish results. Specifically, there is currently a growing interest in value-add among investors, particularly in smaller neighborhood retail schemes. Retail parks also remain a stable investment option.

RESIDENTIAL

Multifamily assets in Europe were among the most attractive investment categories in 2023 and are increasingly interesting for investors, with 28% in the Europe Investors Intention Survey 2024 marking it as the primary property sector to target in 2024.

The Baltics have witnessed several notable transactions in the past few years. The gap between PRS and apartment sales is closing, meaning PRS may become more prominent. While senior housing will develop, it will do so very slowly due to a lack of investors specializing in this type of product. Developers are also becoming increasingly interested in PBSA as universities focus on attracting foreign students and international companies seek external labor attraction.

02

Sustainability

The eminent shift towards sustainability reshapes corporate philosophies worldwide, encompassing environmental, social, and governance domains. In the Baltics, this transformative trend is gradually gaining ground within the real estate markets. Anticipated to gain momentum in 2024, this shift is expected to be particularly pronounced due to the CSRD.

Key Takeaways

01

The shifting regulatory landscape marked by the launch of the CSRD is set to influence multiple commercial real estate market players to move towards higher ESG alignment rates throughout 2024.

02

Integrating ESG into corporate operations has the potential to yield substantial rent premiums, reduce maintenance and utility costs, enhance ROI, and secure more favorable financing terms. From 2024 onward, a widening performance gap between sustainable and non-sustainable buildings is anticipated.

03

Certification trends are not yet evident among retail and industrial & logistics players, while in the office segment, nearly 50% of stock is already certified across the Baltic capitals. Incentivized by the potential of rental premiums and with the assistance of green lease agreements, owners and landlords are likely to increase their sustainability efforts.

List of Abbreviations

CSRD – Corporate Social Responsibility Directive

EFRAG - European Financial Reporting Advisory Group

ESG – a framework incorporating environmental, social, and governance topics

ESRS - European Sustainability Reporting Standards

GHG – Greenhouse gases

RICS - The Royal Institution of Chartered Surveyors

ROI – Return on Investment

SME - Small and medium-sized enterprises

ESG – On the Agenda of International and Local Authorities

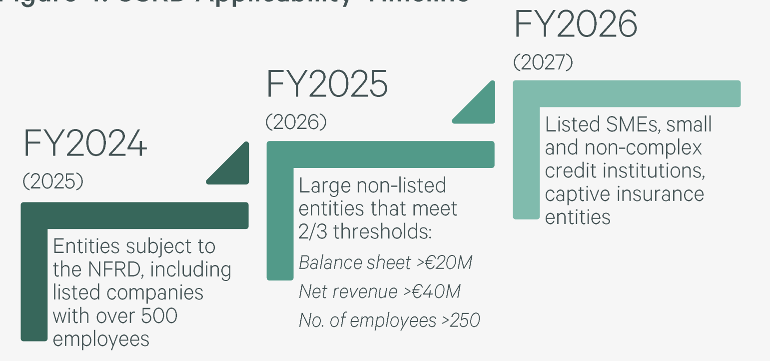
A SHIFTING REGULATORY LANDSCAPE

The advancement of corporate ESG alignment in the EU has been significant over the past decade. As per Figure 4, large and publicly listed entities will be legally required to report their performance in environmental, social, and governance (ESG) domains as per the Corporate Social Responsibility Directive (CSRD) that will come into effect in 2025. The scope of companies required to report has been notably expanded under the CSRD, increasing from about 11,000 to 50,000. However, the extension does not apply to most commercial real estate companies in the Baltic region since they are classified as SMEs. Nonetheless, it is worth noting that EFRAG has introduced a Draft for Voluntary ESRS requirements for non-listed SMEs, which strongly encourages them to report on their progress in implementing sustainability practices.

SUSTAINABILITY – MORE THAN JUST THE ENVIRONMENT

While sustainability or ESG often relies on the environmentally friendly concept, the voluntary ESRS requirements challenge this notion. The shift toward a more sustainable economy involves mitigating an entity's negative and bolstering positive impacts, extending beyond the environment onto society. The metrics that all entities in the Baltic commercial real estate market should be aware of and keep track of include energy and greenhouse gas emissions, pollution of air, water and soil, biodiversity (where applicable), water, resource use, circular economy and waste management, workforce characteristics, workforce health and safety, remuneration, collective bargaining and training, and business conduct (see Figure 5).

Figure 4: CSRD Applicability Timeline



Note: Third-country entities exceeding €150M in revenues in EU will start reporting in FY2028 (2029). Source: European Commission

Figure 5: [Draft] Voluntary ESRS Disclosures

E	**Energy and GHG** Breakdown of energy consumption Scope 1 and 2 emissions	**Pollution** Emitted pollutants to air, water and soil	**Biodiversity** Number and area of owned/leased sited located in sensitive areas
	Water Water withdrawals Water consumption	**Resource use, circular economy, and waste management** Recycled goods and materials Recyclability rates	Annual generation of waste Waste diverted for recycle/reuse
S	**Workforce** Type of employment contracts Employee gender, country	**Health and safety** No. and rate of work-related accidents No. of fatalities	**Other** Wage ratios and Wage gap % of employees covered by collective bargaining AVG training hours/employee
G	**Business conduct** No. of convictions and fines		

Source: VSME ESRS ED

With the launch of CSRD, we expect higher ESG alignment rates to be visible throughout 2024, not only by publicly listed corporations, but by smaller non-listed entities as well.

> ! *The CSRD could potentially affect up to 25% of the major players in the Baltic commercial real estate sector, leaving the remainder subject to its influence indirectly.*

EXEMPLARY ESG INCENTIVES

The topic of ESG is not only becoming increasingly regulated, but incentivized, too. All market players are welcome to make use of the incentives listed below, in addition to multiple others.

Estonia

Subsidies for renewable energy – companies producing renewable energy in Estonia can draw up to €1M with a maximum of €360,000/MWh of electricity storage and €220,000/1,000m³ of thermal storage. Learn more.

Latvia

Increasing energy efficiency – entities of all sizes can apply to receive funding for improving energy efficiency and introducing renewable energy technologies in own operations. Learn more.

Lithuania

Direct loans for renewable energy projects – entities can apply for a loan of up to €10M with a 1.0-2.5% interest rate margin (+6m EURIBOR) to finance the construction and installation of solar and wind power plants for own consumption. Learn more

Proof of Sustainability's Impact

BROWN DISCOUNT

In a 2022 survey conducted by RICS, occupiers and investors were asked about the impact of green buildings on market values and the resulting ROI. In Europe, nearly 60% of respondents suggest that buildings lacking sustainability certification may experience a reduction in market value, referred to as a "brown discount," while ca. 30% believe in a rent premium for sustainable buildings. Most respondents think the discount could be up to 10% of the asset's value, with some considering an even higher impact.

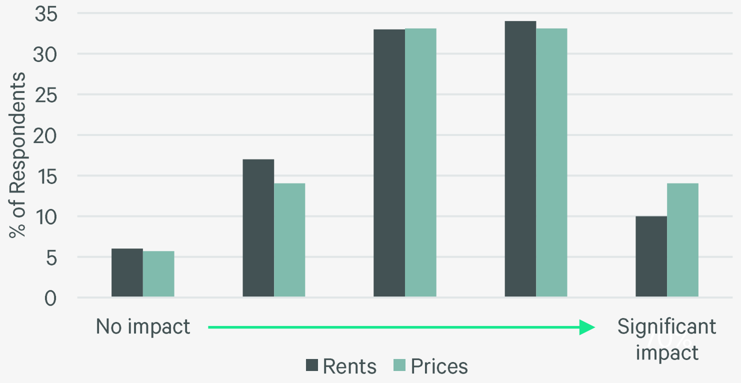
SUSTAINABILITY - VALUE DETERMINANT

Until now, sustainability has primarily factored into a building's value by influencing its perceived liquidity – certified properties were considered more liquid, hence appreciating in value. However, from 2024 onward, valuers adhering to RICS guidelines will be obligated to evaluate pertinent ESG factors and their regulatory context. RICS emphasizes that ESG can impact an asset's financial performance, operations, and external environment. We anticipate sustainable and certified buildings to exhibit noteworthy sales premiums in the upcoming year.

BENEFITS OF ESG

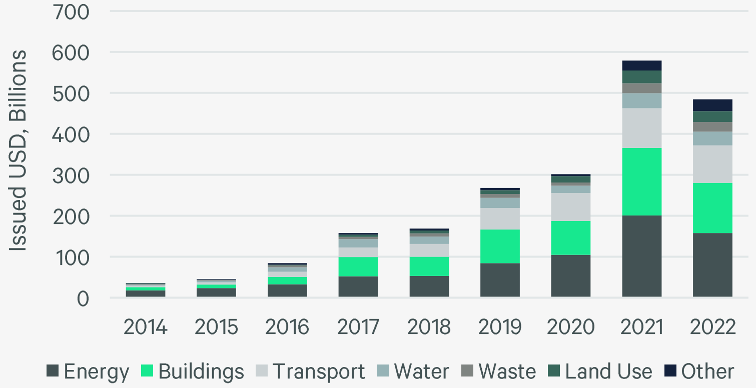
- ✓ Up to 20% lower maintenance costs and lower utility costs due to increased energy and water efficiency
- ✓ Increased occupancy rates
- ✓ Shorter payback periods

Figure 6: Impact of Sustainability Features on Rents & Prices



Source: RICS Sustainability Report 2023

Figure 7: Value of Globally Issued Green Bonds by Use



Source: Climate Bonds Initiative

BETTER FINANCING*

Commercial real estate-focused enterprises in the Baltics have the opportunity to receive either Green Financing or Sustainability-linked financing (among others), which usually tend to offer better terms. With banks now aiming to transform their asset portfolios into green, the requirements to assess ESG data and the need for certification will only increase. We expect this increase to become apparent in 2024.

APPLICABILITY TO REAL ESTATE

With alternative financing models rising, we predict more real estate players to aim for green financing in 2024.

Green financing – such a financing mode can be obtained for assets meeting the following criteria:

- ✓ The building must have a valid energy certificate with a rating of A or higher;
- ✓ Must be a near- or net-zero carbon building;
- ✓ Should have renewable energy in use.

Sustainability-linked financing – this mode is directly linked to the company's sustainability performance, not its assets or projects alone. The entity must have a sustainability strategy and set sustainability-linked goals, which, if met pre-defined period, can guarantee a financing discount. The goals must be:

- ✓ Defined according to a baseline;
- ✓ Scientifically ambitious;
- ✓ Aligned with the bank.

*Financing terms may vary by provider.

Current Practices in the Baltics

CERTIFICATIONS

Currently, ca. 43% of all office stock, 25% of retail stock, and 10% of industrial stock is certified across the Baltics. Compared to a year before, certification rates increased only marginally. With growing attention towards sustainability, certification growth rates in all commercial real estate sectors should increase in 2024.

RENT PREMIUM

Investors and occupiers across Europe believe in sustainability certification providing a rent premium of up to 10%. The average rent premium across European capitals for office stock stands at 6.6% in 2023, while in such CEE capitals as Prague or Bucharest, it even ranges between 16 and 18%. Similar findings are obtained for the Baltic capitals, where, on average, rent premiums in central business districts range between 5% in Tallinn and 9% in Riga. At the same time, in Tallinn's periphery, currently certified buildings do not present higher rent levels, as newly-built premises demand higher prices, while in Riga and Vilnius's peripheries, the trend of premiums persists – BREEAM or LEED-certified buildings tend to price 6% and 3% higher, respectively.

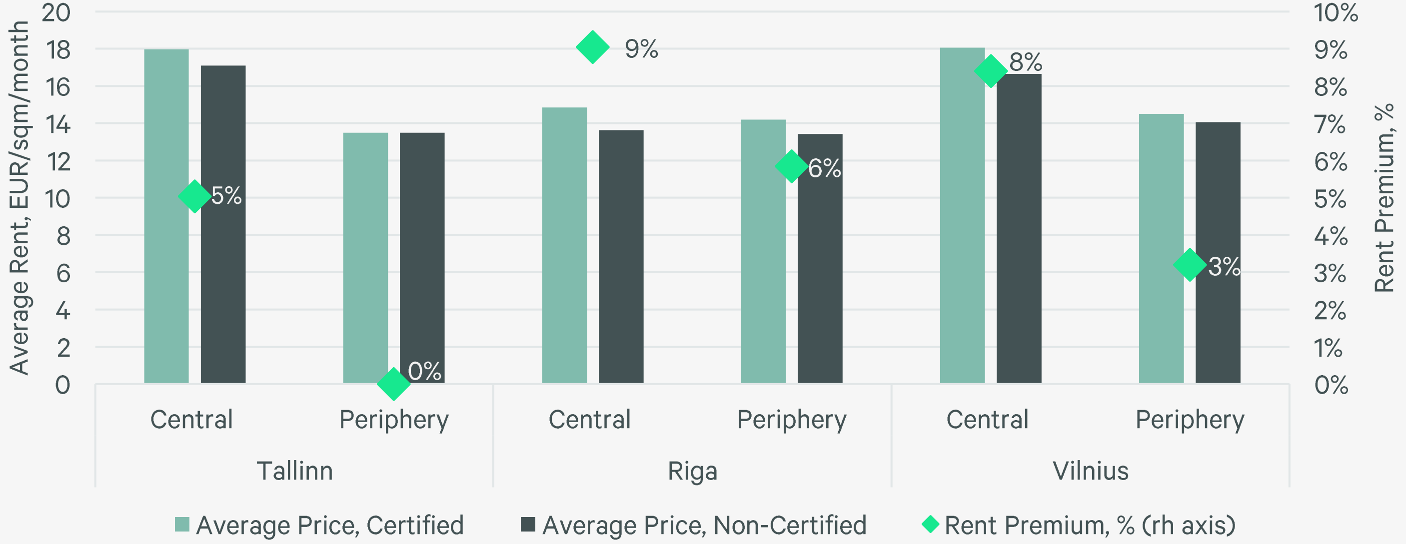
The gap between the rents for sustainable and non-sustainable buildings should widen in 2024.

GREEN LEASES

Baltic occupiers and landlords alike are not yet highly familiar with the notion of a *green lease*. This is a signed agreement between the tenant and the landlord where both parties commit to perform certain activities in relation to ESG within the building.

We expect the use of green leases to increase significantly in the upcoming few years.

Figure 8: Rent Premium for Certified Office Buildings* under LEED or BREEAM, Central and Periphery Districts, Baltic Capitals



32%
European investors would pay a premium for "ESG-friendly" property; more than ½ would pay up to 20% more

63%
European logistics occupiers would pay a rental premium for sustainable buildings with certification

67%
European investors and occupiers would pay a premium for building features enhancing physical and mental health of employees, and buildings with health and well-being certificates

*Note: The modern stock commissioned over 2013-2023 was considered only. The classification of 'Central' and 'Periphery' relies on CBRE Baltics internal classifiers.
Source: CBRE and CBRE Baltics Research.

03

Office

Leasing levels should be fueled by local businesses in 2024. Vacancy levels look to be nearing a peak, reflecting weak economic growth and the shift towards new workplace strategies. Against a significant upcoming office space pipeline, tenants are gaining more negotiating power, influencing landlords to adopt strategic measures to retain and attract businesses.

Key Takeaways

01

The increase in sub-lease options, driven by downsizing and work-from-home policies, is expected to end, leading to a rising structural vacancy across the Baltic capitals.

02

In the current office market, tenants wield increased negotiating power, turning it into a tenant's market. As the Baltic office market transforms, landlords adapt strategies to align with changing tenant preferences and market demands.

03

Local companies currently drive the office market in the Baltic capitals. Despite an impressive pipeline of modern office space, uncertainties about future FDI growth raise concerns about potential oversupply, leading to increased vacancies and a likely decrease in take-up aggregates in 2024.

04

Quality differentials will become even more apparent. Poorer quality space will suffer higher voids and faster obsolescence, but upgrading / refurbishment opportunities will exist.

List of Abbreviations

CBD – Central business district
CEE – Central Eastern Europe
FDI – Foreign direct investment
GBS – Global business services
GLA – Gross leasable area
SQM – Squared meters

Vacancy Peaking Out

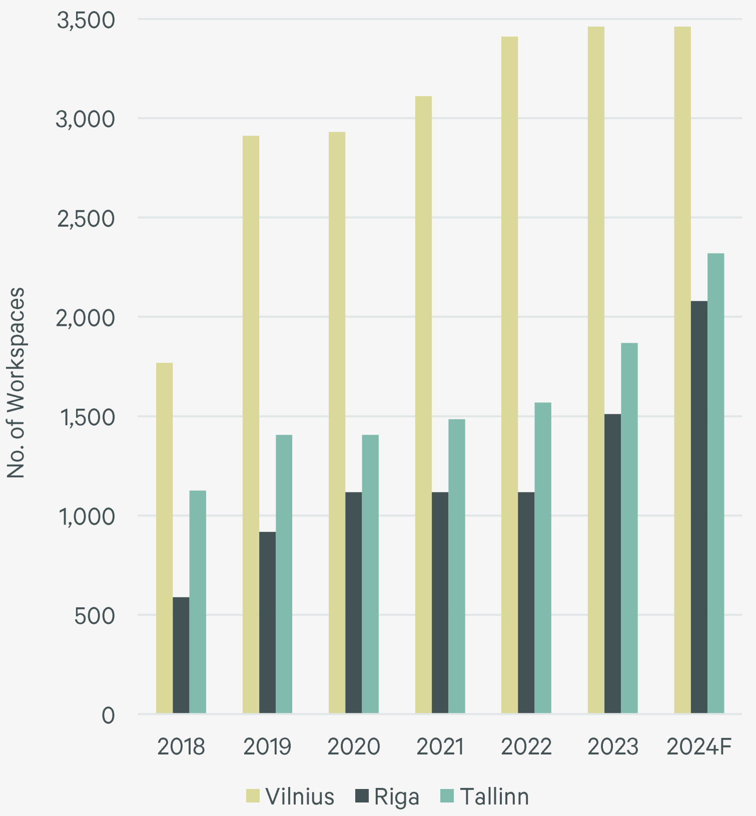
DOWNSIZING IS HERE TO STAY

The trend of downsizing is becoming a permanent fixture, evident in the reduced space allocated per working desk. Previously, the ratio stood at one desk per ca. 1.1 employees, but it has now transformed to 1:4, with 10-15 sqm assigned per working desk. This signifies a shift from the traditional measurement of square meters per person to square meters per working desk, indicating a reduced space requirement per employee. As reflected in the CBRE CEE Occupiers survey (June 2023), >40% of companies in CEE have optimized their portfolios in the past three years. Large occupiers will be progressing their workplace strategies across several fronts: aiming to raise utilization levels, right-size portfolios, and offer quality space as part of the employee value proposition - but also tighten cost controls. Also, in the Baltics, most of the take-up transactions in 2022-2023, or ca. 60%, happened with offices that were smaller than 500 sqm. This downsizing pattern is anticipated to persist in the near future, at least for the next 3 years, showcasing a long-term transition to hybrid working.

INCREASED SUB-LEASE OPTIONS ENDING

Following the onset of the pandemic and businesses' adoption of downsizing and work-from-home policies, there was a notable reduction in office space requirements. Consequently, subleases became more prevalent, especially for larger space lease contracts previously signed for 5-7 years. The range of available sublease space in the Baltics varied from 5% of vacancy in Riga to 20% in Vilnius. Under the current market development, the structural vacancy across the Baltic capitals is expected to approach 15% over the next 2-3 years.

Figure 9: No. of Workspaces in Co-Working Establishments, 2019-2024F



Source: CBRE Baltics Research

Vacancies should continue varying depending on city districts and office class, as was already evident in 2023 (Figure 9).

Simultaneously, a surge in demand for subleases was driven by an increasing number of smaller-scale tenants seeking office spaces through sub-leasing arrangements, primarily motivated by more flexible terms. A significant portion of the available sublease space is set to expire in the coming years. This creates a need for smaller leased space for sublease holders, possibly coinciding with increased co-working demand.

DEMAND FOR FLEX SPACE TO INCREASE

Corporates' growing need for quality and agility also plays into the flex market, and we expect to see increased use of flex space within portfolios. We see scope for further evolution in 2024 as more occupiers become comfortable with an improving offers.

Flex space's popularity corresponds to the increasing demand for reduced traditional office spaces. This shift is particularly noticeable in Tallinn and Riga, where occupancy rates for flexible workspaces have surged. In Vilnius, smaller occupiers typically lean towards sub-leasing options. We anticipate witnessing comparable growth trends in flex space establishments in 2024.

In 2023, the Dealroom data reveals the founding of 86 startups in Estonia, 11 in Latvia, and 21 in Lithuania. In comparison, in 2022, the Baltic region collectively witnessed the establishment of 166 startups. The high numbers of startups indicate potential future growth in demand for flexible office spaces. Such initiatives as the Accelerator program *Plug and Play* in Lithuania aimed at growing early-stage technology startups should also form a part of the take-up in the upcoming 3 years.

Take-Up Structural Changes

FDI GROWTH SLOWDOWN

In 2022, Baltics experienced slow growth in FDI projects, with ca. 15% increase in the number of projects and 8% in the investments attracted, while the negative impact of the geopolitical and economic context is further evident in the employment sphere, with FDI projects creating ca. 13% fewer new jobs compared to the previous year.

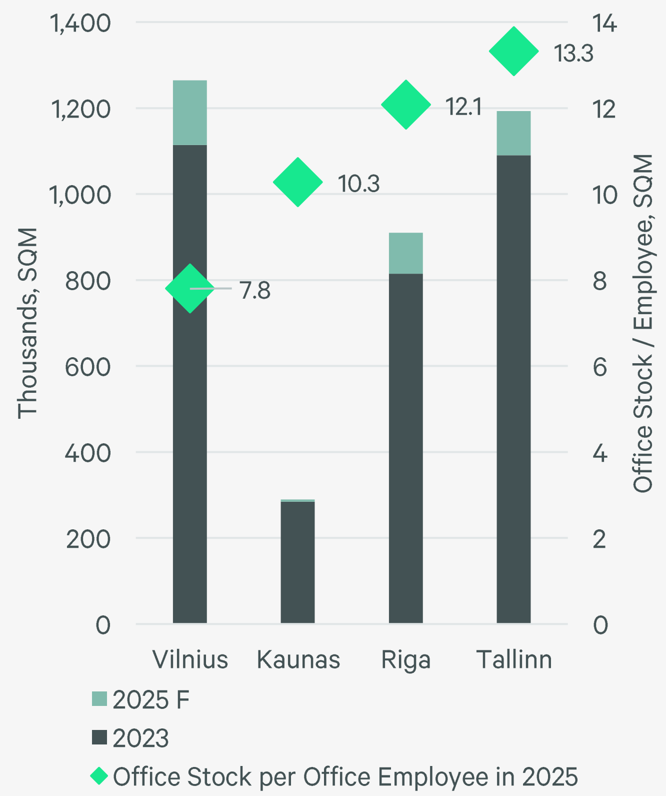
Most of the FDIs in the Baltic capitals come from the GBS sector. The market expects a slowdown in new GBS openings, which has already been evident throughout 2023. Consequently, currently in the Office market, most of the demand comes from local companies that are expanding, relocating, or looking to improve the energy efficiency of their offices and the working conditions of their employees.

NOTABLE PIPELINE - THREAT OR OPPORTUNITY?

In the Baltic capitals, an impressive pipeline with over 400,000 sqm of modern office space is currently under construction. Around 70% of these upcoming projects GLA fall under the A-class category. Notably, many projects set to be finished soon have already secured pre-leases, showing a strong demand for high-quality spaces in the market. The average pre-leased area of the A-class projects before the commissioning accounts for 50-80% of the overall GLA. However, it is worth noting that this demand is mainly driven by expanding entities currently operating within the markets. With limited expectations for FDI increases in the coming years, there's some uncertainty about whether there will be enough demand for these new spaces. As a result, the office segment is expected to see an increase in vacancies, and take-up aggregates might likely decrease in 2024.

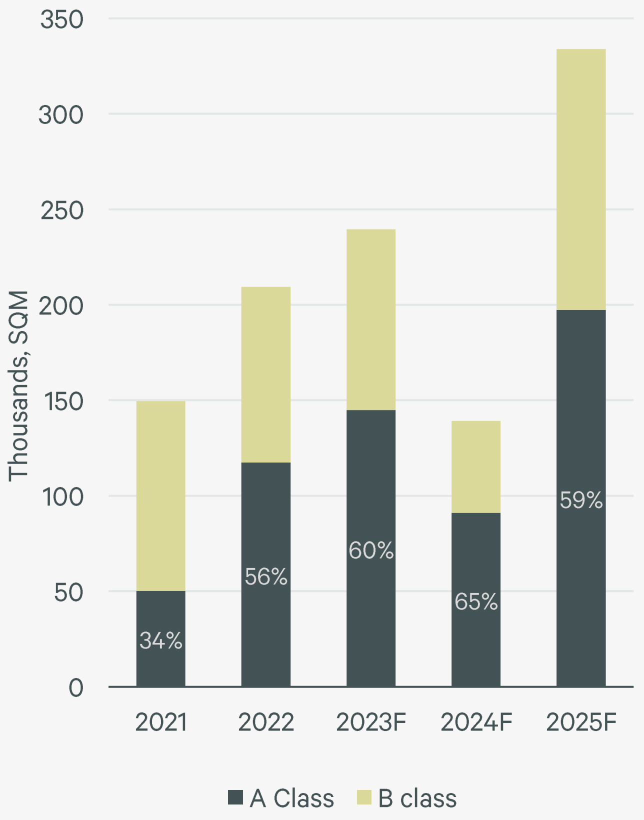
However, the current office stock per office employee in the Baltics is still below that of most CEE counterparts. Therefore, the robust pipeline should expect a relatively quick absorption of newly delivered projects if the demand patterns do not shift significantly.

Figure 10: Existing office stock levels, 2023 & 2025F; Office Stock per Office Employee in 2025 - Forecast



Source: CBRE Baltics Research, Oxford Economics

Figure 11: New Office Supply in Baltics by Class



Source: CBRE Baltics Research

Occupiers Market

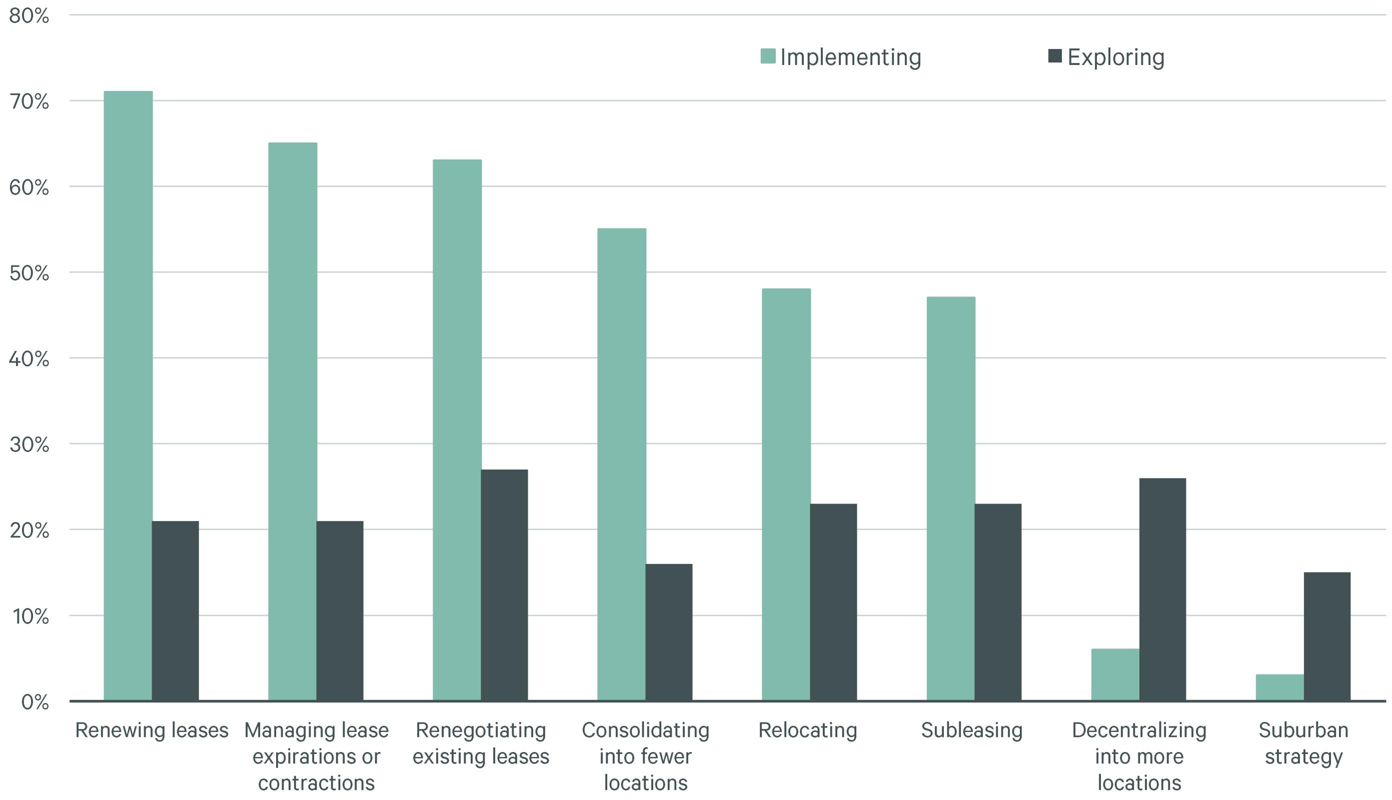
One clear consequence is that differences between the best buildings and commodity space will likely expand through a sustained flight-to-quality. Occupier decision-making is now more motivated by factors like transport accessibility, proximity to retail, leisure, hospitality, and public realm, and - increasingly – sustainability.

In response to demand and occupiers' needs, A-Class office space could see increased rents, while B-Class may face contraction. For buildings classified as the lower end of B-Class (less favorable location, older building), rent rates might decline unless landlords invest in sustainability and quality improvements, and some buildings may even contemplate repurposing. At the same time net rent contracts when factoring in escalating fit-out contributions.

Office landlords are more often adopting strategic measures to attract and retain tenants. One notable trend is the increase in fit-out contributions by 20-25% over the last two years, which currently can reach up to 300 EUR/sqm in Vilnius, 350 EUR/sqm in Tallinn, and 550 EUR/sqm in Riga. Riga, with the highest vacancy and fit-out contributions in the market, can be characterized as a more occupier market than the rest of the Baltics.

According to the CBRE CEE Office Occupiers Sentiment Survey, 42% of respondents are seeking shorter lease terms. This trend is evident in the Baltics, where 2-3 year contracts have become more common than the previous 5-7 year ones. However, shorter leases usually entail lower fit-out contributions from landlords. In the Baltics, more than half of the lease renewal negotiations involve occupiers requesting lower rents or smaller spaces, which could also be expected from landlords in the coming year.

Figure 12: Focus Areas For Portfolio Strategy



Source: CEE Office Occupier Sentiment Survey, 2023

04

Industrial & Logistics

After a period of unprecedented logistics demand during the pandemic, 2023 was a tougher year. 2024 begins with the same challenges but with expectations that the economic outlook will improve and the sector's strong fundamentals will remain apparent, albeit at more normalized levels.

Key Takeaways

01

The I&L sector is a driving force behind regional growth in the Baltics. However, potential barriers to sustained expansion emerge in the form of labor shortages and challenges in attracting foreign players.

02

Urban logistics are becoming more prominent across the Baltics, with increased activity in stock office and self-storage unit developments.

03

The increasing interest in nearshoring to the CEE region brings hope for more foreign activity in the Baltics.

04

In the coming year, a substantial growth in speculative I&L stock is anticipated. However, amidst ongoing economic challenges faced by sector players, a concern arises among speculative stock developers.

List of Abbreviations

I&L – Industrial and Logistics Segment
GDP – Gross Domestic Product
FEZ / SEZ – Free / Special Economic Zone
GLA – Gross Leasable Area

Potential of the Baltic Periphery

REGIONAL INDUSTRIAL ACTIVITY

Economic activity outside the I&L sector generally holds minimal significance in the Baltic regional cities. While the industrial sector remains a crucial driver of regional prosperity, its growth is impeded by growing construction costs and labor shortages. For example, construction costs in the Baltics have increased by ca. 12-17% during the period from Q4 2021 to Q4 2023, mainly affected by supply chain disruptions and heightened inflation. As for the labor conditions, the Lithuanian I&L market has consistently recorded close to 10,000 quarterly job vacancies throughout 2023, while Latvia has around 5,000, and Estonia has ca. 1,500.

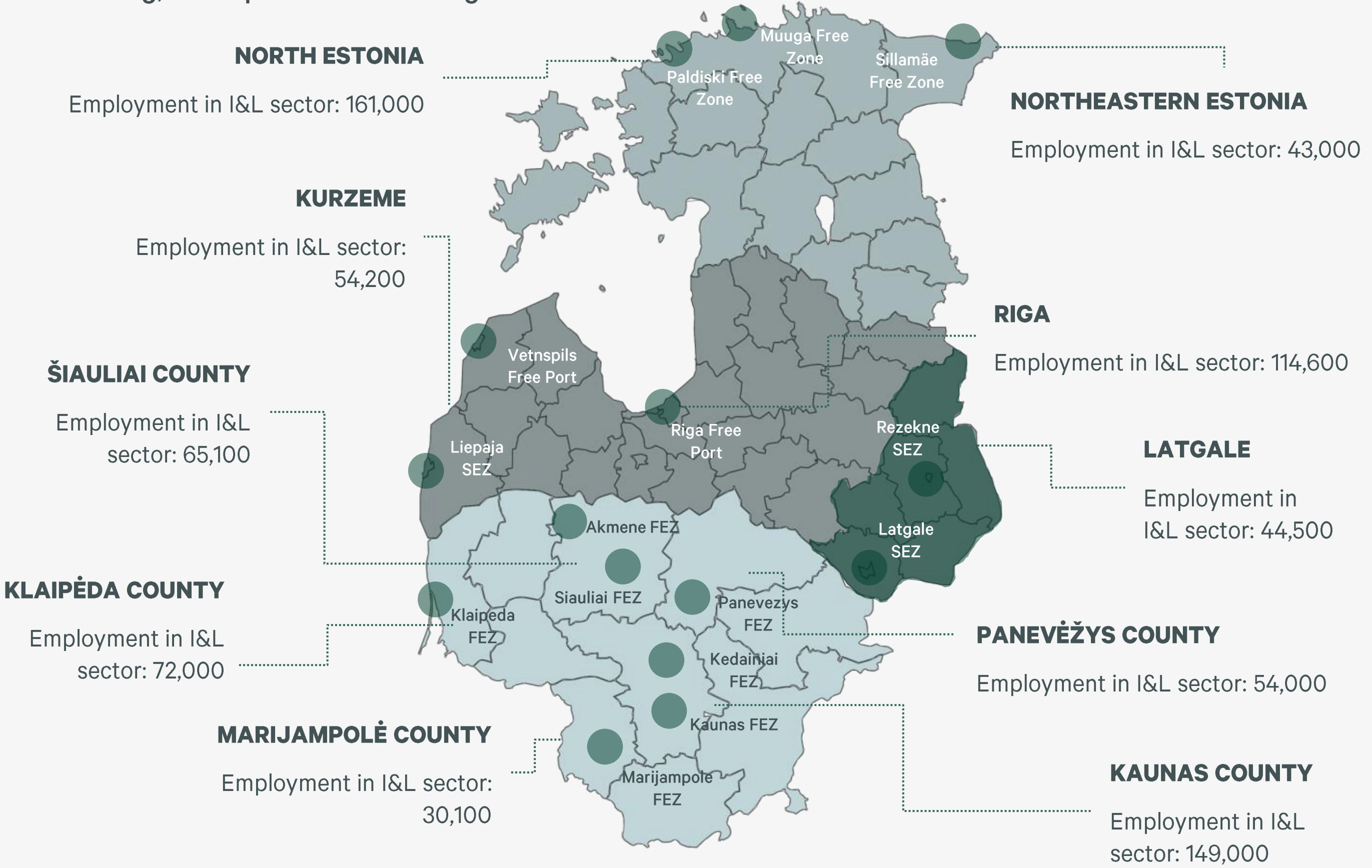
While the scarcity of available labor is expected to increase, the establishment conditions and costs of Baltic industrial labor remain competitive in the CEE region. This is likely to sustain the interest of both local and foreign I&L players in the years ahead.

FEZ / SEZ

The primary hub for regional industrial activity remains in free (special) economic zones. Some of these zones have achieved notable success, exemplified by the expansion plans of Kaunas FEZ, Panevėžys FEZ, and Marijampolė FEZ in Lithuania, as well as success stories of Liepaja SEZ and Ventspils Free Port in Latvia.

Currently, local entities are the primary drivers of industrial developments, as geopolitical tensions in neighboring countries pose too high a risk for foreigners. This signifies the necessity for more proactive regional measures to attract substantial FDIs to the region's free zones, as activity among international occupiers is anticipated to regain momentum only once peace settles.

Figure 13. Free (Special) Economic Zones Across the Baltics and Regional Employment in Industrial, Manufacturing, Transportation & Storage Sectors



Source: Invest in Estonia, Latvia's State Revenue Service, Invest Lithuania, Oxford Economics, November 2023

Urban Logistics

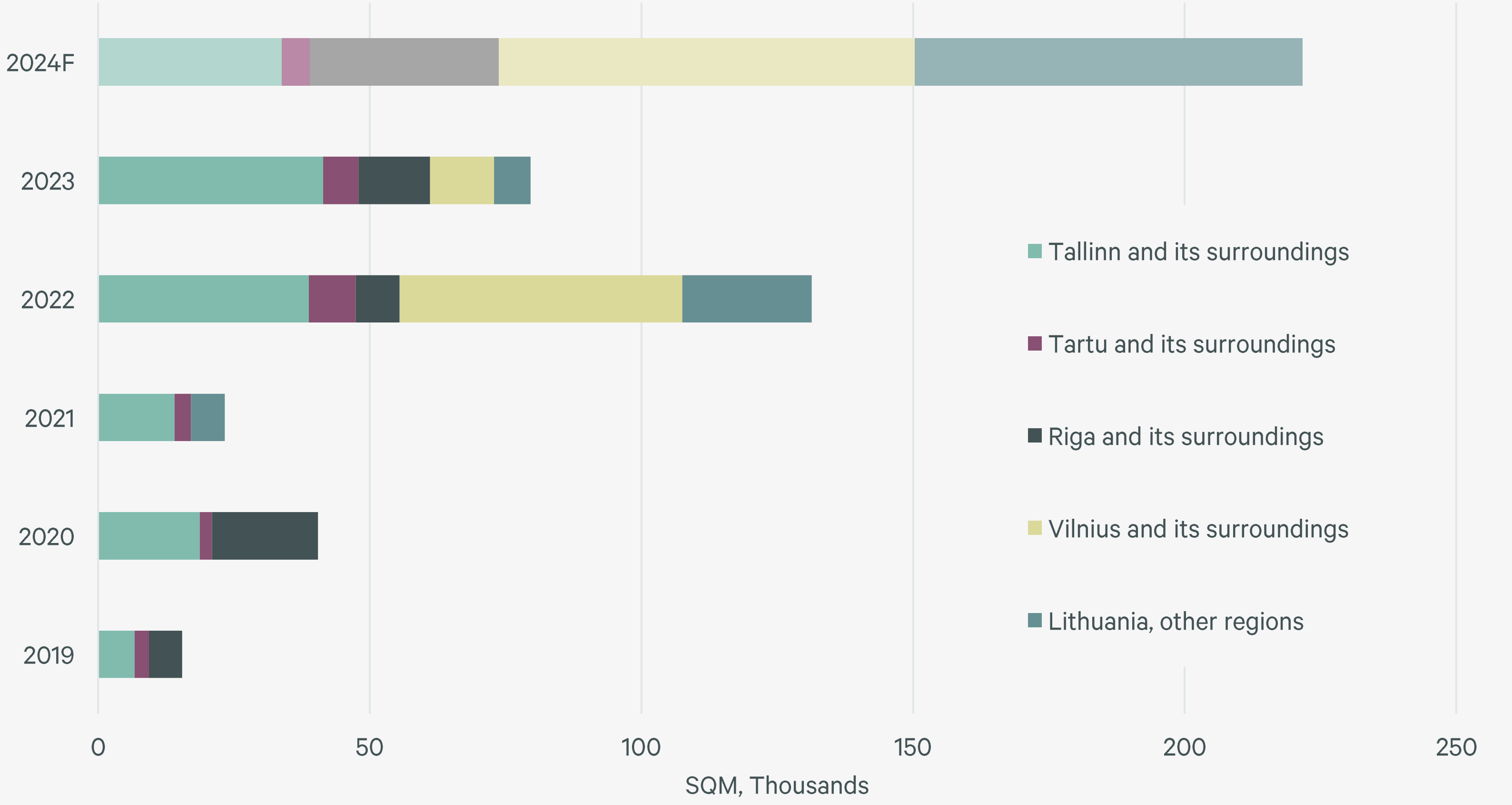
THE ERA OF STOCK OFFICE GROWTH – NEARING ITS PEAK?

Since the mid-2010s, the influx of stock offices into the I&L market has ignited an interest in the segment. Developers, noting a surge in demand in 2020 fueled by e-commerce growth, initiated modest stock office projects, now progressively scaling up. In contrast to the 2021 average size of ca. 4,000 sqm in GLA, the projected stock offices for 2024 are averaging 9,000 sqm each. The scale of projects has also seen a notable rise: while only 5 projects were commissioned across the Baltics in 2021, a total of 24 are slated for completion in 2024. With such fervor for the segment, we anticipate it to persist in the coming years. However, developers must navigate cautiously, given the sudden surge in stock and pricing strategies leaning towards the higher end (9-14 €/sqm/month), ensuring a careful assessment of demand patterns to avoid oversupplying the market.

SELF-STORAGE CATCHES THE EYE OF INVESTORS

Another segment gaining traction in the I&L market is self-storage, which is evident in the transformation of old buildings into such units across Baltic capitals. The primary audience for these rental schemes typically includes private individuals, but there is a noticeable trend for businesses seeking additional storage space as well. While private investors have predominantly driven development activity, institutional investors now show increased confidence in the segment.

Figure 14. Stock Office Development in the Baltics, 2019 – 2024F



Source: CBRE Baltics Research

I&L Growth Perspectives

TAKE-UP COMPOSITION

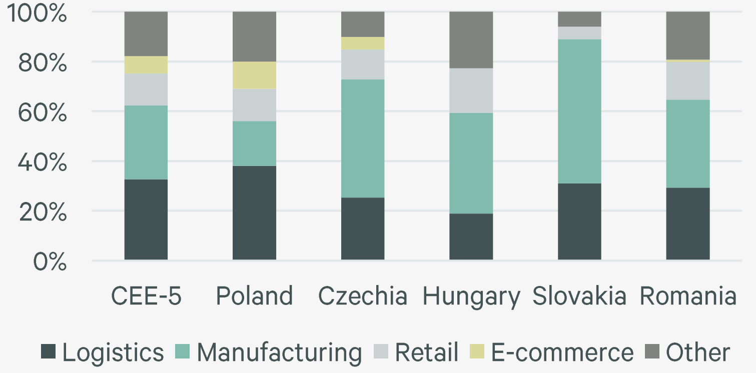
The extraordinary growth in logistics space needs coming from online retailers has ended. During the pandemic, these retailers were forced to expand rapidly, occupying in a few months space it would typically take years to acquire. While e-commerce will keep growing, 2024 will not see a return to the same growth rates. More traditional logistics sectors will see their appetite for expansion affected by the weak economic outlook. Still, we anticipate outperformance in sectors such as manufacturing, particularly from sustainability-related producers, as well as grocery and discount retailing.

Outsourcing and restructuring of supply chains – including near-shoring strategies– should continue to benefit third-party logistics players and boost their space requirements. Throughout the CEE, the momentum of nearshoring has surged, with a notable increase in demand for manufacturing space between 2021-2023 alone. The CEE region, mainly led by Poland, has become a focal point for nearshoring endeavors, especially in the automotive, electronics, and furniture sectors.

OLDER INDUSTRIAL ASSETS REMAIN CHALLENGED

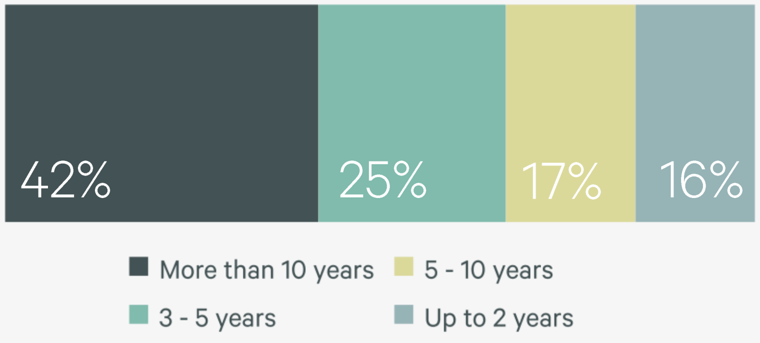
A significant portion of the modern I&L stock in the Baltics is over a decade old. These buildings, no longer suitable for their original purposes, are increasingly catching the interest of various developers seeking to reestablish historical spaces. Given the success of some recent conversions and the diminishing availability of suitable land plots for commercial real estate in or around city centers, we anticipate a surge in the popularity of I&L conversion projects in 2024.

Figure 15. Sector Share in I&L Take-Up, CEE, Q1-Q3 2023



Source: CBRE Research

Figure 16. Baltic I&L Stock by Age



Source: CBRE Baltics Research

An important trend to watch during 2024 will be the change in the composition of vacant stock. Older units coming back to the market could struggle to be leased unless they undergo refurbishment to offer occupiers operational efficiencies, including new ESG features. We anticipate the rental gap between new prime units and older units to widen, effectively creating a two-tier market.

SUPPLY TRENDS

In Tallinn and Riga, speculative I&L developments outpace those in Vilnius. Projections for 2024 indicate that over 65% of the Vilnius region's I&L stock will be built-to-suit. Conversely, in other Lithuanian hubs like Kaunas and Klaipėda, 60% of the ongoing I&L developments are speculative. In Tallinn, nearly 50% of the 2024 pipeline is speculative, while in Riga, the entirety falls under this category. With increasing construction costs, the popularity of speculative industrial stock reflects a tendency to secure facilities driven by the need for prompt occupancy when leases expire.

UNCERTAINTIES IN THE SHORT TERM

Between the pre-pandemic year of 2019 and 2023, data from National Statistics reveals a notable surge in gross wages within the I&L segments: across the Baltics, the salaries grew by 35%-50%, while producer prices have risen by 35-60%. These unprecedented cost escalations have resulted in several bankruptcy cases, forcing other sector players to adopt cost-cutting measures. In the face of ongoing challenges, businesses will likely persist in saving costs. Considering these trends, it remains to be seen whether the anticipated influx of speculative I&L stock will attract sufficient occupiers, potentially leading to an increase in vacancies.

05

Retail

Lower inflation and rising real wages should boost consumer fundamentals, with a positive effect on retail sales. E-commerce will grow further but at a slower rate. Retailers will continue to explore flagship store formats in prime locations.

Key Takeaways

01 Retail sales growth should benefit from falling inflation rates and rising real incomes. Footfall and sales at key retail assets are expected to continue their upward trajectory. The lagged effect of earlier interest rate rises remains a downside risk.

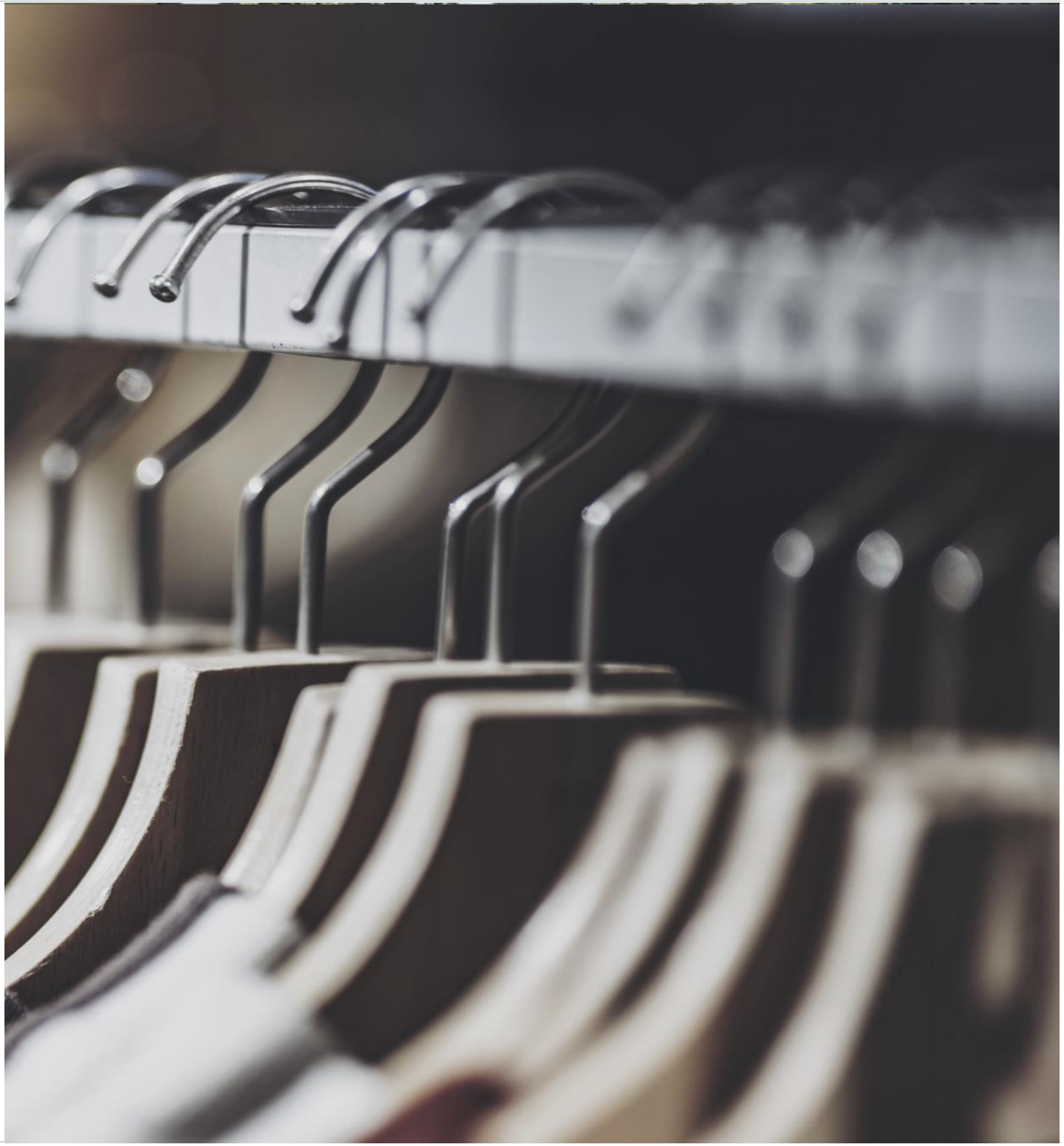
02 Retail parks are gradually becoming more prominent in the region, while high street retail faces ongoing difficulties. Occupiers will likely continue their investment in physical stores, focusing more on prime locations.

03 The Baltic retail market is witnessing heightened activity in suburban locations, driven by evolving consumer shopping patterns. Post-pandemic, the trend of accessing goods and services close to home has gained momentum and is anticipated to persist in the future.

04 E-commerce growth is expected to continue but at a more moderate rate than during the pandemic. Physical shopping remains highly valued by customers and is unlikely to be entirely substituted by e-commerce.

Definitions

Modern Retail Stock – the total completed modern retail space (occupied and vacant). Total Retail Stock includes purpose-built space converted from other uses and independent space forming part of a mixed-use development. It includes shopping centre stock, total retail space in retail parks, theme-oriented centres and department stores with a gross leasable area from 5,000 sqm.



(Re)investment for (Re)development

LIFECYCLE

The steepest growth of the modern retail stock was observed in the waves of 2001-2003, 2006-2007, and 2019-2020. Currently, shopping centers are expanding rapidly, with a modest 2-4% growth annually. It is not a decline, and the Baltics have experienced just a few cases where the stock has been withdrawn to repurpose. However, maturity has already been reached, and the strategies landlords must employ must be adjusted.

Maturity is usually featured by investment and improvements to keep the stock at the highest footfall and turnover levels. However, the cost of renovating shopping areas and opening new stores is also unpredictable and depends heavily on the prices of building materials and labor.

Renovation, expansions and modernization are currently actively pursued within the Baltics to bring back the commercialization of the retail assets.

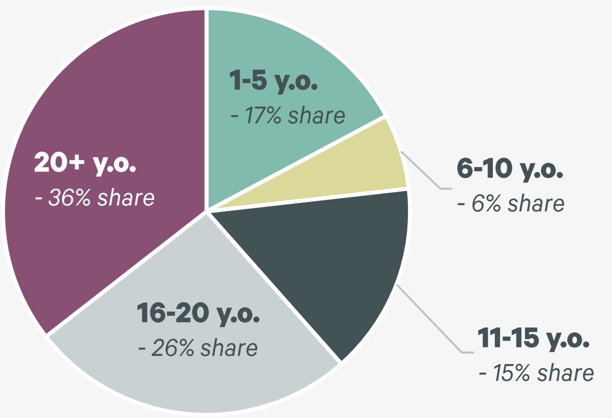
CONSUMER FUNDAMENTALS LIKELY TO IMPROVE DUE TO RISING REAL INCOMES

While consumer confidence fell sharply following the outbreak of the war in Ukraine, retail sales across the Euro area held up and, despite their mild downward trend in 2023, remain above December 2019 levels in real terms. The growth in purchasing power is expected to have a positive effect on retail fundamentals. Nevertheless, the lagged impact of interest rates rises remains a downside risk.

Inflation has been among the core topics last year and remain a significant market force for 2024. Rents are expected to increase in 2024 (which remain mostly capped or based on the European average inflation). Currently, the market starts leaning towards tenants' favor, so tenants are better positioned to (re)negotiate terms.

In Estonia, upcoming VAT hikes may soon be reflected in prices. The rise in prices sparked by tax changes from the new year may start to affect shop prices in the months ahead unless the economic downturn in Estonia pushes retailers to change their pricing policies.

Figure 17: Purpose Built Shopping Centers, GLA >10,000 sqm, Baltic Capitals



Source: CBRE Baltics Research

Figure 18: Refurbished SC Stock over 2013-2023, % of Existing Stock & Number of Projects

Tallinn	Rest of EE
36% of existing stock refurbished over 2013-2023 (6 projects in total)	17% stock (5 projects)
Riga	Rest of LV
40% stock (8 projects)	15% stock (5 projects)
Vilnius	Rest of LT
61% stock (7 projects)	35% stock (6 projects)

Source: CBRE Baltics Research

Convenience is Everything

Convenience-focused retail assets will continue to perform strongly in the Baltics.

RETAIL PARKS

In Europe, the sales recovery is led by retail parks, though dominant regional shopping centers with a leisure component remain strong. The resilience of retail parks as an asset class was underlined during the pandemic, and its attractiveness to occupiers and investors continues. Retail parks in CEE continue to deliver robust occupational performance. Even if inflation continues to apply pressure to consumers' disposable income, a decline in consumer spending is not expected to impact all occupiers equally, and many product categories present in retail parks are well positioned to overcome the economic headwinds.

However, within the Baltics, the expansion of retail parks has started relatively recently, and inner shopping centers remain the preferred mode of retail schemes. Due to changed commuting habits, developers are pushing for retail parks to be established closer to residential areas.

SHOPPING CENTERS

Shopping centres are still the core assets for retailers willing to expand their retail chains. Even though the shopping centre stock is stabilized in most of the countries and expansions and new developments are now limited, owners of shopping centres are constantly taking care of their properties for the purpose of their attractiveness, as brick-and-mortar is still considered as more effective compared to online according to retailers.

City in the City

Relevant retail and mixed-use curation have become the key agenda for many retail market players. To create attractive and inclusive retail destinations, developers started leveraging multifunctional spaces and increasing the scale. The cornerstone for such a concept is to make use of the expertise of operators from different sectors. Such types of destinations offer good entry yields for investors.

GROWING POPULARITY OF CLOSE-TO-HOME CONCEPTS

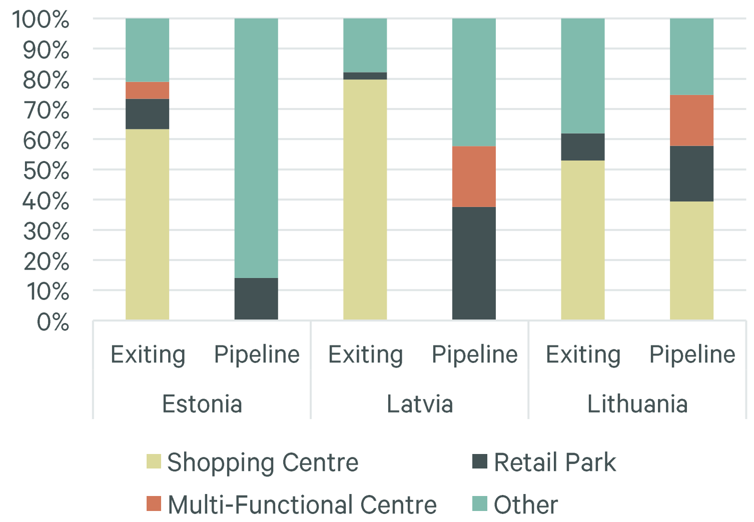
Developers used to concentrate mainly on the inner-center or active transition areas. Currently, the residential function is the central element of almost all large-scale developments. Here, the business model is typically different. While the mix of shops matters, experience, and supplementary services become more important. The positioning of physical stores in the consumption chain is evolving from being a simple sales outlet to playing a role as a location to undertake omnichannel sales, customer service, community building, and cultural experience.

Living within a 15-minute radius of urban focal points is not yet the standard way of life for most Baltic city dwellers. However, the fact is clear that retail is coming closer to where people live, helping to mitigate traffic congestion and reduce commute times by enabling people to carry out more of their activities close to their homes. While many of these developments are based on the *live-work-play* concept, some innovative projects abroad have successfully integrated public services such as city halls, hospitals, and kindergartens.

INNER-CITY RETAIL

Urban planning and mobility are essential for inner-city shopping districts. The Baltic capitals have taken the lead in making their cities people-friendly by implementing initiatives such as lowering maximum speed limits and banning traffic in the city center in the evenings and weekends to improve traffic flow and safety. As a result, we expect competition for the main shopping streets to be high in 2024. Specific attention should be given to inner-city retail clusters that can attract tourists, serve as the heart of the city district, and be a meeting place within the community, considering the expected increase in the number of people residing in the central catchment areas.

Figure 19. Existing and Pipeline Stock Split by Sub-Use, Baltics



Source: CBRE Baltics Research

E-Commerce Penetration Stands Flat Since the Pandemic

CBRE's recent analysis of post-pandemic e-commerce trends found that for key European markets, e-commerce penetration has broadly returned to its pre-pandemic growth trend. There has been little or no sustained acceleration of the growth rate due to the pandemic.

CBRE expects e-commerce to continue to grow in 2024 but broadly follow this pre-pandemic trajectory. Occupiers will likely continue to focus on creating a strong omnichannel experience, which seamlessly combines the online and brick-and-mortar experience and increases customer engagement.

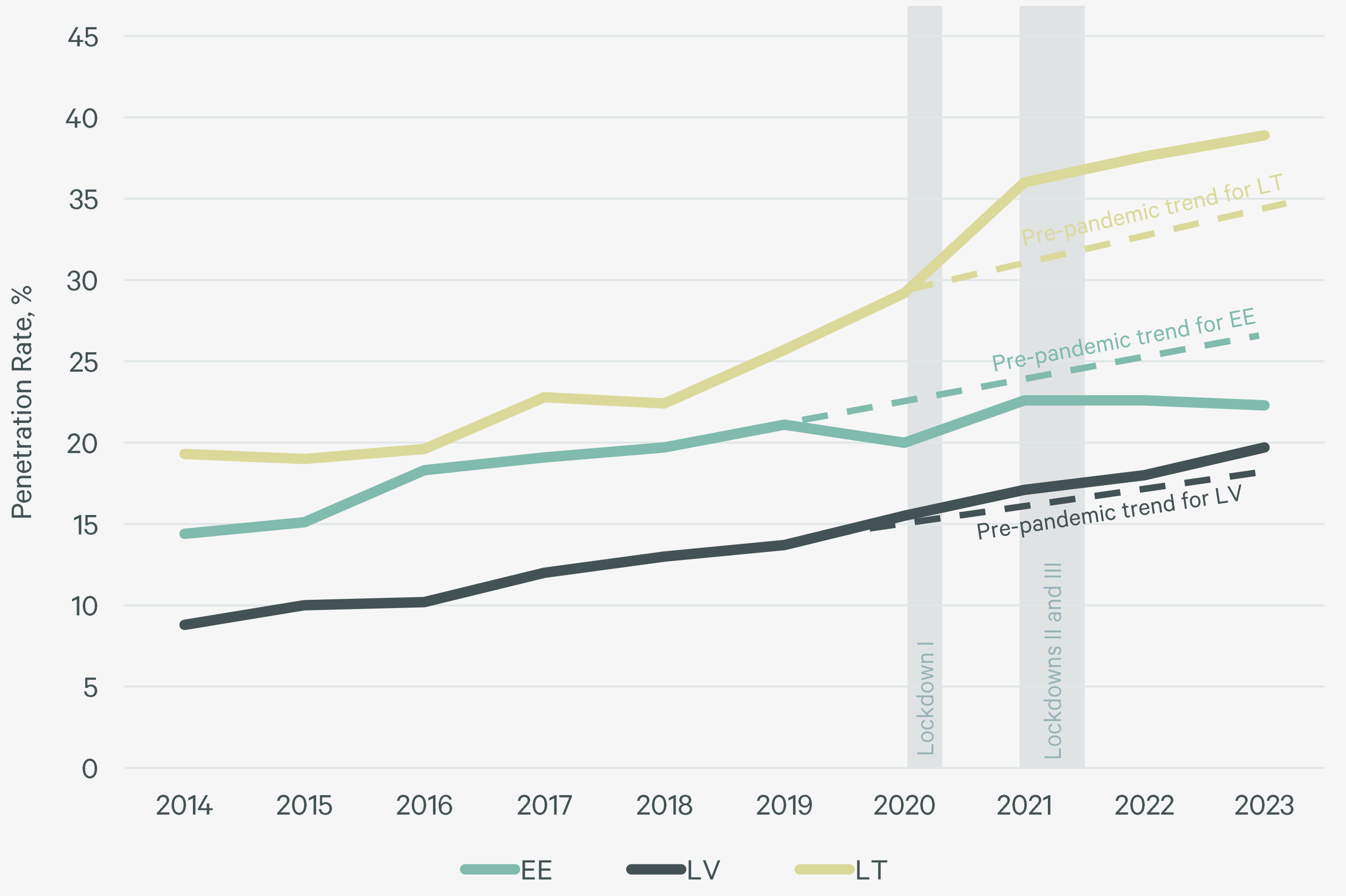
PHYSICAL EXPERIENCE STILL RELEVANT

E-commerce penetration surged during the pandemic, though Estonia is behind the pre-pandemic trend for e-commerce development, while Lithuania and Latvia exceed it. However, ever since the ease of pandemic lockdowns, the e-commerce penetration growth has become flat in Lithuania and Latvia and even faces a negative path in Estonia. Such flatlining in penetration growth could indicate that consumers value physical retail and e-commerce markets are close to their saturation point. Subsequently, in the Global Live-Work-Shop Report, CBRE surveyed over 20,000 consumers worldwide, where 60% of consumers in all European markets reported a preference for in-store shopping, while half of the respondents indicated a preference to see the product before purchase. At the same time, in the Baltics, the integration of online and in-store purchases tends to be high.

THE MERGE OF PHYSICAL AND ONLINE SHOPPING MODES

Currently, the Baltic shopping centers are integrating more and more stores that operate as small-size tenants for the pickup points. Consumers also tend to search for products online rather than go to the physical store to try or see the product before buying it. Additionally, stores in shopping malls are gaining a new "display" function, where the customer can view the products and then order them online to their own address.

Figure 20: E-commerce Penetration Rates, 2015-2023, Trend and Actual (%)



Source: CBRE Baltics Research, Eurostat

06

Residential

Housing affordability is approaching a critical low in the Baltic capitals, prompting residents to increasingly turn to rental apartments. This shift is creating a growing demand for purpose-built rental properties and co-living schemes, evidenced by the heightened market activity among investors and developers. This trend is expected to persist, particularly if interest rates remain elevated.

Key Takeaways

01

The evidence suggests that as of year-end 2023, renting an apartment in any of the Baltic capitals is about 30% cheaper than purchasing it using credit. As a result, the housing affordability index is dropping, leading residents to opt for rentals.

02

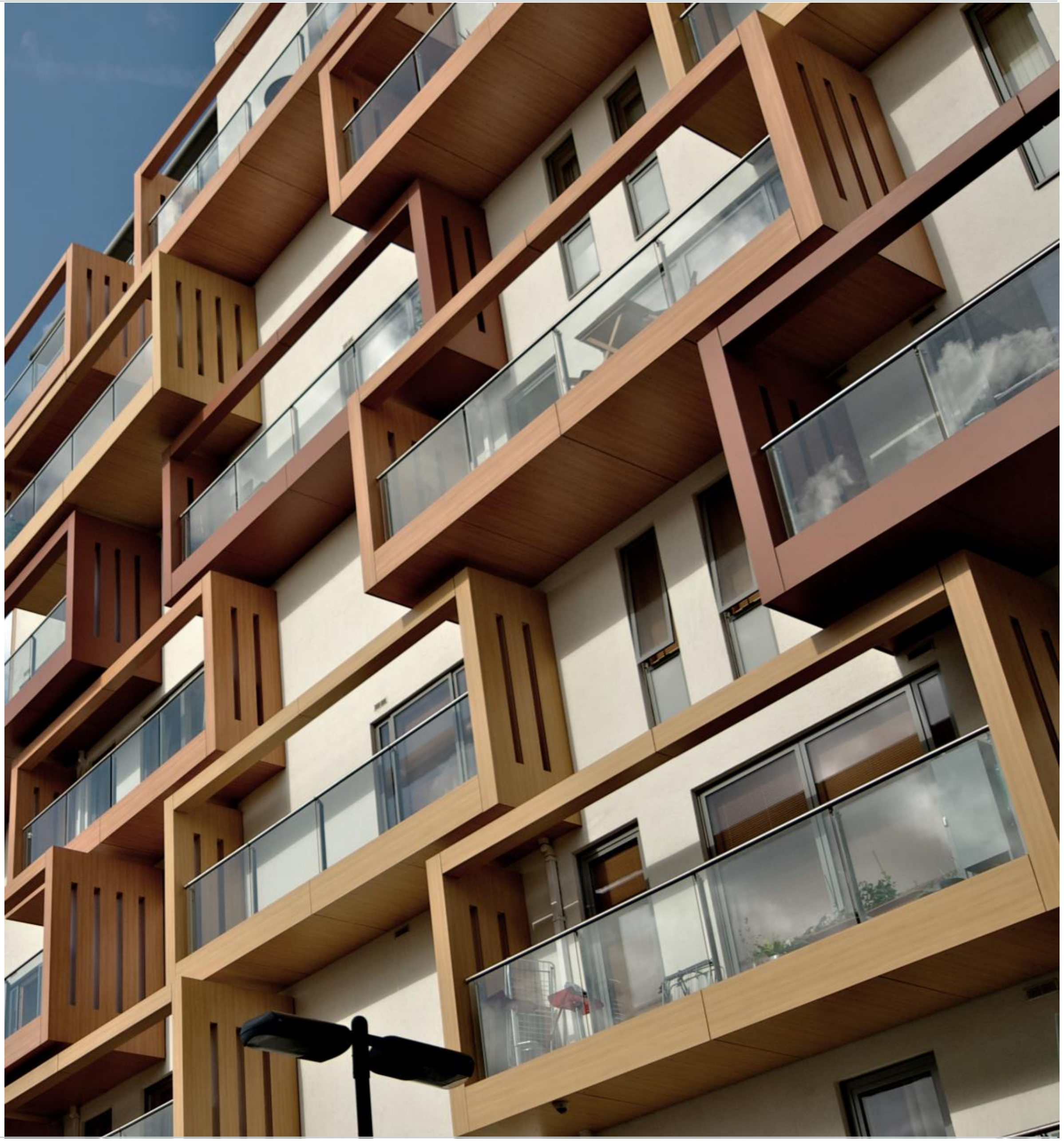
The evolving residential landscape prompts local developers and institutional investors to broaden their engagement in the Built-to-Rent (BTR) segment. Fueled by the enticing potential for increased profitability and growing demand, a surge in new participants entering the market is anticipated in the coming years.

03

Co-living is garnering growing interest from Baltic investors as well, primarily propelled by the ongoing influx of foreigners arriving in the Baltics for work or educational pursuits. Simultaneously, there is an anticipation of growth in senior housing developments due to low supply and accessibility in the region.

List of Abbreviations

BTR – Built-to-rent
GLA – Gross leasable area
PRS – Private rental scheme
SQM – Squared meters



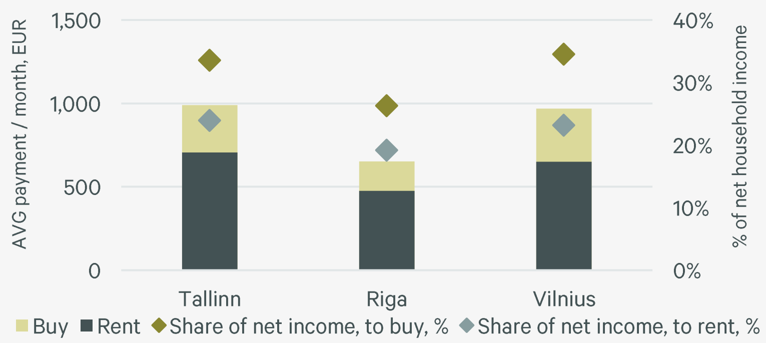
Growth Trends in Residential Segments

RENTAL RESIDENTIAL

In the current times of escalating interest rates and diminishing housing affordability, purpose-built rental apartments are gaining traction. Up until 2022, according to Swedbank, housing affordability had been growing in all three Baltic capitals; however, since then, the index in Tallinn fell from 145 to 90, Riga slumped from 205 to 145, and Vilnius dropped from 145 to 86—nearly revisiting figures not seen since 2010. Consequently, there's been a marked uptick in rental activity in these markets. Evidence suggests that by the close of 2023, renting an apartment in the Baltic capitals is approximately 30% more cost-effective than purchasing it with a loan (refer to Figure 21). Responding to these market dynamics, an increasing number of residential and commercial real estate developers and institutional investors are venturing into the Purpose-Built Rental (PBS) market. The stock of professionally rented apartments witnessed a 20% surge between 2022 and 2023, and projections indicate a further 18% growth in 2024. Accordingly, we anticipate a continued increase in developer and investor interest in this segment throughout 2024.

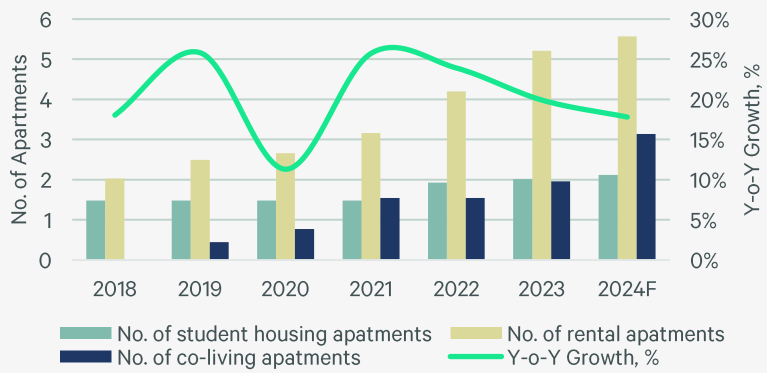
The trend is induced not only by switching consumer behaviors but also by the allure of higher profitability for developers. In PBS apartment buildings, rents are generally higher due to added conveniences such as fully furnished apartments, efficient management, central locations, and extra amenities. In Tallinn prime areas, one-room flats rent for around 580-620, and two/three-room flats for 650-800 €/month. In Riga, one-room apartment rents start at about 400, while two-room flats go for over 500 €/month. In Vilnius, one-room apartments are rented for approximately 550 €/month, and two-room apartments at 650 €/month and above.

Figure 21: Cost Comparison of Buy/Rent Scenarios, Baltic Capitals*



Source: CBRE Baltics Research, National Statistics, National Banks

Figure 22: No. of Rental Residential Apartments, Baltics



Source: CBRE Baltics Research

*Note. Estimations were made considering a two-room 50 sqm apartment and a household of two persons with average wages. A loan term of 30 years and local interest rates for Oct 2023 were considered.

CO-LIVING

The concept of co-living has gained immense traction recently. Across Europe, more than 50% of European investors plan to enter the co-living investment market in the coming years. In the Baltics, the trend has caught up, too - from private developers to institutional funds, development action has grown significantly. For 2024 alone, the Baltic co-living stock is expected to increase by more than 47,000 sqm in GLA, expanding the rooms available by up to 1,500. With international borders blending for remote workers and an increase in foreign student attraction, it is apparent that the concept of co-living is expected to attract even more attention.

SENIOR HOUSING

Based on the National Statistics, the median age of the Baltic population has been growing for several decades now and currently stands at around 43-44 years across the Baltics. The proportion of the elderly has also followed the upward trend, and in 2023, approximately 20% of the Baltic population was aged 65 years and more. At the same time, this figure is expected to rise to 26-29% by 2050. Nonetheless, a report done by the European Commission indicates that senior housing provision is low across the Baltics, while quality and accessibility highly varies from region to region. Responding to this trend, the Baltic residential sector has seen an increase in senior housing development projects – Nordic senior housing providers are now stepping into the region, while in Latvia, the segment has caught the attention of institutional investors. Moving from 2024, we expect the activity in senior home development to increase.

07

Hospitality

The Baltic hospitality sector is set for growth as the region continues to attract a growing number of tourists, the introduction of new trains, bus lines, and airline expansions is expected to significantly enhance connectivity, creating a dynamic and sustainable hospitality landscape in 2024.

Key Takeaways

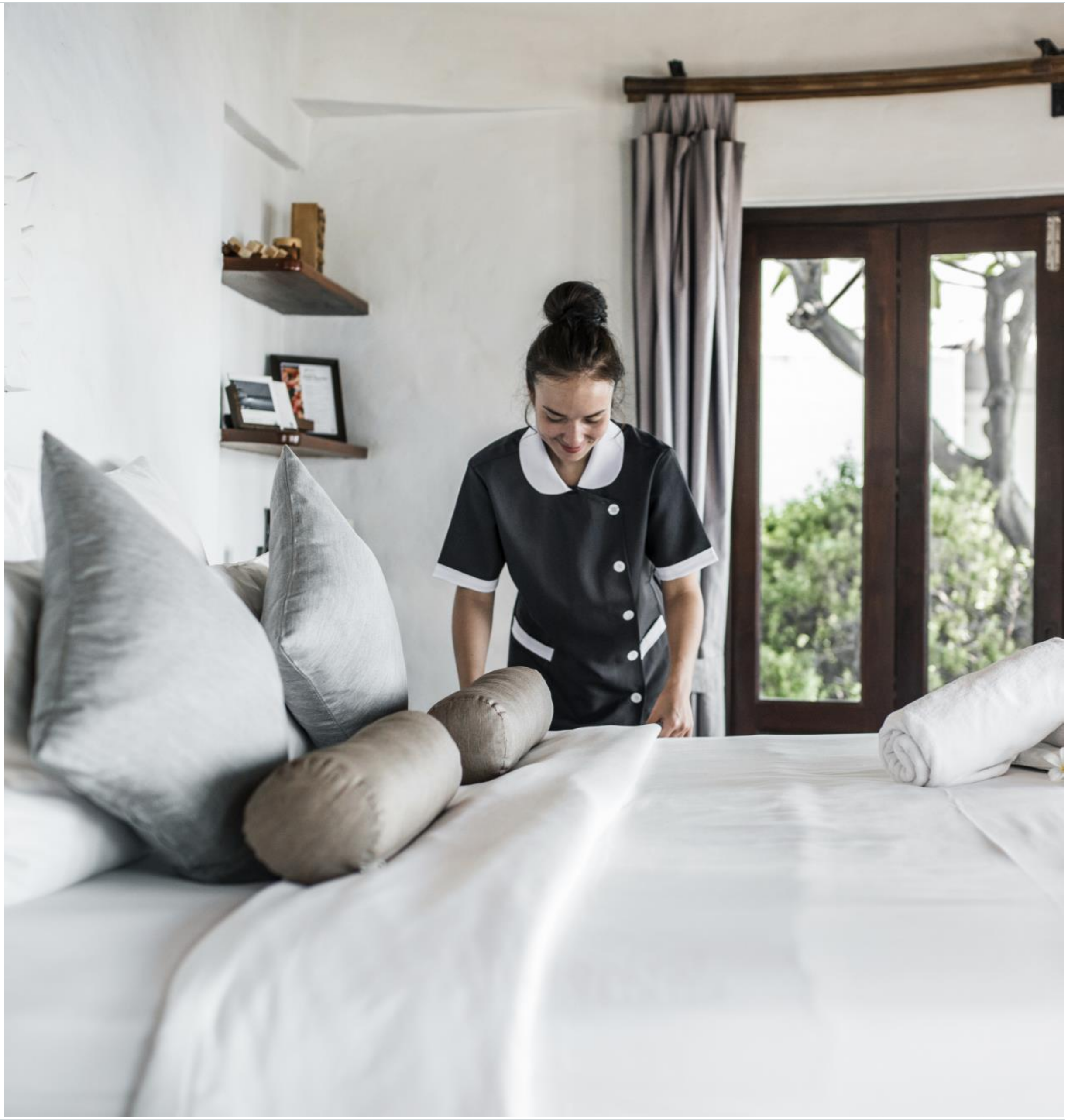
01 Elevated savings levels partially support the ongoing trend of travel prioritization among consumers. In Europe, global travel is nearly back to 2019 levels, with short-haul leisure travel being the primary driver, while long-haul and business travel face challenges due to a weakened economic backdrop.

02 In 2023, the Baltics showed one of the highest decrease rates in Europe in foreign visits. The tourism is expected to start slowly reviving in 2024. However, nurturing the visitor and resident experience will be crucial to ensuring a positive impact and attracting more tourists.

03 Various airlines and bus companies, together with Rail Baltica developments, are set to play crucial roles in enhancing connectivity, contributing to a more comprehensive network for travelers in the region.

List of Abbreviations

EU – European Union



Travel Recovery in the Horizon

HOSPITALITY IN THE BALTICS NEEDS A BOOST

Despite travel remaining a priority for consumers, with the consumption share of leisure travel in advanced economies hovering around 8%, returning to pre-2019 levels, the trend is expected to grow further next year. In Europe, global travel is nearly back to 2019 levels, driven primarily by short-haul leisure travel, while long-haul and business travel continues to struggle due to a weakened economic backdrop. However, the situation differs in the Baltics, where foreign visits and overnight stays have experienced the highest decrease in the EU (20-30%) compared to 2019. Looking ahead, we anticipate a shift from comparing travel to 2019 and instead focus on year-over-year comparisons.

As of 2023, the Baltic capital cities hosted approximately 200 operational 3*, 4*, and 5* hotels, providing over 19,000 rooms. Despite a steady increase in hotel numbers over the last two years, the figures still reflect a decline compared to 2019.

Even though the hotel sector was the sole recipient of increased investment volumes in 2023, investor interest in hotel assets in the Baltics remains uncertain due to regional geopolitics. Investors are primarily drawn to hotels in the above-average and below-premium segments. While the Baltic States are attracting interest from new entrants and potential expansions by existing hotel chains, the scarcity of available pre-built structures for their operations is evident, and investors remain cautious about starting new construction projects.

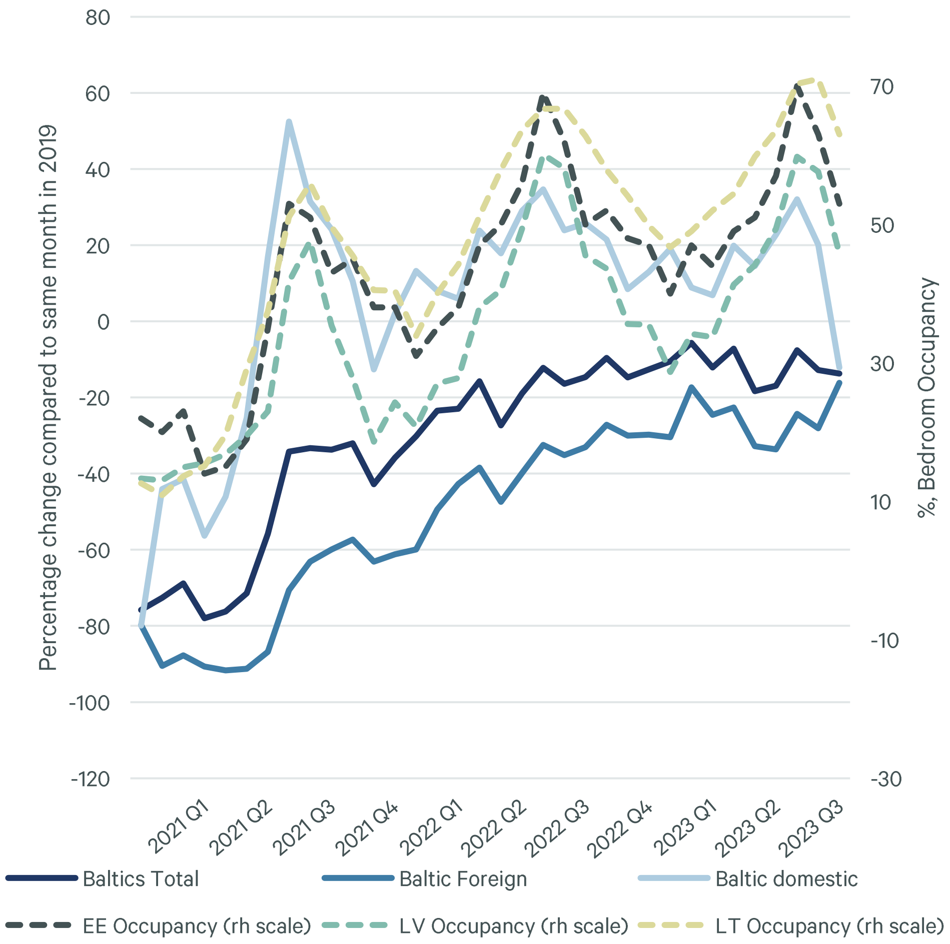
FUTURE-FORWARD BALTIC CONNECTIONS

As ecological considerations gain prominence and influence travelers' choices, especially in modes of travel, and cheap and available flight destinations increase tourist numbers, the Baltics present opportunities for growth, particularly in the eco-friendly segment. However, air travel emission intensity in the Baltics exceeds the EU average, while the share of trips by train is only around 3%, compared to the EU average of 13%, primarily due to a lack of available means of travel.

Looking ahead to 2024, there are promising developments to increase visitors and enhance connectivity, with several new routes connecting the Baltics. For environmentally-conscious travelers, implementing new railways, such as the Rail Baltica project, provides a more sustainable option. The route connecting Riga-Vilnius became operational by the end of 2023 and connected to central Europe, as Vilnius already had a railway connection to Warsaw. New bus lines from the Baltics to Central Europe are also available.

Also, the most popular means of tourist arrival in the Baltics, air travel is expected to continue growing in 2024. For instance, Ryanair is set to reintroduce 15 regular flight routes to Lithuania and launch four new regular flights from Kaunas. Transavia France is launching flights between Tallinn and Paris, while Norwegian plans to offer two new routes from Riga. AirBaltic also plans to launch 11 new routes from the Baltics, contributing to a more comprehensive network for travelers in the region.

Figure 23: Arrivals at tourist accommodation establishments and occupancy levels



Source: Eurostat, CBRE Baltics Research

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