THE ASCENT TO THE PEAK

Growth escalator driving activity

The escalation in economic growth momentum through 2017 has taken the CEE-6 real estate leasing and investment markets closer to a cyclical peak. Sentiment indicators are still pointing towards a further expansion in CEE-6 investment volumes in 2018, over and above 2017's cycle high of EUR 12.9bn. Solid GDP growth in Europe (2.5% yoy in 2017) is a support for CEE exports. Increased general investment in the CEE-6 from local sources and the EU, as well as consumption should see the region approach peak economic growth. The cycle may top out in 2019.

Signs that the peak is somewhere near

After several years, rent growth is picking up in the office sector more readily across the region, something we interpret as an indication of buoyant economic activity. In addition, construction sentiment data series across CEE-6 are suggesting that a development "boom" may be imminent. The last boom, in 2007-08, ended spectacularly badly, amid the chill winds of the Global Financial Crisis. A third indication of "peak" conditions is that hotel investment volumes in CEE-6 more than doubled in 2017 to EUR 988mn: A spike in activity in hotels is often a sign of exuberance. Watch this space.

Key risks: altitude sickness?

Most of the risks that we foresee for 2018 were evident in 2017 and progressed somewhat. Specifically, rising inflation as a result of strong growth conditions and labour shortages, is a salient feature of the CEE-6 macro in 2018 and implies higher interest rates, which we are seeing already in Romania and the Czech Republic. This and any surprise change of policy from the ECB, dealing with strong growth in Europe may mean higher funding rates and a risk consideration for transaction yields. Other risks remain extant, including e-commerce for retail, taxation and populist politics and an over-extension of the development boom, the latter perhaps more for 2019. China debt instability, uncertainty over US trade policy and perhaps a reversal of Japan's zero-bond yield regime might surprise risk asset markets trading at buoyant valuation levels.

Growth drivers

Sentiment leads to flows, rents up

Economic sentiment in CEE looks well-set to firm further in 2018, most likely propelling the region's GDP growth higher. We set out the positive and leading relationship between the most-followed European leading indicators and the path of CEE economic sentiment and GDP growth in our 2017 Outlook. And the German IFO Index has indeed continued to lead the composite CEE-6 EU ESI overall economic sentiment upwards. Europe itself is booming, the Eurozone registering a healthy 2.5% year-on-year expansion in Q3 2017.

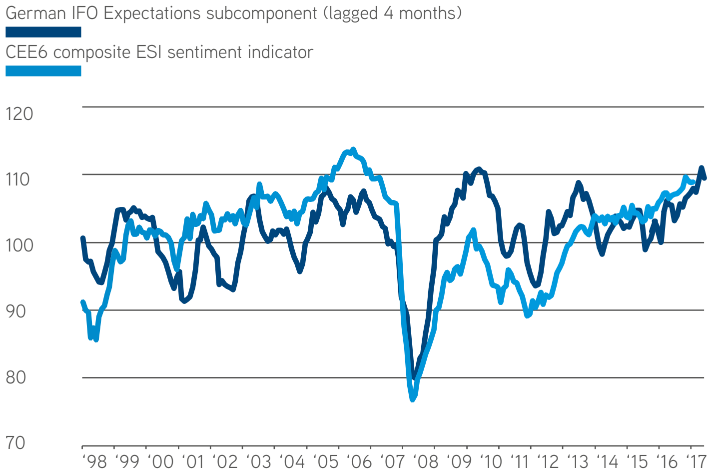
CEE-6 GDP growth rates are escalating, as a result of exporting to Europe (and elsewhere), investment and consumption, Romania's stunning 8.8% yoy Q3 2017 real GDP growth data point stands out but the rest of the region expanded in that quarter at a real rate of between 3.4%-5.0% yoy. Though interest rates are (in Czech Rep. and Romania) rising and will continue to do so, growth momentum should sustain into 2018.

A particular dynamic we highlighted last year but which is intensifying is CEE-6 wage growth, where the gap between pay hikes and CPI is helping to drive consumption. Analysis we conducted using Eurostat unit labour cost and gross value added ("GVA") in CEE since 2000 suggests that a 10% annual wage hike sustained over a 4-year period adds c.2% GVA growth per annum to an economy and causes a 0.7 percentage point of GVA shift per annum towards service sector activity. This in effect demonstrates how the real estate sector grows in importance in these economies over time.

As the sector grows, thus the investment volumes rise. As we pointed out last year, the CEE-6's blended EU ESI consumer sentiment indicator was signalling for a gentle rise in investment volumes compared to the previous year. 2017 duly delivered with EUR 12.9bn of flows, 6% higher than 2016's EUR 12.2bn and kissing 2007's all-time record of EUR 13.0bn. The path of the sentiment is indicating another 18 months of positive flow growth.

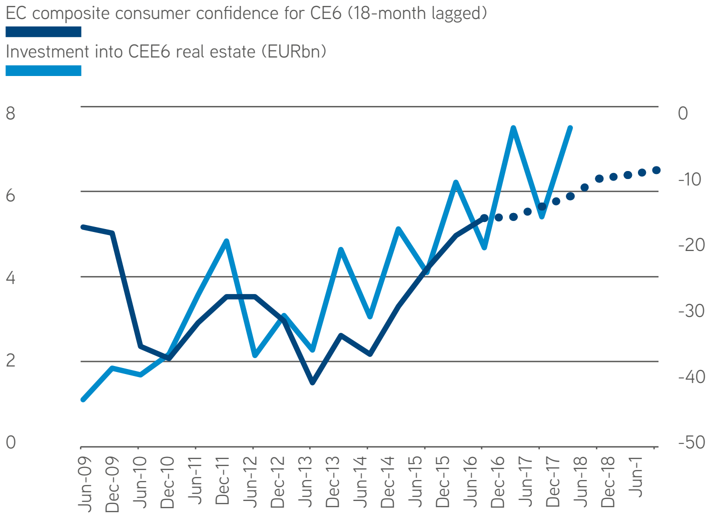
Why should buyers buy? The story really is one of rental growth in most of the capital city markets. We remarked upon the rent growth momentum in rents in TSC retail 12 months ago. This has continued, especially in the most liquid markets, Warsaw and Prague. Occupancy of key shopping centres is at saturation level. What is perhaps more of note is a cyclical pick-up in office rents, noticeable particularly towards the end of 2017, meaning that this larger, broader representation of the economy is finally showing signs of boom times. This is most apparent in Budapest, Sofia, Bucharest and Prague.

Fig. 1: German IFO leading CEE-6 EU ESI economic sentiment (4-month lead)



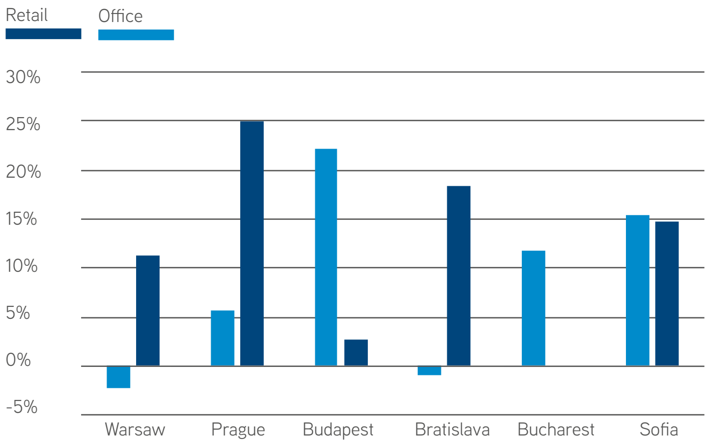
Source: IFO Institute, Munich, Eurostat, Colliers International

Fig. 2: CEE-6 investment flows and EU ESI consumer sentiment (18-month lagged, rhs scale)



Source: Eurostat, Colliers International

Fig. 3: 2-year office and retail rental growth in CEE-6 prime capital city markets



Source: Colliers International

Rents and boom

Office rents ascending

We looked in more detail at the relationship between GDP growth and office rent levels across the region and found several leading relationships, where the path of GDP growth has historically led the absolute headline rental values over time. We show the 30-month lead of Czech GDP growth over Prague prime office rates. The chart suggests that Prague prime rents look set to rise over the next 30 months, unless supply intervenes in a big way. GDP growth strengthening points towards falling Czech vacancy rates in 12 months' time by 12 months, on our reckoning. A similar lead time exists in Hungary and Slovakia. The inverse GDP growth-vacancy rate relationships seem to hold reasonably well across the region, whilst the GDP momentum signals for Polish and Romanian rent levels are perhaps less strong.

Tab.1: Observed leading relationship between GDP growth signal and vacancy rates and absolute prime capital city rent levels

GDP GROWTH LEAD TIME [MONTHS]	ON VACANCY RATES	ON RENTS	VACANCY RATE [Q4 2017]
Poland	12	15	11.70%
Czechia	12	30	7.47%
Hungary	12	30	7.50%
Slovakia	9	30	6.18%
Romania	9	12	9.70%
Bulgaria	6	9	9.20%

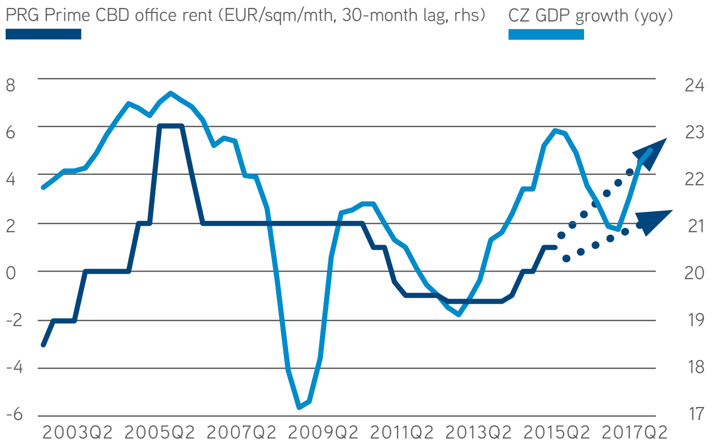
Source: Colliers International

Our analysis suggests that given the strong GDP growth momentum already noted and the prospect of it continuing into 2018 that we should expect firming rents in CEE office sectors.

Development boom coming?

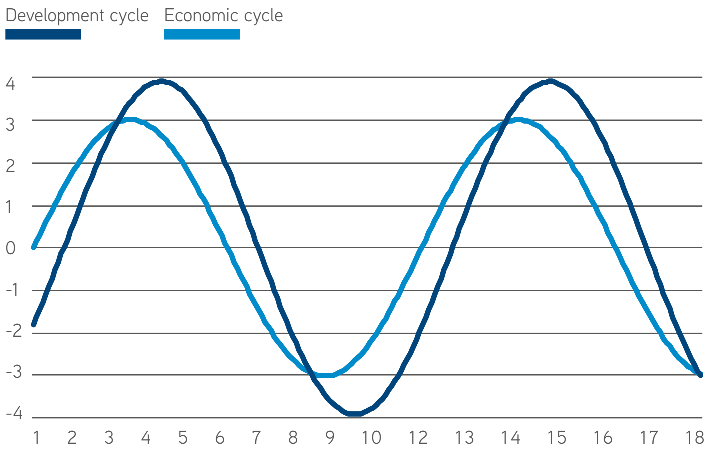
One possible reaction to vacancy rates falling is the encouragement of development. Elasticity of supply is different across the region but the conditions are in place for a development boom unfold over the next 2 years in the CEE-6. A schematic sketch of the cycle suggests excessive pessimism at the bottom of a cycle as developers shut up shop and exuberance towards the top, as developers scramble to deliver product. Symptoms of the latter include that construction costs rise rapidly, which is certainly the case in Warsaw and Budapest presently. A comparison of the blended EU ESI construction sentiment sub-index (monthly data) to the EU ESI overall economic sentiment bears the pattern out. Office space under active construction at the end of 2017 grew in 5 of the 6 CEE-6 capital cities (the exception was Prague, shrinking -7%), with the fastest growth in Sofia (24%). Industrial space under construction grew over 120% in both Bratislava and Sofia last year. All of our experts in the region foresee a boom in the office development but only in Bratislava and Budapest do we predict a boom in retail. Only Sofia and Budapest might miss out on an industrial boom and the latter only if rents do not firm.

Fig.4: Czech GDP growth yoy and Prague prime office rent (EUR/sqm/mth, 30-month lag, rhs)



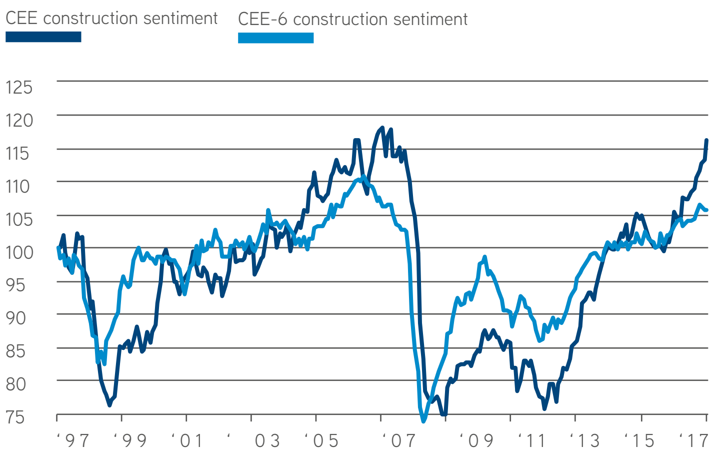
Source: investing.com, Colliers International

Fig.5: Schematic real estate and real estate development cycle



Source: Colliers International

Fig.6: CEE-6 EU ESI construction sector sentiment and CEE-6 EU ESI overall economic sentiment (rebased)



Source,: Eurostat, Colliers International

Altitude sickness?

Key risks in 2018

The key risks extant in 2018 for the CEE-6 investment arena all developed somewhat in 2017 but none proved sufficient to slow the ascent of markets. Wage rises forcing inflation rates up did unfold last year: rampant wage inflation was particularly evident in Hungary (+13%) and Romania (+15%) last year. We foresee at least 8% wage growth nationally in every country across the region except for Slovakia in 2018. We argue again that CPI rates will rise.

The factor aside from economic growth that is driving these wage rises is labour shortages. Labour shortages are causing manufacturing companies to rein back on growth plans. A very worrying 79% of Hungarian companies in the key quarterly survey think so. Such acute labour shortages require more radical demographic and productivity-related solutions than is acknowledged by CEE governments, as well as wage rises.

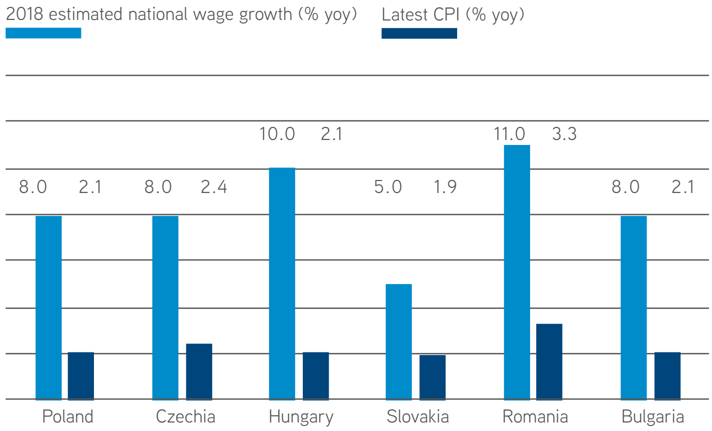
All this pricing pressure is bound to push interest rates up. The Czech National Bank kicked off the process in the whole of Europe in August 2017 and raised again in November. Romania followed in January. There is no sign of a "tectonic shift" in the other countries. Interest rate rises, including any surprise from the ECB, will gradually slow economic activity, affecting the leasing markets. For investment activity, we believe funding rates are likely to rise. This probably means that commercial real estate yields are not likely to fall in prime Prague. And investors may think harder about transaction yields in Bucharest. A pricing correction is not expected because the "funding cushion" or yield gap remains relatively wide, in line with historical averages even in these locations. This gap is narrowest in the most liquid market, Warsaw, presently.

We foresee uncertainty over the low degree of taxation of capital/assets relative to taxation of labour common to many countries around the world with popular "populist" political movements. The initial VAT-related tax issues in Poland appear more settled presently. A general election is due in Hungary in 2018 but we expect no change in the ruling Fidesz party.

The e-commerce threat to TSC retail in CEE grows slowly and is certainly stymying the "bricks & mortar" development pipeline. Online shopping penetration data varies but one source, APEK in Prague, suggests that the Czech rate of 9.5% of total retail sales is the 5th-highest in Europe. The lowest in CEE (and the EU) according APEK is Bulgaria, at 1.3%.

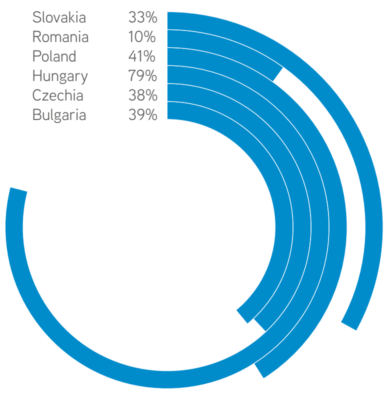
Extant global risks that can disrupt richly-valued risk asset markets remain the over-extension of credit in China, causing strains in its vast financial sector, perhaps a reversal of the zero-bond yield policy in Japan and an enactment of President Trump's campaign promises on increased protection for American workers affecting global trade volumes. It is noticeable that US and German bond yields have risen in recent weeks: bond investors are pricing more risk/inflation in.

Fig. 7: Colliers wage growth estimates for 2018 and latest CPI levels (yoy, %)



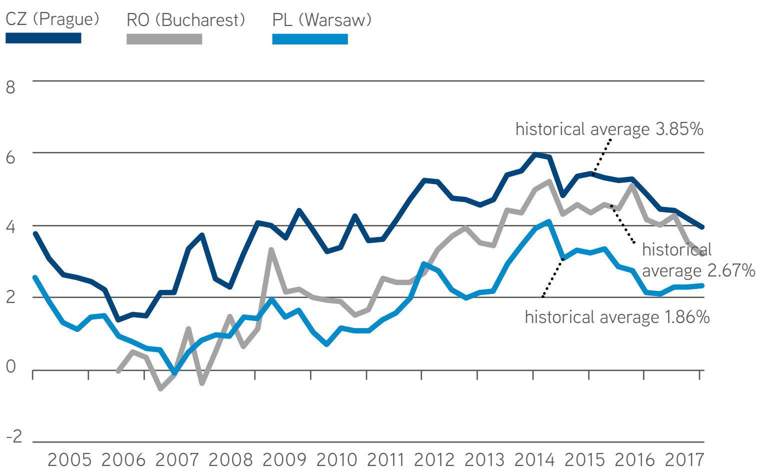
Source: investing.com, Colliers International

Fig. 8: % of manufacturing companies in CEE-6 reporting labour shortages that are preventing capacity increases from occurring (Dec. 2017)



Source: Eurostat, Colliers International

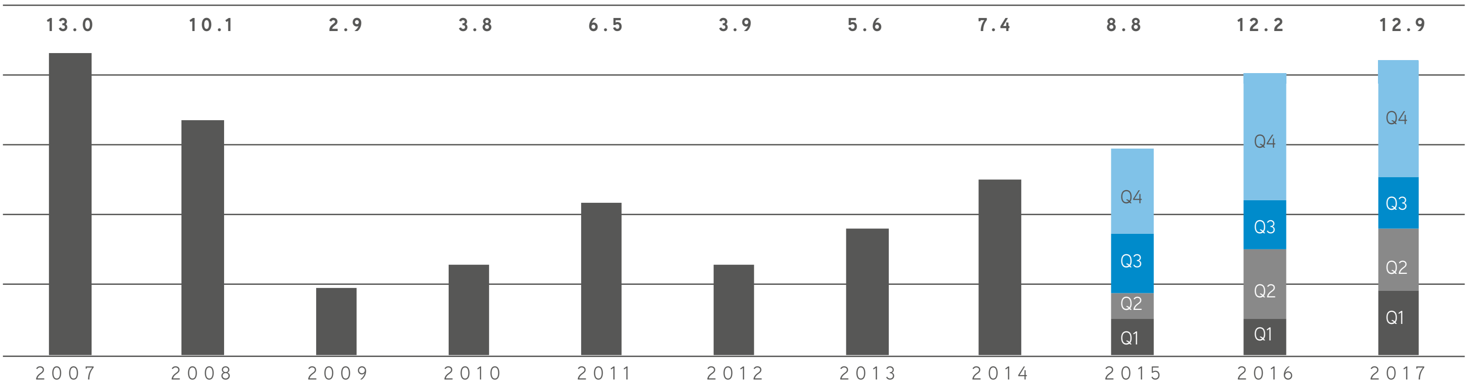
Fig.9: The "funding cushion" in Prague, Bucharest and Warsaw. Blended prime capital city real estate yields minus local sovereign bond yield (%)



Source,: investing.com, Colliers International

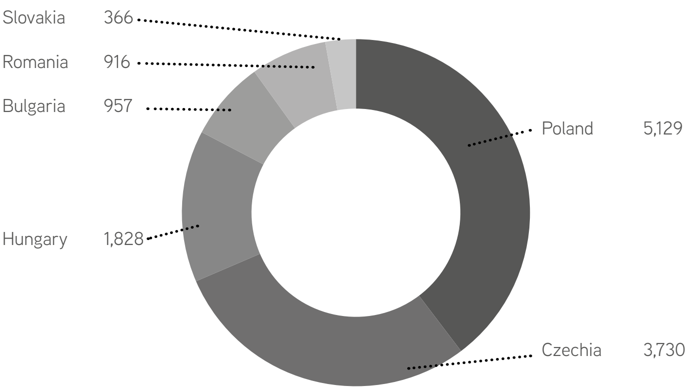
Key data

Fig. 10: CEE-6 fund flows between 2007 and 2017



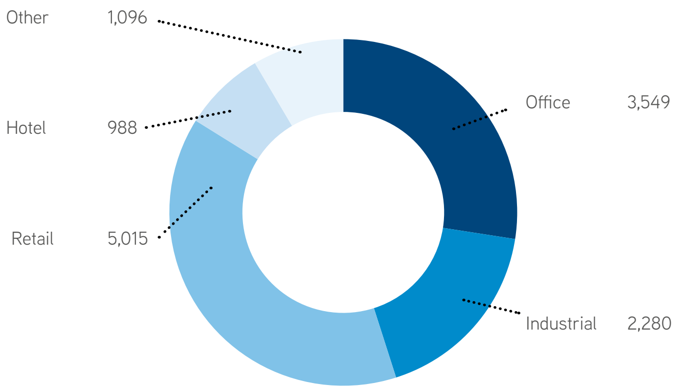
Figures for 2017 are provisional.
Source: Colliers International

Fig.11: CEE-6 2017 fund flows split by country



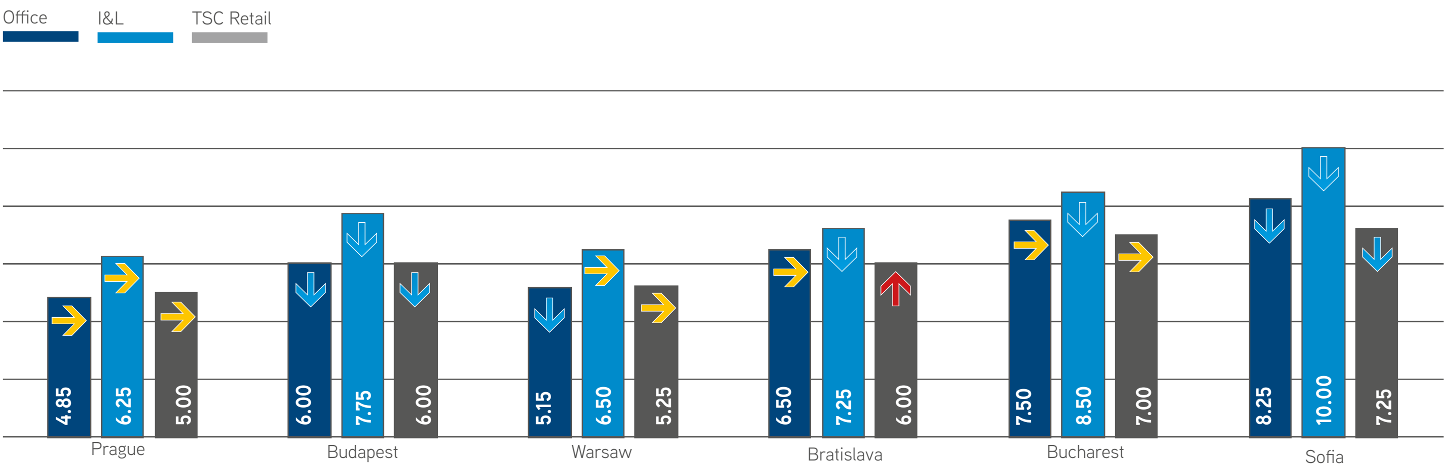
Source: Colliers International

Fig.12: CEE-6 2017 fund flows split by sector



Source: Colliers International

Fig.13 Prime yields in CEE-6 capital city markets in Q4 2017 [direction of yield movement in 2017 indicated]



Source: Colliers International

€2.3
billion in
annual revenue

170
million square meter
under management

15,000
professionals
and staff

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