The CEE Investment Scene

H1 2023

Introduction

Economic growth faltered in the CEE-6 region at the start of 2023, with 3 countries, Czech Republic, Hungary and Poland seeing negative annual GDP growth as of Q1 2023, despite Romania and Bulgaria recording the best performances after their economies expanded by over 2%. Ahead of the second quarter GDP results, due mid-August, we can note that, unfortunately, the weak streak is set to continue, at least over the short term, as high-frequency indicators are still not up to par for quite a few of the countries.

For instance, the European Commission's economic sentiment indicator, which tracks near-term momentum of local businesses quite well, is above the historic average in just two countries: Romania and Bulgaria. Furthermore, in Q2 2023 versus Q1 2023, morale improved materially only in Poland and saw smaller increases in only a couple of other countries. On the flipside, the Eurozone's sentiment indicator jumped quite sharply in the second quarter, which could lead to improved external demand for CEE-6 economies down the line.

It is also worth pointing out that GDP growth is but one part of the picture and in fact, the CEE-6 economies are at, or close to, a peak in terms of economic activity, as the overall employment rates are at or close to multi-decade highs in all countries; so, the state of these countries cannot be judged as poorly. With labour markets this tight, employees are shielded to a certain extent from the current economic challenges, though this lack of flexibility within the economies suggests a significant acceleration is off the table, for now.

2 billion
H1 2023 total investment volume

1.2%
CEE-6 GDP growth forecast in 2023

2.7%
CEE-6 GDP growth forecast in 2024

11.7%
CEE-6 inflation forecast in 2023

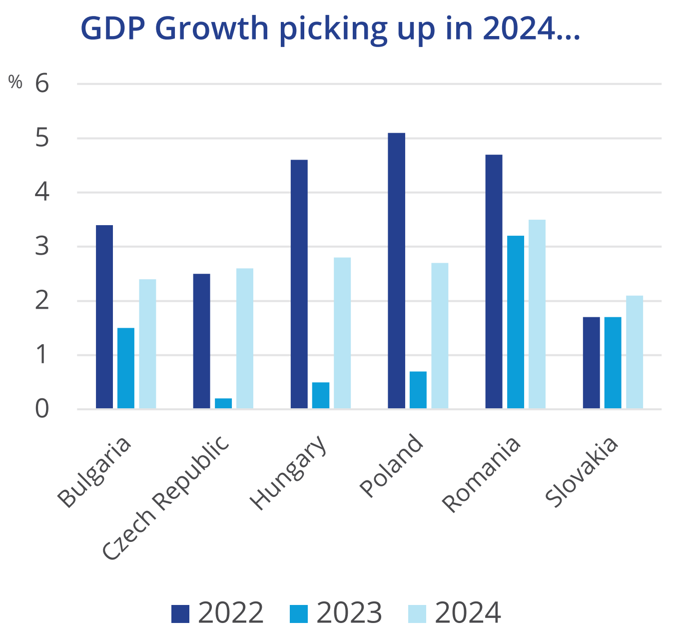
5.0%
CEE-6 inflation forecast in 2024

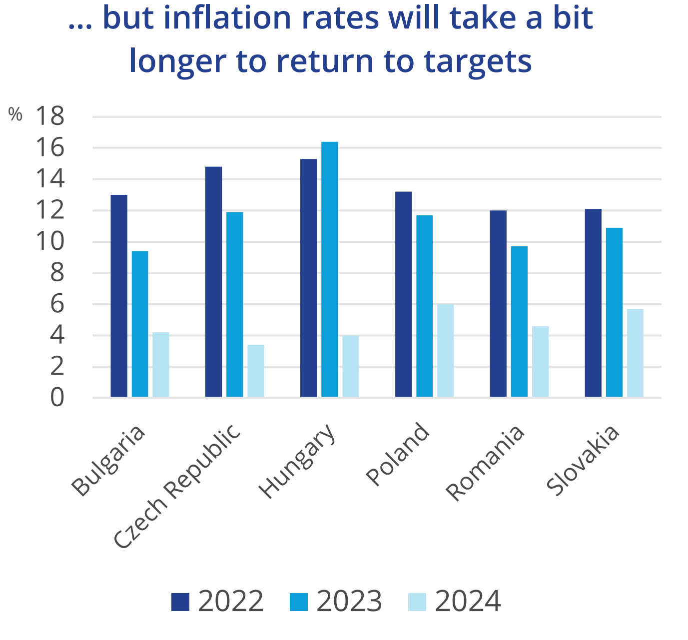
Meanwhile, the impact of high interest rates (accompanied by an increase in the cost of risk) alongside a shaky global economic backdrop is still negatively impacting countries in the region. Inflation remains a challenge, particularly as most of the drop in consumer price growth in recent months has been caused largely by the volatile components of the CPI basket, in particular energy. Meanwhile, the so-called core inflation, which strips away components like energy and seasonal food items, is seeing a decline, but quite a bit less. This suggests that high interest rates will remain in place for quite a long time, even if they start to decrease a bit as soon as Q4 2023 or Q1 2024.

Inflation

Inflation in the Western world is finally dropping, although it is declining mostly on account of commodity prices, while the all-important core inflation is decreasing more slowly. Is this down to "greed-flation", or not, is it still the residue of the ultra-lax monetary policy for over a decade or is it because of geopolitical tensions? According to the expectations of financial analysts, a drop in interest rates could potentially start to materialise in the next 2 or 3 quarters. However, irrespective of what is causing consumer price growth to remain sticky, it is clear that central banks will not be comfortable with cutting rates as rapidly as they increased them. Furthermore, it is likely that when EUR or USD policy rates do decrease, unless the economy demands it, policymakers will likely try to keep a level that is more or less in line with inflation and keep real interest rates positive. Therefore, interest rates are likely to stabilize at higher levels than before 2020.

More importantly, it is no longer just about rates, as it is starting to become clear that central banks in major economies are also



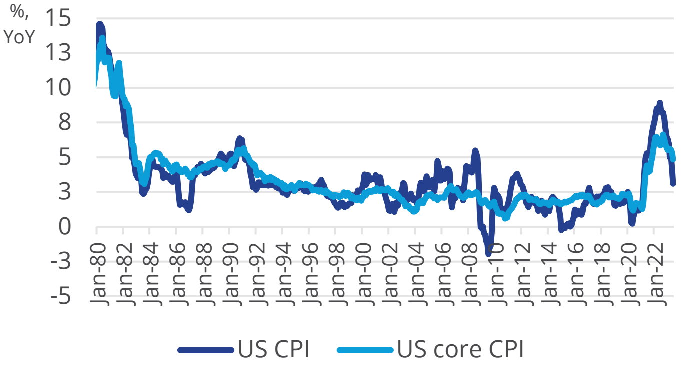


pursuing a normalization of monetary policy in general and it remains less clear how far this will go. And a key aspect of this return to orthodoxy requires trimming their very bloated balance sheet after two decades of excesses, although the monetary response to the pandemic has been spectacular. As a relevant aspect, the balance sheet of the 4 major central banks in the world (the USA's, the Eurozone's, China's and Japan's), was sitting at around 5 trillion dollars in 2007 or less than 9% of the world's GDP. By the start of the pandemic, it had reached in excess of 20 trillion (or around 25% of the world's GDP), peaking in early 2022 at over 31 trillion (or over 30% of the world's GDP).

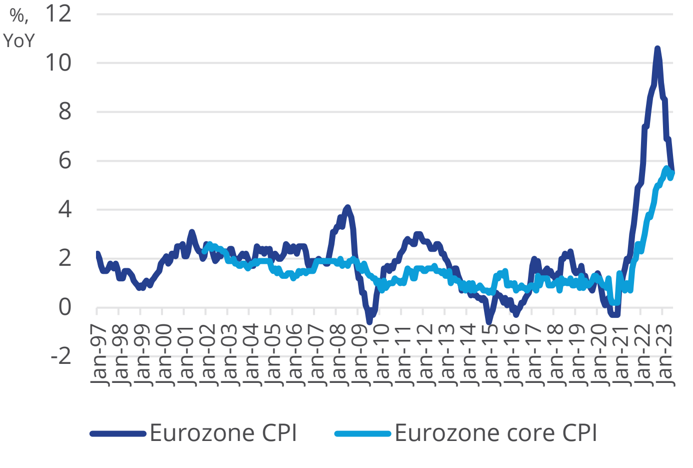
Starting in 2022, major central bank's (with the exception of China's) have mostly started the so-called quantitative tightening process, sterilizing massive amounts of money, but there is still a long road ahead. At 27 trillion dollars as of mid-2023, the balance sheet of the major 4 central banks is still at a sizeable level of 25%, so nearing pre-pandemic levels, but to arrest inflationary pressures, central banks may feel inclined to do more.

Where does this leave the CEE-6 economies, which are small (on a global scale) and fairly open economies? Under normal circumstances, this process would suggest some medium-term pain is in store for these countries, but we still maintain a very rosy long-term view regarding the region. Between the geopolitical reshuffling taking place globally, the fact that CEE economies have a solid track record of fast economic development and still offer some of the most attractive wage-productivity gaps in the Western world, we would consider any potential medium-term pain to offer opportunities geared at the longer-term.

Headline US CPI is dropping faster, but core CPI is still way off "normal" levels despite some favourable base effects kicking in



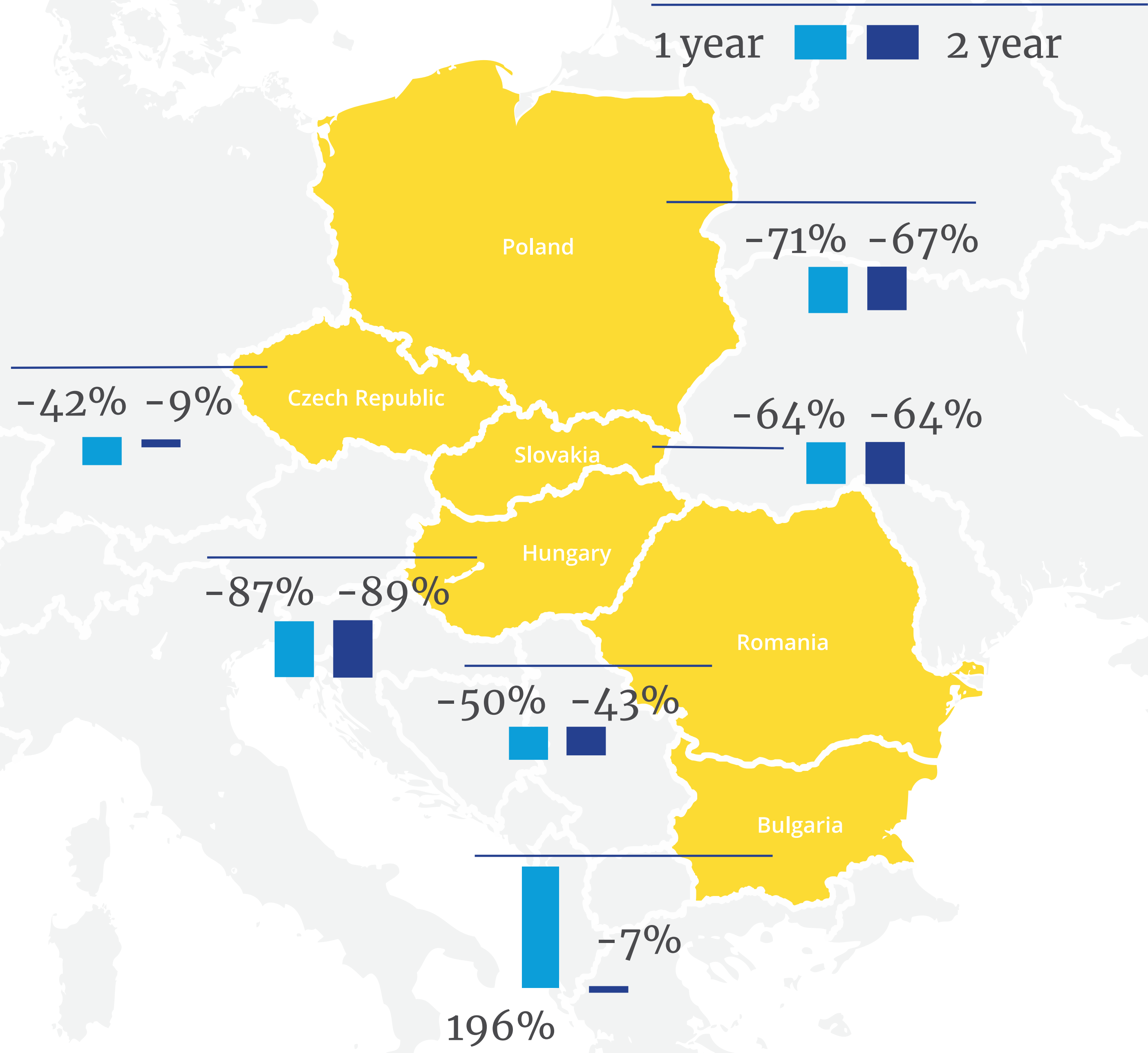
Meanwhile, Eurozone inflation is proving a bit more problematic



CEE Investment volume growth rates

(H1 2023 vs. H1 2022 & H1 2021)

Volumes for Q2 and H1 2023 across CEE were some of the lowest levels on record. Poland secured a majority share of regional volumes at ca. 42% but activity overall was slow. The Czech Republic followed with a 34% share. Bulgaria was the only market in the region to record a year-on-year increase, while the other markets all had drops in volumes of between 42% and 87%. The lack of transactional evidence in the market is dragging out the period of price discovery and a meaningful recovery will depend greatly on an improved inflationary and interest rate environment. While we have not yet seen any significant signs of distressed sales, refinancing, maturing bonds, ESG compliance and other specific sector or country-related themes may have an impact on hold strategies for some investors.



Source: Colliers

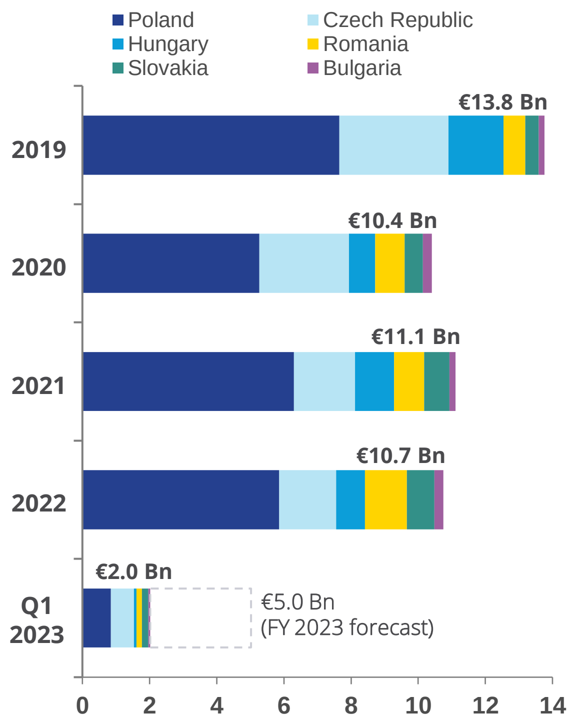
CEE Investment volumes by country

2019 to Q1 2023 (€ BILLION)

At **€2.02 billion,** the first half of 2023 saw CEE investment volumes decline by ca. 64% YoY. According to preliminary results, this is unfortunately in line with European and Global results. Given the current conditions, particularly in relation to the cost of debt, predicting market activity for the remainder of the year remains challenging, but we estimate it could reach **€5.0 billion** or above at the current trajectory.

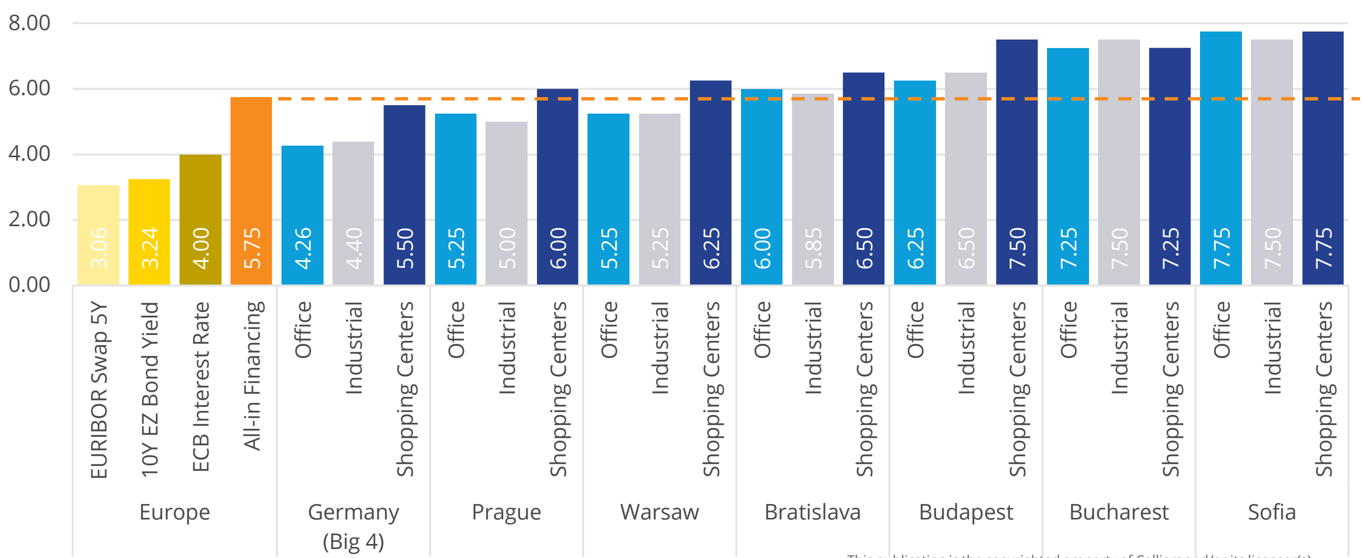
CEE Investment volumes by country

2019 to H1 2023 (€ Bn)



H1 2023 Prime yields (%)

With the continued lack of evidence in the market, it remains a challenge for all market players to pinpoint where yields are currently. This means we need to look at a more sentiment-based, in-house view, taking current market conditions into account. As described last quarter, these views should take into consideration the various factors that are impacting liquidity. These include, but are not limited to, interest rates, bond maturities, ESG compliance and structural changes to occupier markets for some sectors, where applicable. All-in financing costs are currently above 5.5%, driven by significantly higher interest rates from just 12 months ago, as well as the costs of other financial tools such as interest rate swaps. In addition, the spread of real estate to other investment strategies has largely disappeared and in some cases are starting to look like compelling alternatives, putting further pressure on buyers' expectations of pricing.



Source: Colliers

CEE Flows by sector (%)

Office investment volumes have declined significantly, both Globally and in CEE, accounting for just 29.5% % of CEE volumes in H1 2023, similar to that of the I&L sector. Retail was back on top with a 35% share of activity at the end of half year period, and included the only transaction over €100 million in Q2, a shopping centre in Pardubice, Czech Republic.

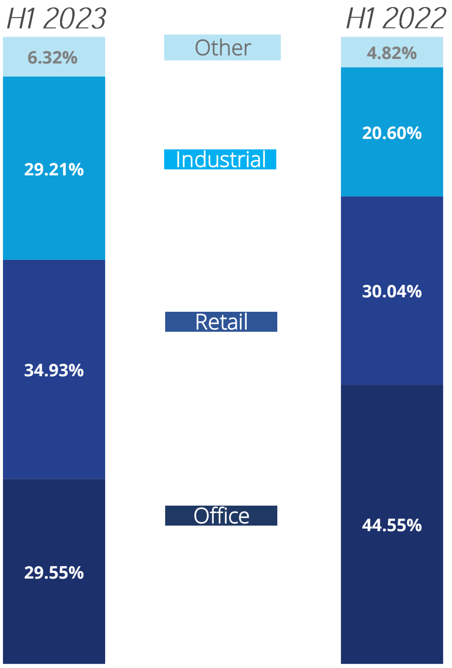
CEE Flows by origin of purchaser (%)

CEE-6 domestic capital has been the most active so far in 2023, with an impressive 59% share of total regional volumes. In particular, Czech capital (40%) secured the highest volume and almost 17% in just 2 transactions (both Retail).

Other CEE regional capital picked up a further 19%. These were followed by European (14%), APAC (7%), USA (5.4%) and Middle Eastern (5%) capital.

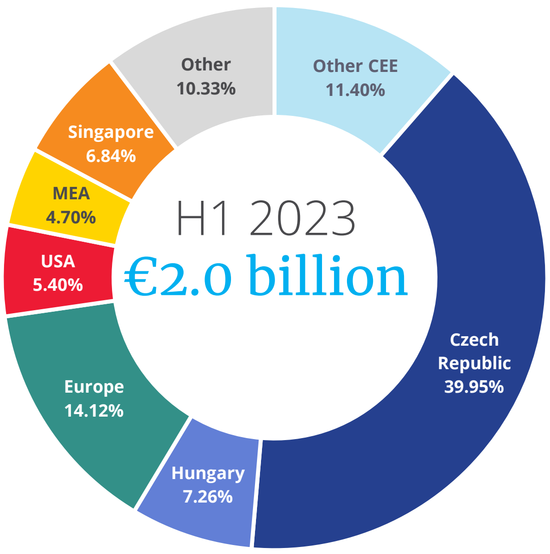
CEE Flows by sector (%)

H1 2023 vs H1 2022 (€ Bn)



CEE Flows by origins of buyer (%)

H1 2023 (€ Bn)



Source: Colliers

Rental levels H1 2023

Rental growth YoY and Colliers 12-month forecasts

At the time of writing, the final supply and demand data for Q2/H1 2023 is still being analysed for their overall impact on vacancy and prime rents. However, we can see that a combination of these factors, plus inflation and the overall rise in costs, have either already led to rental growth over the past 12 months, or we expect to see further growth materializing in the coming months. This is particularly the case in the I&L sector, where we expect vacancy to remain low, and have recorded, or are expecting double-digit growth in some markets. Prime office rents have also seen growth across the region, particularly in newly delivered product, but also in the most sought-after locations.

OFFICE / INDUSTRIAL / RETAIL	OFFICE PRIME RENT (€/SQM/MONTH)	OFFICE PRIME RENT GROWTH (% YOY)	OFFICE PRIME RENT 12M FORECAST	I&L PRIME RENT (€/SQM/MONTH)	I&L PRIME RENT GROWTH (% YOY)	I&L PRIME RENT 12M FORECAST	SHOPPING CENTRE PRIME RENT (€/SQM/MONTH)	SHOPPING CENTRE PRIME RENT GROWTH (% YOY)	SHOPPING CENTRE PRIME RENT 12M FORECAST
Bratislava	17.00	3.0%	→	5.20	25.1%	↑	50.00	0.0%	→
Bucharest	19.00	2.7%	↑	4.60	7.0%	↑	70.00	0.0%	↑
Budapest	25.00	8.7%	→	6.00	17.6%	→	70.00	0.0%	→
Prague	27.00	5.9%	→	7.50	7.1%	→	100.0	0.0%	→
Sofia	15.00	11.1%	↑	5.50	11.1%	↑	50.00	0.0%	→
Warsaw	27.50	5.8%	↑	6.00	20.0%	↑	135.00	9.8%	↑

Summary

As we move into the second half of 2023, we are still registering good interest in the CEE markets, but the ongoing conditions, as mentioned earlier in this report, still suggest a significant gap between buyers' and sellers' expectations. This in turn is leading to a current lack of product being brought to the market, as can clearly be seen by the H1 2023 volumes.

While CEE domestic capital, has continued to be and will remain active (Czech capital in particular), many of these funds will require some level of leverage. At the same time, the cost of finance remains elevated so in order for deals to stack up, something needs to give. However, unless current property owners have a real need to sell or are willing to adjust pricing to accommodate a proportion of those rising costs, then we may continue to see some owners holding on to their assets a while longer.

These trends are not exclusive to CEE, and we are recording very similar challenges elsewhere in Europe and other regions Globally. Now while some form of meaningful recovery may not occur until 2024, there are green shoots of optimism out there, at the right pricing. Outside of the much sought-after I&L sector, for development land/projects, sale & leasebacks and standing assets/portfolios, there is also increasing demand and recent activity in the retail sector, and this has also included shopping centres which now seems to look like good value. After a particularly challenging time through the pandemic, there seems to be greater stability and transactions are starting to appear. The same can be said for the living/PRS sector but product availability is still rather limited across the region.

Overall, we expect the summer to be typically slower, which leads us up to EXPO Real where we expect to get a better read on the mood of buyers, sellers and lenders alike. We should certainly see more product being positioned for sale and judging by the demand for advice and action, ESG compliance and its impact on assets attractivity, financing and saleability, is rapidly moving up the agenda for many market players, This is particularly true for all things related to energy supply and efficiency.

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