UBS

Real estate markets

Opportunities in Central and Eastern Europe

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- We expect CEE real estate to outperform continental European property investments slightly thanks to the ongoing catch-up of their economies. We expect investors to benefit from continuing yield compression.
- Relative strong economic growth prospects, higher levels of infrastructure spending than Western Europe, and the current lack of modern commercial surfaces will continue to drive total return in the real estate market over the coming years.
- The office, logistics/warehouse and residential market are, in our view, the most appealing segments. In contrast, retail spaces look less favorable.

Source: Istock

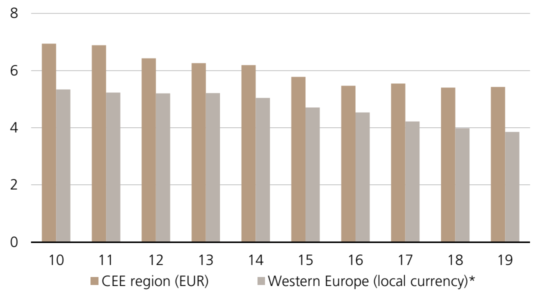
Central and Eastern European (CEE) real estate has been in high demand in recent years. According to Colliers, the money flows into this region increased from EUR 9 billion in 2015 to about EUR 13 billion in 2019. Polish properties attracted about 45% of total money inflows. Real estate investments in the Czech Republic accounted for 25% and in Hungary for roughly 15% of the total volume. Moreover, the capitals of these countries were among the top 15% most liquid markets globally in terms of cross-border real estate investments. Property investments in Romania, Bulgaria and Slovakia are currently much smaller and hence less liquid. These countries are not covered in this publication.

The rapid growth in transaction volumes in the CEE region was clearly above the overall global trend but the CEE property markets still constitute only a small portion of global investment volumes. We expect that international property investors will maintain their interest in this region. There are several reasons why CEE direct property markets remain an attractive investment opportunity in our view.

First, returns have been compelling when compared to Western Europe. In 2019, the total return on CEE real estate properties amounted to more than 10% according to MSCI versus less than 6% in developed European markets on average. Despite its compression, the income return in CEE countries of almost 5.5% remains comparatively attractive and has exceeded the Western European market by an average 130 basis points since 2010. As the prime yields (average over different segments) are just below the 5.5% mark, net cashflows of new investments continue to deliver attractive return to new investors, in our view. Moreover, we expect that investors will continue to benefit from ongoing yield compression, although this is declining.

CEE income returns are higher than in Western Europe

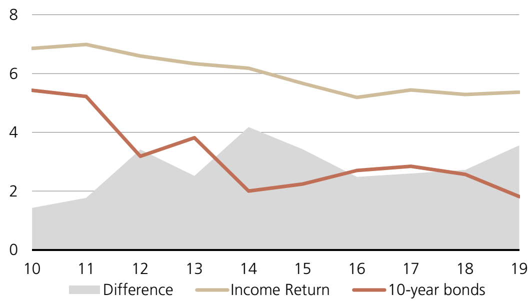
IPD income returns (EUR), in %, all properties



Source: MSCI IPD, UBS. *GDP-weighted average of FR, DE, NL, ES, UK, CH.

Income returns are attractive despite the recent yield compression

GDP-weighted average of Poland and Czech Rep., in %



Source: MSCI IPD, Bloomberg, UBS.

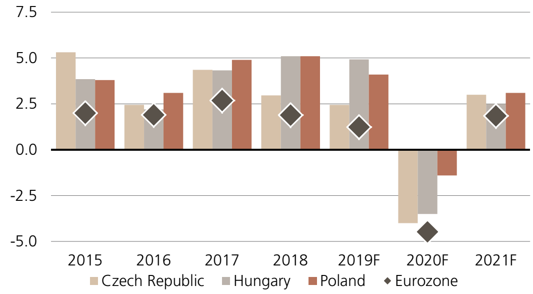
Second, given that foreign investors have the opportunity to finance CEE property investments in their own currency at historically very low interest rates, the leveraged returns on investments look even more appealing in a broad European context. The average volatility of CEE exchange rates versus the euro has fallen significantly over the last decade. Though some more volatility given the current situation looks likely, the integration of CEE economies in the wider European economy should lead to less fluctuation again. Moreover, according to UBS currency forecasts, the Polish zloty and the Czech koruna are expected to appreciate slightly over the next few quarters, , recouping some of the losses suffered over the past weeks.

Finally, the economic and political stability of CEE countries has improved. They are growing faster than countries in Western Europe: economic growth in the CEE region (Poland, Czech Republic and Hungary) averaged almost 4% in real terms in 2019 according to UBS IB estimates. Though a recession in 2020 is highly probable (UBS IB estimates a GDP decline of almost 2.5% on average), the CEE economies will likely grow by roughly 3% in 2021. Hence, economic growth in the CEE region should be higher than in the Eurozone in both 2020 and 2021. After 2020, this should translate into better employment prospects, robust wage increases and higher purchasing power, supporting the take-up demand.

We recommend investors to focus on office and industrial properties. Investments in retail markets have in our opinion a less attractive risk-return profile. In any case, investors should understand the local demand and supply conditions before investing.

Rental growth supported by economic growth

Real GDP year-on-year growth, in %



Source: UBS IB, UBS. F= UBS Forecast

Relative risk-return relationship of direct real estate investments globally

This assessment considers the attractiveness of a market compared to its own historical data

	Overall	Office	Retail	Residential	Logistics/ Industrial
US	■■	■■	■	■■■	■■■
Canada	■	■	■	■■	■■
UK	■■	■■	■	■■	■■
Eurozone ex Germany	■■	■■	■	■■■	■■■
Germany	■■	■■	■	■■■	■■■
Central & Eastern Europe	■■	■■■	■	■■	■■■
Switzerland	■■	■■	■	■■	■■
Japan	■	■■	■	■■	■■
China	■	■	■	■■	■■
Australia	■	■	■	■■	■■
Hong Kong	■	■	■	■	■■
Singapore	■■	■■■	■■	■■	■■
Brazil	■■	■■	■■	■■	■■

■ Unfavorable ■■ Balanced ■■■ Favorable

Source: UBS. *Favorable*: An investor entering the market today would achieve attractive risk-adjusted returns over the investment horizon of 7-10 years. *Balanced*: We advise remaining invested and only adding exposure selectively. *Unfavorable*: Market conditions are currently unattractive. We advise cutting exposure or extending the investment horizon. For further details see the report UBS Global direct real estate: LINK (internal only).

Office markets

Historically low vacancy rates, but slight increases likely

Market insights:

- The office market has attracted the lion's share of investors' money since 2015 (60% of the total volume). According to Colliers, prime yields for office space are 4.25% in Prague, 4.5% in Warsaw and 5% in Budapest. Krakow and Wroclaw, Polish regional centers, follow with prime yields just below 6%. Therefore, the yields are compelling as compared to about 3% in Western Europe.
- Increasing labor and construction costs have supported rental growth in some Polish cities. Prime rents in Warsaw average 24 EUR/m2/month, slightly higher than in Prague. In Polish regional cities rents are considerably lower, at 15 EUR/m2/month. This is the level of A class offices in Budapest, as well.
- Vacancy rates have been falling in CEE markets. In Prague, the share of vacant offices is the lowest among the three capital cities. It fell from 16% in 2015 to below 5% in 2019. In Budapest, 6% of stock is empty, a third of what was available in 2012. The Polish office market has the highest vacancy rates in the region. In Warsaw, 8.2% of the stock is vacant, the lowest number since 2012 according to Colliers. In regional cities, 9% of the existing spaces are empty on average.
- The demand for newly constructed surfaces should remain robust after 2020, in our view, given the positive economic growth expectations. In particular, employment growth in the business services sector is strong. Central European markets are still trailing their Western counterparts with respect to the stock of modern office spaces. New take-up demand is expected to absorb the biggest portion of new area. A continued relocation from older to modern high-quality offices is expected.
- Consequently, rental growth will likely remain positive, in our opinion. This should support further investor demand and yield compression.

Risks:

- New surfaces under construction are considerable though, according to Colliers. Until 2021, new supply is expected equivalent to 10% of the current stock in Prague, 15% in Budapest and 20% in Warsaw. In most Polish regional markets supply growth may be even more considerable.
- While a high portion of spaces under construction is pre-let, new take-up demand has likely peaked in 2018 already. Hence, we believe vacancy rates have reached a trough and may slightly increase. Hence, an ongoing economic growth after the recession in 2020 is prerequisite.

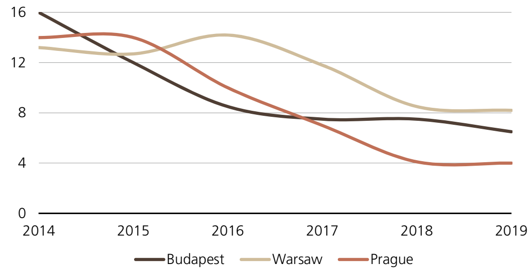
Investment view:

- The office markets in the CEE region still offer attractive investment opportunities, in our view. Relatively high income stream and further yield compression in market average will likely benefit potential property owners.
- Unless a long-term economic recession hits the region, which is not our base case, the risks of falling rents and capital losses are manageable. However, expected new supply entering local markets needs to be considered.

Overall assessment: attractive

Vacancy rates have decreased

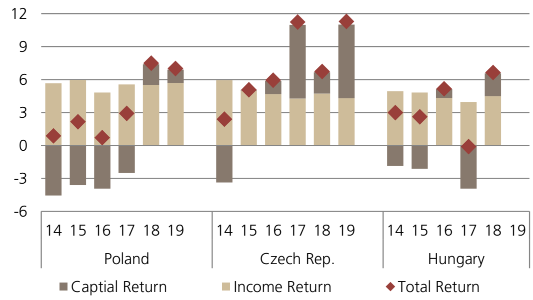
Office vacancy rates as of year end*, in %



Source: Colliers, JLL, Knight Frank, DB, UBS. *2019 - the last available data

Capital values started to increase

MSCI IPD returns, in %



Source: MSCI IPD, UBS

Industrial markets

Beneficial infrastructure investments

Market insights:

- The industrial prime yields have converged strongly in the region, but remain higher than in Western Europe (e.g. below 4% in Germany, according to JLL in 2019). Investors can earn about 5.5% in Prague, 6.5% in Warsaw and 7% in Budapest according to Colliers.
- Moreover, CEE warehousing and logistics should benefit from ongoing massive infrastructure investments in the next few years. Better motorway and railroad network, partially financed by EU cohesion funds, increase the potential take-up demand and support further yield compression.
- The demand for logistics and warehousing spaces is further supported by strong economic and e-commerce growth.
- While the Polish logistics market benefits from its central location between Western Europe and Russia, Hungary and Czech Republic have a stronger focus on their internal markets. Hence, the Polish logistics properties show higher levels of liquidity.
- Despite recent increases, operating costs in CEE, like rents or salaries, are still lower than in Western Europe. For example in Warsaw, the most expensive CEE city, prime rents are close to EUR 5/m2/month, about 25% below the level in Munich, Hamburg or Stuttgart.

Risks:

- Due to the increasing supply of modern surfaces, vacancy rates have risen. In Poland, more than 6% of current modern stock are empty; in Czech Republic the rate is just below 5%, according to Colliers. In Hungarian capital region, vacancy rates headed downwards in 2019, to around 2%.
- Vacancy rates are likely to continue to rise as new surfaces under construction are considerable. According to Colliers, the modern industrial stock may be extended by 10% in Poland and Hungary over the next few quarters, and by more than 5% in the Czech Republic.
- While the risk of rising vacancies should not be ignored, we expect the new supply to be well absorbed after the economic recovery sets in in the second half of 2020.

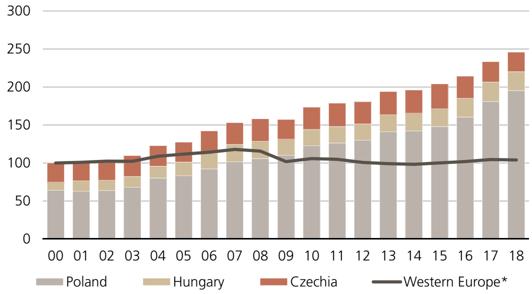
Investment view:

- Investments in industrial properties, with special focus on logistics, offer attractive investment opportunities in our view.
- We recommend investors to focus on locations targeted by infrastructure investments that potentially benefit further capital gains.

Overall assessment: attractive

Growing demand for goods

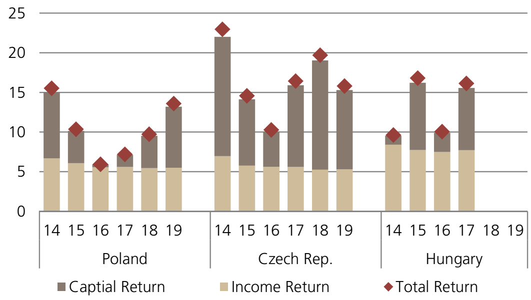
Goods transport, tonnes-kilometers, index 2000 = 100. Index for CEE is split by country.



Source: OECD, UBS. *Sum of FR, DE, IT, NL, ES, UK.

Industrial real estate with highest returns

MSCI IPD returns, in %



Source: MSCI IPD, UBS

Retail markets

Prudence warranted

Market insights:

- According to Colliers, shopping center prime yields are 4% in Warsaw, 4.75% in Prague and 5.5% in Budapest, somewhat lower than in previous years. Prime yields have hence reached similar levels to Western Europe. E.g. in Germany, shopping center prime yields are close to 4.5% according to JLL.
- Household expenditures, purchasing power and retail sales in Poland, Hungary and the Czech Republic have increased faster than in Western Europe. This has supported the demand for retail surfaces and led to a strong increase of new supply.
- Prime rents in shopping centers are the highest in Prague and amount to 150 EUR/m2/month according to CBRE. In Warsaw and Budapest the level is slightly lower at roughly 120 EUR/m2/month according to JLL. In other Polish regional markets, the level is significantly below those values, at roughly 50 EUR/m2/month.
- Developers of shopping centers concentrate on multi-functional projects incl. entertainment and catering amenities as well. Traditional space concepts are less attractive and may underperform.
- Poland restricted the opening times of shopping centers last year. They have to stay closed on most Sundays during the year. This one-off event was already priced in by the appraisers: the capital return in Poland was strongly negative in 2019.

Risks:

- Retail markets, especially in the biggest cities, have reached a high level of saturation. Therefore, new supply has been trending down.
- Following the experience of developed countries, take-up demand may slow due to further growth of online shopping. Although the level of e-commerce market penetration is lower than in Western Europe, the turnover has been growing faster than, for example, in Germany or France.

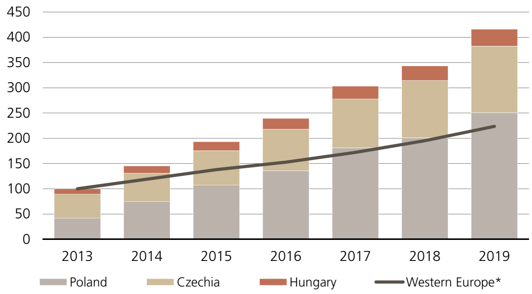
Investment view:

- We recommend investors to remain cautious towards investments in secondary locations. Selectivity is key. At the local level some properties may still be an attractive addition to diversified portfolios.
- We do not expect further yield compression. Hence, investors should focus on stable income flows at the property level.

Overall assessment: unfavorable

Rapid e-commerce growth puts pressure on retail space

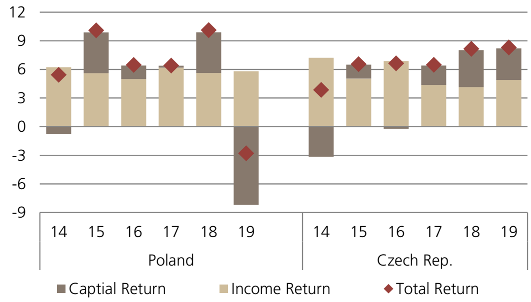
B2C ecommerce turnover, index 2013 = 100. Index for CEE is split by country.



Source: Ecommerce Europe, UBS. *Sum of FR, DE, UK, IT, NL, ES.

Challenging market despite decent returns

MSCI IPD returns, in %



Source: MSCI IPD, UBS

Residential markets

New opportunities arise

Market insights:

- The rental residential market is less developed than in Western Europe, as more than three quarters of the CEE population live in owner-occupied homes.
- Supply of new homes reached historically high levels in 2019, but it is lagging the demand growth. Undersupply of modern housing stimulates the price growth. Real wage growth, a more attractive mortgage financing environment and increasing construction costs (land, labor and material costs) all support higher prices.
- In Poland (average of 7 biggest cities), real housing prices are 25% higher than in 2014. In Czech Republic, the growth amounted to 30% and in Hungary almost to 90%. Currently, housing in Prague is the most expensive: a square meter cost there more than EUR 3,000/m2. Warsaw follows with prices close to EUR 2,500/m2. In Budapest as well as in Gdansk and Krakow, a square meter costs around EUR 2,000.
- The growth in employment and the attractiveness of CEE job markets for office locations have revealed a structural shortage of modern residential rental units in urban centers.
- In Warsaw as well as in other Polish cities, rental returns on the primary market are estimated at between 5% and 6%. In the Czech Republic however, such investments yield less than 4% according to the Czech National Bank.

Risks:

- Price growth has outpaced wage growth, and the affordability of modern urban housing has decreased. Due to the current lockdown, we expect the residential market to slow down this year. Afterwards, we expect a positive price growth again but at a slower pace than until now. The growth will likely shift to cheaper suburban locations.
- In the long term, the demand on the residential market may suffer due to low population growth. Over the last decade, the total population in Poland, Czech Republic and Hungary has stagnated. According to World Bank forecasts, the population is expected to shrink, with Poland and Hungary affected the most.
- There are differences in landlord-tenant laws between Poland, Czech Republic and Hungary. Investors are advised to contact local market specialists.

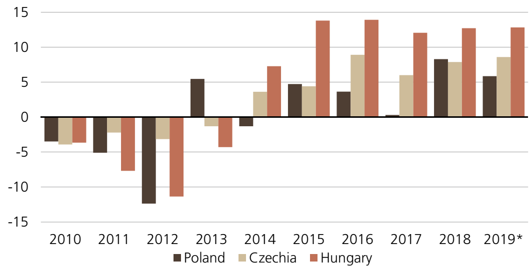
Investment view:

- Given the high number of completions and rising land prices, investors should focus on value-add properties, incl. redevelopments or restructurings.
- Investors should focus on locations, where international companies are actively investing.

Overall assessment: balanced

Residential property prices are on the rise

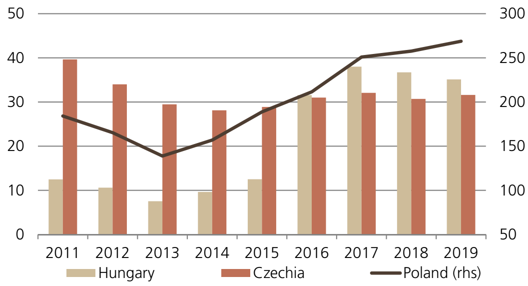
Real year-on-year growth rates, in %



Source: National banks, Bloomberg, UBS. *CZ: 3rd quarter, HU: 2nd quarter.

Construction boom in Poland and Hungary shows sings of slowdown

Construction permits issued for residential dwellings, in thousand



Source: Statistics Poland, HCSO, CZSO, UBS.

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