Real Estate House View
Hungary, Poland, Czech Republic

SwissLife
Asset Managers

Second half-year 2018

Key takeaways

- The robust economic environment is creating a good basis for the real estate markets in Central and Eastern Europe (CEE). Yet the dynamic market for developments, especially in the office sector, is preventing a sustained upward trend in the letting and investment markets.
- Following a recovery of the office markets in Budapest and Prague and an upswing in rents, a new phase of high construction activity is imminent, thus severely limiting the prospects for rental growth. Warsaw will remain the weakest market for the foreseeable future due to its high level of completions.
- Rising incomes and consumer spending are boosting the retail sector. Once again, the expansion of retail space, especially in shopping centres, limits rental growth in high streets and in the centres themselves.
- Investors' demand for real estate in CEE has risen sharply in recent years and transaction volumes have reached record levels, which has led to significant yield hardening. We expect modest yield compression to persist.
- With yields falling and rents rising, investors in Hungary and the Czech Republic enjoyed strong performance in 2017. However, total returns are likely to weaken in the coming years.

Chart in focus

Source: MSCI

The buoyant economy and the significant recovery of the office leasing markets in the recent past were reflected in a significant increase in the total returns in Hungary and the Czech Republic in 2017. Poland did not participate in the upturn due to its challenging office market and continues to be the worst performing market in the CEE region.

With their exposure to manufacturing, Poland and the Czech Republic are benefitting from robust growth in the Eurozone. Declining unemployment rates pave the way for stronger wage growth and explain high consumer confidence levels. Yet, as the global upswing enters a mature stage, the growth/inflation mix is deteriorating. Domestic price pressures are intensifying. To fight potential inflation risks, the Czech National Bank continues with monetary policy tightening. An intensifying trade dispute with the US would hurt economic activity in the Czech Republic in particular. Furthermore, local government quarrels with Brussels may be limiting foreign direct investments from other European markets into the region.

Investors take advantage of high initial yields

In 2017, investors' appetite for real estate in CEE remained at a high level for the second year in a row, with even a slight increase in Poland and Hungary. In contrast to many European markets, investors are focusing on retail property, which accounted for a market share of over 40% in 2017. Only approximately 35% of investment volumes were spent in the office sector. Prime initial yields were subject to different regional trends in 2017 and in the first quarter of 2018. In Poland and the Czech Republic yields remained stable for the office, retail and logistics sectors. Yields in Hungary were under pressure. The flat movement in the first months of 2018 should also be monitored in the coming quarters. It seems that investors are increasingly ignoring political risks and willing to gamble on a considerable yield premium. We expect yields to soften in Hungary and, to a lesser extent, in the Czech Republic in 2018. Yields in Poland are predicted to bottom out.

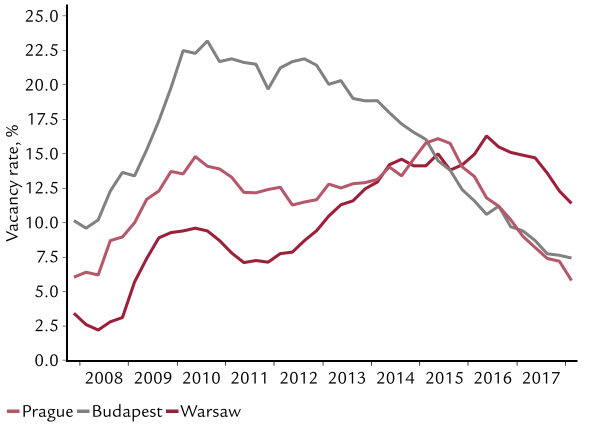
Stagnation of office markets ahead

The performance of office investments clearly correlates with the differing dynamics of the respective letting markets. The office total return in Hungary reached a 10-year high of 8.8% in 2017. There was also a positive trend in Poland. However, the result was a weak 4.1% because capital value growth remained negative. Considering the rental markets, the previous year's strong demand continued in 2017, leading to record take-up in Budapest, Prague and Warsaw. As a result, vacancy rates fell in all markets by at least 200 basis points. However, only the Budapest and Prague markets were able to translate this decline into rental growth. In Warsaw, prime rents stagnated in 2017 as the vacancy rate remained in the double digits and construction activity was high. Nevertheless, the outlook for Warsaw could improve as a flattening of completions is emerging. This could aid the prospect for rental growth in the medium term. Elsewhere in Poland, regional markets such as Krakow and Gdansk, where the growth of modern property stock is being driven by strong user demand, are gaining in significance. In Prague and Budapest the future outlook could deteriorate for landlords. The availability shortage and rising rents are prompting significantly higher levels of development activity. Vacancy rates and downward pressure on rents are expected to increase in the near future. Overall, in our view the prospects for the CEE markets are subdued, which should be reflected in office sector performance.

Retail continues its upswing

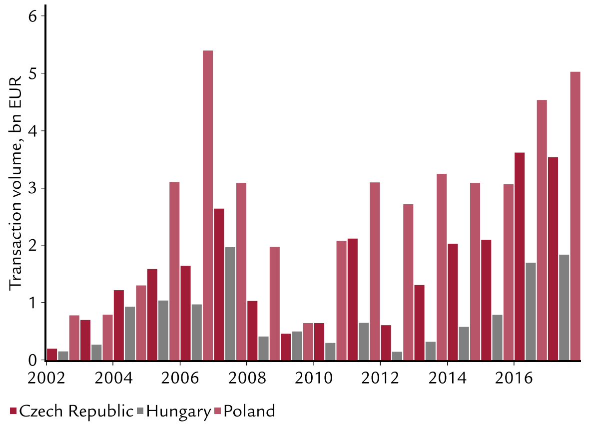
Performance figures for the retail sector reflect a fairly robust situation. According to MSCI, retail investments in the CEE region achieved a solid total return of 6.8% in 2017. The strong economic environment is underpinning consumer and retail spending, from which store-based retail will benefit to a larger extent than in many other European countries. The importance of online sales in CEE countries has also been much less pronounced so far. New international retail and restaurant chains are opening branches in the CEE, mainly in the high streets of the capital cities, resulting in rental growth. Budapest and especially Prague offer good prospects due to their high tourist appeal. By contrast, Warsaw lacks a dominant high street and thus our expectations are much more subdued by comparison. The market is characterised by prime rents in shopping centres that are significantly higher (approximately 130 €/sqm/month) than in the high street (approximately 80 €/sqm) according to Cushman and Wakefield. Shopping centre competition, including new buildings or extensions, is restricting rental growth in all markets and competition is intensifying. We believe that only the prime shopping centres offer sustainable rental growth in the short and medium term.

Chart 1: Office vacancies in CEE's main office markets



Source: PMA

Chart 2: Commercial transaction volumes for the major CEE countries



Source: PMA

Authors

Corpus Sireo

Andri Eglitis
Director Research
andri.eglitis@corpussireo.com

Emanuel Eckel
Senior Manager Research
emanuel.eckel@corpussireo.com

Swiss Life Asset Managers

Francesca Boucard
Economist Real Estate
francesca.boucard@swisslife.ch

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch

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