Top 10 predictions for **CEE-6** in 2023

January 2023

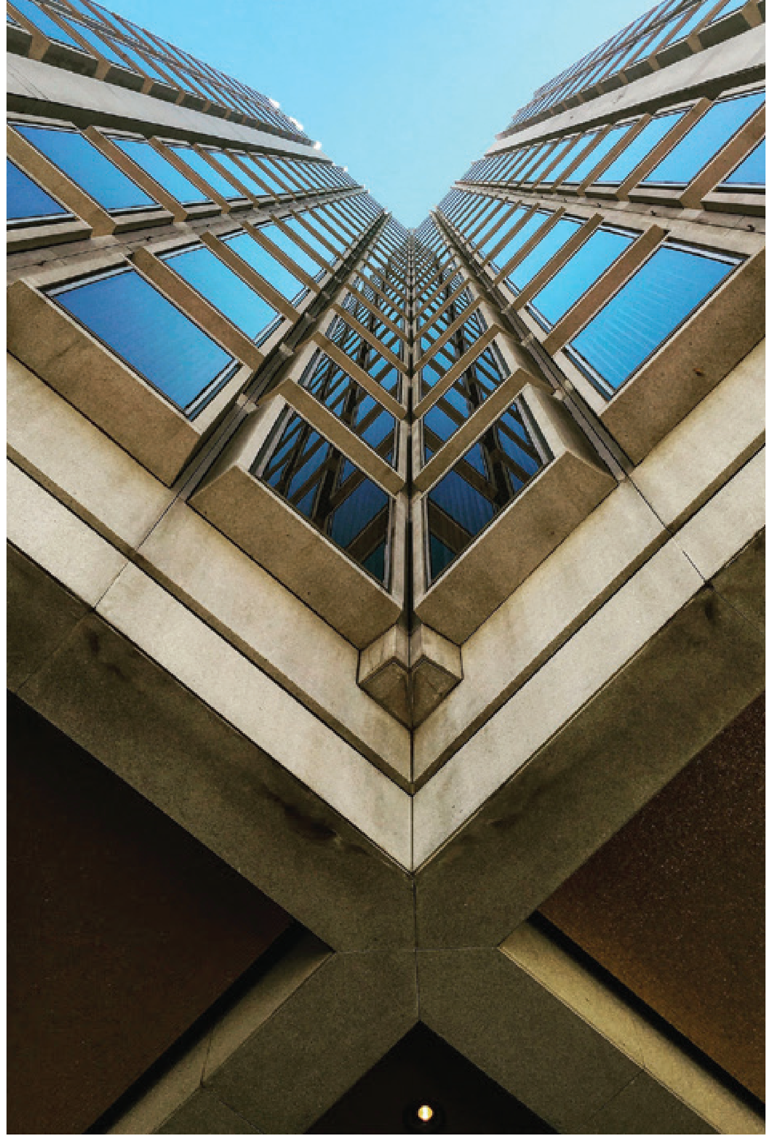
It is evident coming into 2023, that uncertainty remains high. Having reasonably accurate expectations regarding the future remains a challenge, so adaptability remains a valuable trait for any real estate market player in the coming period. Nevertheless, we have certain convictions about the Central and Eastern European region and the six major economies of Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia.

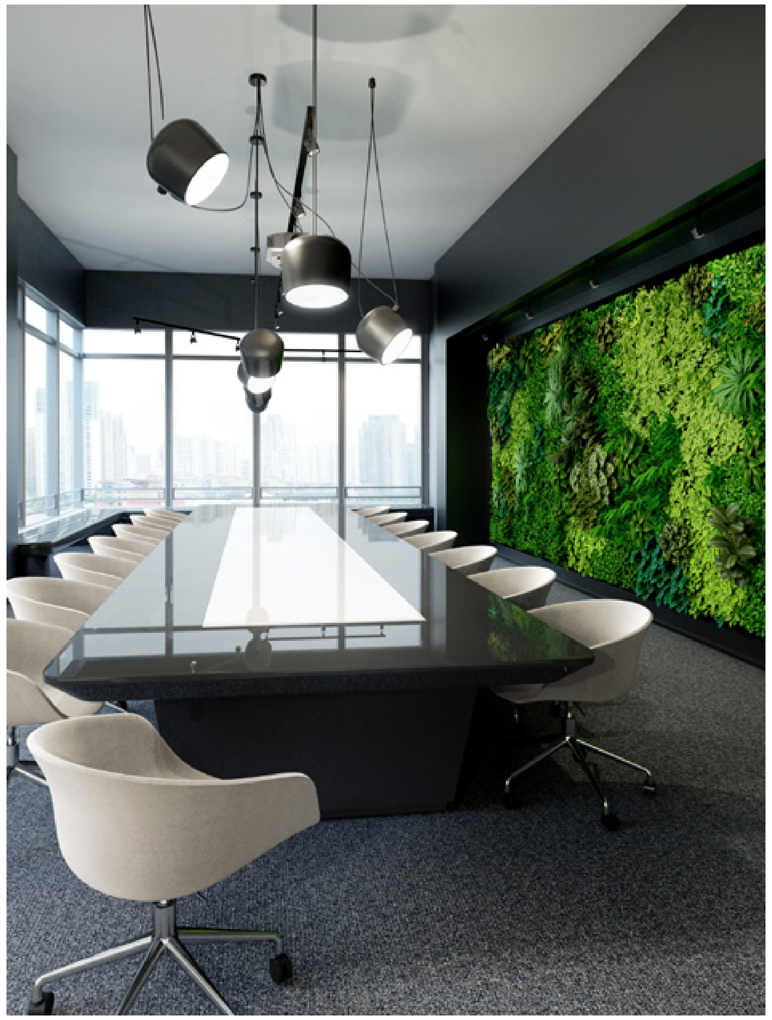
GDP growth in the region is set to halve in 2023, as per the latest figures from the IMF's World Economic Outlook but, is expected to quicken in 2024. Nevertheless, the important thing is that the CEE economies remain some of the most dynamic in this part of the world, attesting to the fact that investments, job creation and wage growth are still taking place. This means that demand for renting and buying real estate should remain decent over the longer term, despite 2023 most likely being a bit more challenging than a normal year. This is because the European Central Bank is set to tighten the screws even more, pushing the cost of risk even higher; so we cannot yet begin to understand the full effects of persistently high interest rates (as it is quite likely they will not move lower soon) and this period of acclimatization with the new reality may push previously established business models to the curb. Consequently, we hope that this report will shed some light about what might happen in the following period and in doing so, improve the adaptability of its readers by being better prepared.

A slowdown, not a recession, is in sight, with economic convergence still ongoing

While operating at different expansion rates and cooling down compared to the previous year, growth in all CEE-6 countries is forecasted to remain in positive territory in 2023. The expansion for the region is forecasted to slow down to 1.5% by the IMF, less than half the pace seen in 2022 (3.7% estimate). This is the worst pace in almost a decade if we overlook the 2020 pandemic year. Specific challenges exist in each country, from the political backdrop to geopolitical issues to specific macroeconomic issues, but the growth recipe is still in place and thankfully, longer term forecasts still show the CEE-6 growing twice as fast as the Eurozone.

Meanwhile, inflation is set to remain a major issue; while decreasing on average in most cases (with the exception of Poland), all countries will remain well above what should be regarded as normal levels. This means monetary policy will remain tight (or continue to tighten) through 2023 at least.





Geopolitics to remain center stage

We cannot pretend to understand, let alone forecast, all the major shifts taking place on the global geopolitical scene, but it is clear that big changes are underway. What we can see is the CEE region becoming much more relevant globally, so much so that the reputed commentator George Friedman said that amid the war in Ukraine, Europe's center of gravity is moving North-East. This translates to much more importance for Poland and the Baltic states and we assume that some of this new relevance will also spill over to more central and southern parts of the CEE region as well.

A more centre-stage focus on the region by the West entails strengthening the democracies and economic prowess in the CEE, as Western capital will flow more abundantly into countries which offer a stable backdrop for investing at much lower costs than those in developed economies. "Friend-shoring" was more of a buzz word in 2022, it will become more of a reality starting in 2023.

Green/efficient buildings in focus

Before the pandemic period, adopting ESG criteria was a somewhat slow process, although it was at least moving forward. The 2020 European Green Deal accelerated the process, while the sharp increase in energy prices we saw in 2022 put things into overdrive. This is because staying in a green and energy efficient building as a tenant has become much more than a simple checkmark that companies and investors include in their reports to shareholders, it can yield actual (and quite significant) financial benefits.

Consequently, we expect to see a greater differentiation for the rent/value of a building based on how green/efficient it is, for all countries in the CEE-6 group. This should apply to all real estate sectors but particularly offices and industrial.

The inflation consequences

The high inflation and sharp increase in construction costs we saw in the last couple of years will haunt the real estate markets in the CEE region for many years to come. Indexing rents to inflation will mean a sharp increase in current rents (though many tenants may seek to negotiate with landlords and may score some discounts). The higher construction costs will mean that we will have fewer deliveries than we may have normally seen, despite the fact that in a few instances (like the Prague and Bratislava office markets), deliveries may still remain solid in 2023, though maybe these exceptions will be rare and short-lived.

Higher funding costs (another consequence of inflation) will also dent the appeal of new projects relying on bank loans. Overall, fewer deliveries of commercial real estate projects will mean increased pressures on rents over the medium term, provided that real estate markets continue to see robust demand. Nevertheless, in spite of this supply gap that is shaping in certain submarkets, we do not want to be too optimistic, particularly as we have yet to feel the full force of monetary policy tightening in developed economies (and its influence on the CEE region).

Office demand recovering, but it is still not there yet

We see office leasing demand as having recovered, but it is still not fully on par with pre-pandemic levels. But there are some interesting dynamics that will extend from 2022 into 2023: firstly, we noted the growing share of renegotiations rather than relocations. Tenants in good offices are encouraged by various factors, from rising fit-out costs to higher tents, to extend their leases in their current location rather than relocate.

At the same time, some tenants in older buildings, which hadn't aged quite well, are still seeking to relocate to more efficient buildings in spite of the higher rents, as other financial burdens that come with lower building quality/efficiency start to add up in their bills. Furthermore, given the rise in remote work, it means that the time spent in the office is that much more valuable for the employees. Either way, this gap between good/prime buildings and the older ones is a common theme in the CEE-6 region, with implications for other sectors as well, irrespective of whether we're talking about commercial or residential real estate, or about renting or buying property.

How people work is still changing

The way we work has changed dramatically and has yet to settle in its final form. Hybrid work is here to stay, but that needn't have a devastating effect on office occupancy; as we have seen in recent years, companies will still keep most of their offices, irrespective of how many days per week employees work from home, as they will want to keep the office option open. But what they will do is change the way the office is layered and structured, as it will not be purely focused on work/open spaces, but also spaces to foster creativity, team spirit and so on.

Also, as employees will be spending less time in the office, companies might as well make that time matter more. But this discussion about how employees will work will go much deeper. Already there are first examples in the region, where some companies (like Telekom Hungary) have introduced a 4-day workweek. In Romania, legislation has been drafted in the Parliament (yet to be adopted) that would allow for four 10-hour workdays per week.

Industrial, still in high gear

Industrial developments and leasing demand show no signs of a material slowdown and, in some cases, are set to remain on par with previous years, which have been record-setting for some countries. On a per capita basis, the modern I&L stock in the CEE-6 countries remains well below that of a "normal" Western country, so there is still a lot of room to grow over the medium term.

A country's economic momentum as well as its infrastructure dictate how fast each market will grow. Otherwise, the highly competitive backdrop and a low barrier of entry for a new developer (unlike offices and retail) has meant that rents have been largely kept in check, but this is likely to change, particularly amid higher construction costs and international tenants increasingly focused on green warehouses.

Brick-and-mortar stores and e-commerce, from competition to synergy?

The convenience of e-commerce during the pandemic cannot be overstated, but only up until a certain point. In general, e-sales growth has been slowing down or outright pulled back a bit in 2022 following many years of steady gains. That said, the line between brick-and-mortar stores and e-commerce is blurring, as more and more players have integrated both into their business models, with many trying to optimize the customer experience through the omnichannel approach.

Interestingly enough, with the exception of Hungary which has a smaller share, around one in two people in the CEE-6 (if not more in some countries) will not shop only online because they would rather see the product before they make the purchase. Nevertheless, this (possibly) cultural reluctance to shop online is exactly why a BOPIS model (buy online, pick up in-store) may work quite well in the CEE.

Investment slowing down

Commercial real estate transactions are likely to wind down quite considerably in the following period, with the cost of capital to dictate the direction. A period of price discovery is beginning and investors will not want to be locked in a project at a yield that's suddenly become too low given the current realities. So, it is clear that real estate values will be decreasing, it remains to be seen if, and how much of this can be countered by the rise in rental revenue.

That said, under current circumstances, we would expect yields to continue to move north, at least slightly in some submarkets, as major central banks (particularly the ECB) are not yet done with tightening. Consequently, we believe we will see a significant decrease in investment market turnover and a more opportunistic approach to deal-making in the following period.

Residential sector to go through deep changes

While the CEE-6 markets are all at quite different stages of their residential scenes, the ECB's models show that prices are at least in the fair value region (if not a bit below) for most countries with the exception of Czech Republicw, which is experiencing what looks like a residential sector bubble. This would suggest that unless the economic conditions do not turn particularly nasty over the next few years, prices should not drop too much, even as higher interest rates reduce the number of potential buyers.

Meanwhile, fewer buyers will mean that more people consider renting. The private rental sector was just starting to become interesting for investors and developers in recent years, with Poland clearly ahead of the pack in the CEE-6 region, but other countries are following. Given these newer developments, we would expect things to accelerate on the rental side in 2023.

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