Mixing the Good and the Bad News

Making sense of short-term risks and long-term opportunities for Romania

MID YEAR REPORT 2022 | ROMANIA

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Mixing the Good and the Bad News

Making sense of short-term risks and long-term opportunities for Romania

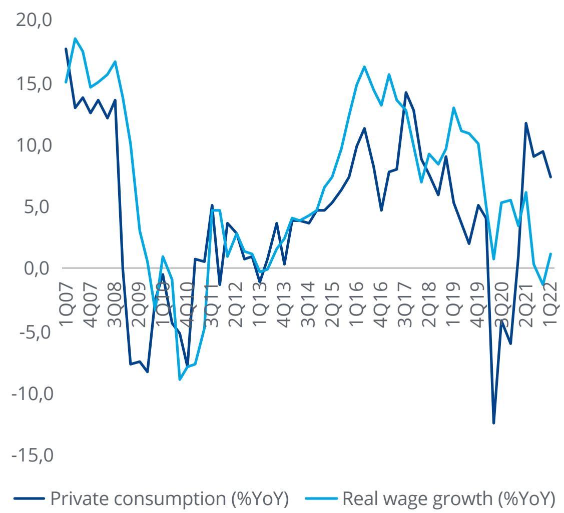
The last few years have seen both positive and negative factors intertwine, but at no other time has the picture been cloudier than at the current juncture. To sum up our house view, we retain a cautiously optimistic approach towards both Romania and the local real estate market, but acknowledge that the risks are higher than they have been in the recent past, while also noting the fact that the threat of a hard landing of the local economy is quite high should a negative scenario come to pass.

To start off with the positives, the consumer story is still more or less intact, in spite of the challenging backdrop; this is also a big reason explaining why we are somewhat confident Romania can weather out the storm in financial markets without entering a recession. Nominal wage growth (+12.5% year-on-year in May 2022) has remained more or less on par with the headline CPI (14.5% in May), albeit slightly negative, meaning that consumption in general has not slowed down dramatically; furthermore, hiring intentions remain robust for large swaths of the economy and are actually comparable to pre-pandemic levels, meaning that in a tight labour market like the current one, upside pressures on wages will remain in place. As a sidenote, back in the 2009-2010 recession, the major factor bringing down consumption was not the decline in wages or purchasing power (on account of the inflation), rather the steep rise in unemployment, with around one in seven jobs lost.

A second positive factor which keeps us hopeful regarding both the short term and the longer term is the huge inflow of EU funds. While absorbing part of these these hinges on following some material reforms and there are concerns that the government might be backtracking on some of these promises or at least might delay them, we work under the assumption that these funds will nevertheless arrive. The post-COVID recovery fund set up by the European Commission has one of the largest allocations in the EU for Romania, as a % of GDP (in excess of 13%); all in all, together with the normal structural funds and agricultural subsidies, the sums allocated for Romania up to 2027 could add up to roughly 40% of the GDP. Or at least 6% per year for this period. Besides the money itself, it is also about what it might enable if properly used, as a huge part of these funds will be heading towards vital infrastructure works, which can unlock significant untapped potential in various parts of the country.

All in all, there is quite a lot of momentum in the local economy and following a very robust GDP reading at the start of 2022 (albeit based on one-off factors, notably inventories), we will likely see a full year print of around 4% even if growth peters out in the second half on account of the inflation chipping away at purchasing power. For next year, however, things look quite a worse, given the strong ties Romania shares with other major developed economies; in a context of a lackluster the EU and in other major economies, we would likely not see more than 3% GDP growth in 2023.

Real wage growth has fed past consumption cycles, but it is quite subdued currently



Source: National Institute of Statistics, Colliers

Weighing on future growth is also the fact that the era of cheap funds is drawing to a close, and it's not just for the EUR and USD, with the Fed and ECB likely to continue hiking. For instance, inflation might be peaking around the middle of 2022 in Romania, at over 15%, but it will take at least until 2025 to return to the central bank's target interval, meaning that interest rates have to rise even higher and remain there for some time, weighing on the appetite consumer loans and mortgages. And this is even without taking into account risks for a new flare-up in inflationary pressures in the following months on account of renewed pressures on energy or food prices, for instance.

On the bad news side, we feel the list has increased in size since our last report back in February, mostly on account of the war in Ukraine and the worse external economic environment. While we do not feel comfortable in speculating about the war and its endgame, we can however note that the global economy is in a worse spot now and that it faces double-edged risks: on the one hand, we have the inflation story, which has still not fully abated – though there are some signs of CPI peaking, with some metal prices dropping sharply over fears regarding a global recession – which is still nevertheless pushing interest rates higher. On the other hand, we have the slowdown story. To a certain extent, higher interest rates and inflation are feeding into a slowdown of the economy, which will in turn help with disinflationary pressures in the end, but it is not yet clear if the global economy will escape a recessionary scenario later in 2022 or in 2023.

The Russian invasion of Ukraine is particularly relevant for Romania, given the geographical proximity to the conflict, but also the ramifications it will have. Looking beyond the horrendous human tragedy and focusing solely on the economic impact, the much lower Russian gas imports are likely to hit the European economy in the next quarters, which, in turn, will impact Romania. But over a longer term, as we stated in previous years, both the Russian situation and the shifts in ties with China will likely lead to a huge inflow of capital in other parts of the world, as diversification of production and logistic facilities will become key; we expect the CEE to become a significant beneficiary of these relocations.

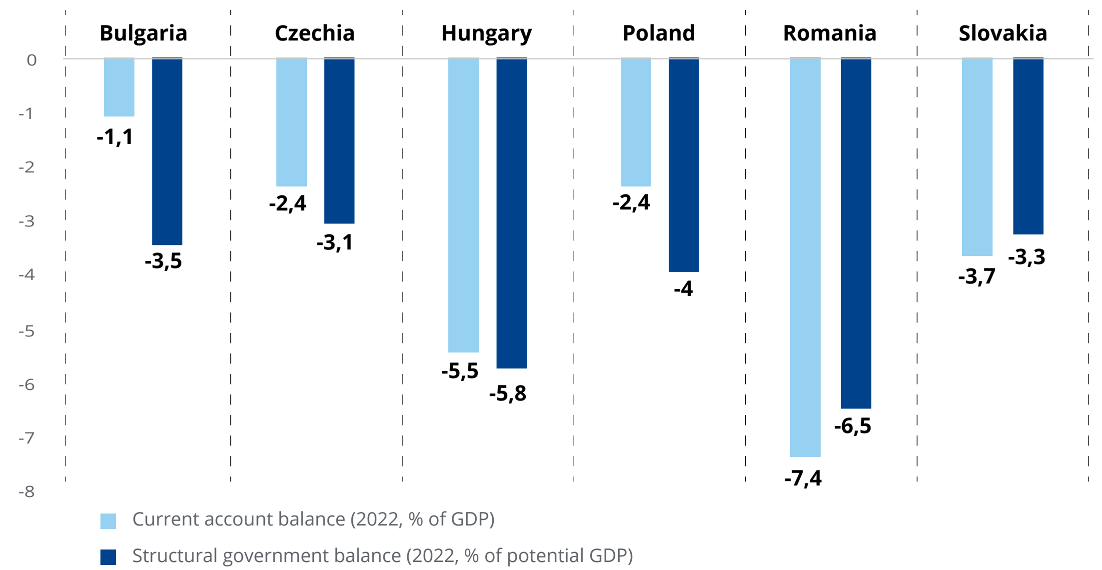
Besides these external factors, Romania also faces some challenges of its own making, which could become particularly bad to deal with if they would overlap with a global recession; such a scenario could lead to an unorderly correction of the economy reminiscent to the "hard landing"-type recession that began late 2008 and lasted through 2010, with high unemployment, business closures and a subsequent slower recovery in the upcoming years. While we attach low chances for such a scenario to take place, we cannot exclude it completely at this point.

Returning to the internal challenges Romania faces, one such topic is related to the gaping "twin-deficits", or the current account balance and the fiscal balance. The structural balance – i.e. the fiscal balance adjusted in the context of the economic cycle – is set to hit -6.5% of GDP this year, the second worse figure in the EU, marginally better than Latvia's, which will correct it faster, meaning that in 2023, Romania will fare the worst in the EU.

Meanwhile, the current account deficit is also set to widen to over 7% and could very well move north than 8% by the end of the year.

All in all, we retain a cautiously optimistic view regarding the Romanian economy, but also acknowledge that we need to be mindful of risks that could change the situation quite rapidly. Still, even in case of a negative scenario unfolding, one of our favourite stories we fall back to is the fact that in spite of the sharp correction Romania saw during 2008-2010, over the last two decades, between 2000 and 2020, Romania was still one of the top 10 best performing economies in the world. And given the capital inflows we expect and the shifts created by the changes in the geopolitical context, we cannot help but remain very optimistic over the longer run.

Romania is facing the global challenges with the worst internal imbalances among CEE-6 economies



Source: European Commission, Colliers

Bucharest Office Market

Supply

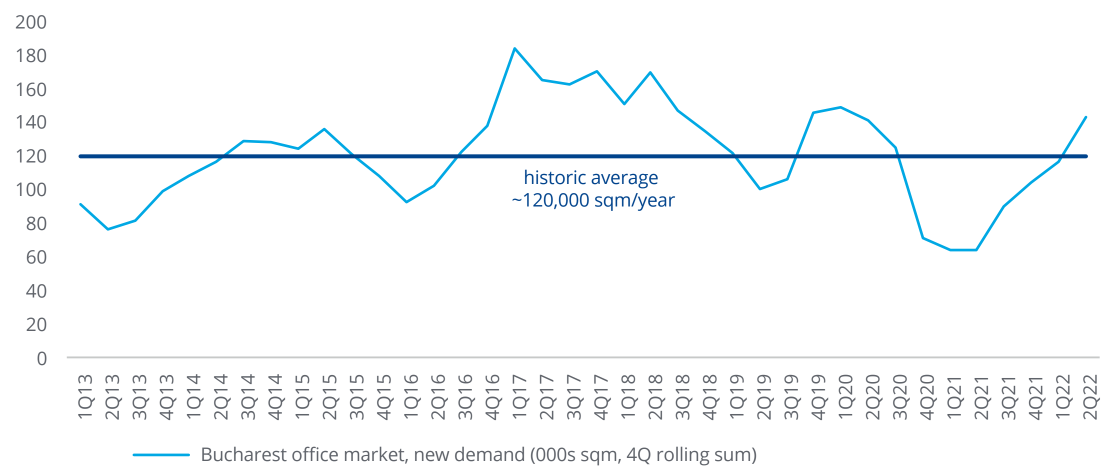
While we have had no deliveries in Q2 2022, a bit over 70,000 sqm of modern office buildings were delivered in Q1 2022 to the Bucharest scene, taking the overall stock closer to 3.3 million sqm of leasable modern office buildings. The additions were River Developments' Oslo and London buildings part of the Sema Parc project (31,500 sqm), Forte Partners' Tandem (21,000 sqm) and the first building in Atenor's @Expo project (21,000 sqm). A similar figure of new stock is expected for the second half of the year.

Demand

Demand for modern office spaces continued to recover in the first half of the year and actually gathered pace. In fact, the second quarter of 2022 was the best one we saw after Q4 2019. And while it does not hold a candle to the best quarters in the pre-pandemic peak years (2017-2018), it would have qualified to be a decent reading even back then. Otherwise, given the ups and downs related to the pandemic period, the c.73,500 sqm of new demand we saw in the first half of 2022 (up by 94% compared to last year) would be better visualized if we annualized the figures, i.e. if we expressed each quarter as a rolling sum of the previous 4 quarters. The over 140,000 sqm of new demand seen between Q3 2021 and Q2 2022 is comfortably above the historic average and more or less on par with the full result for 2019. Gross take-up for the first half of the year stood at over 130,000 sqm, which is also up over last year's first semester, though by a less impressive 16%.

In fact, this divergence between total demand and new demand, where one is expanding nicely and the other is growing exponentially, is probably one of the more interesting trends of the recent period. We believe this highlights a few things. Firstly, it shows that the fears some had that the majority of companies would be cutting back their office space after the pandemic were overstated; in fact, we note that companies scaling back their office presence amid hybrid work is not the

Bucharest office market, new demand



Source: Colliers, Bucharest Research Forum norm. Secondly, the sharp acceleration in new demand is also fueled by the fact that some of the companies have been on the sidelines for most of the pandemic period and are now finally pulling the trigger when they feel they have more clarity, with the pipeline of leasing deals still looking impressive, based at least on our own knowledge of the market. Taken together with a somewhat light calendar of new buildings to be delivered in the next years, the office scene is starting to feel like a landlord's one in certain submarkets/areas.

That said, we still need to underscore the fact that at least several large tenants which leased large surfaces before the pandemic are still trying to sublease part of their offices on account of adjusting their strategy; this space could alleviate some of the supply concerns in the future to a certain extent.

Rents & Vacancy

Upside pressures on rents are clearly emerging; headline rents for new office buildings yet to be delivered (say, during the next couple of years) are climbing steadily; meanwhile, rents for older, albeit good office buildings, remain flat when the leasing deal is up for renewal. The latter would not have been common practice a few years ago, when landlords would try to woo tenants with more attractive terms.

Another topic which we have talked about in recent years is also become more visible, with lower quality buildings starting to feel the pinch even more, meaning a bigger discrepancy in terms of rents between these ones and class A offices.

Otherwise, the drop in vacancy from 16.50% at the end of last year to 15.25% mid-2022 is indicative of a market in recovery-mode, but even more impressive is the fact that vacancy for good buildings is much lower than this. Furthermore, occupancy increased in most of the large office markets, with some now seeing the vacancy rate firmly in single-digit territory.

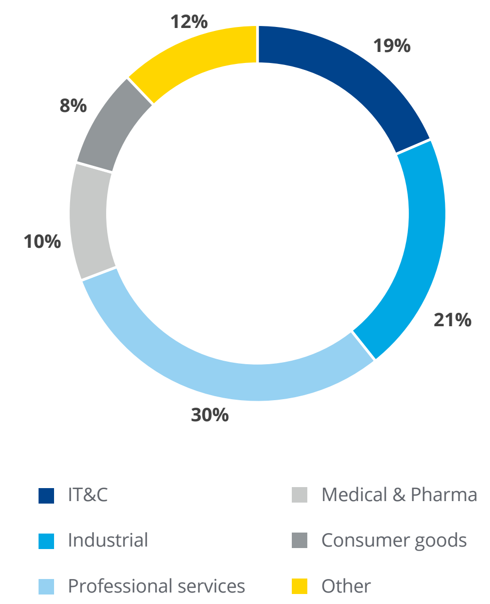
Outlook

We are hesitant about being too optimistic about the office market given the inherent risks in the global economy (please see the macro page for our thoughts on this), but momentum does seem to suggest that this real estate submarket could get even hotter, with significant new entries still waiting to open up a service center here in Romania (like Booking, Ford at the start of 2022).

As stated, based solely on our pipeline of leasing deals and knowledge of the market, it looks like office leasing activity could return to pre-pandemic peak levels within two years if the trend holds, a few years sooner than we would have normally anticipated. Taken together with a less than robust deliveries calendar (around 120,000 sqm of new offices expected per year between 2022 and 2024), we would expect a generalization of upside pressures on rents for good buildings in the following quarters. Inflation is also an argument for higher rents.

Overall, based on this strong demand, vacancy could drop towards single-digit territory within two years from over 16% at the end of 2021. Vacancy for good offices is likely in neutral market territory, no longer a tenants' one. Just to put things into context, after the previous recession, vacancy in the Bucharest office market peaked at over 21% in 2010 and it took until 2017, with various ups and downs, to reach single-digits. Back then, the market was also less developed, with well fewer large blue-chip companies present.

Breakdown of Bucharest office leasing, new demand in H1 2022 (%)

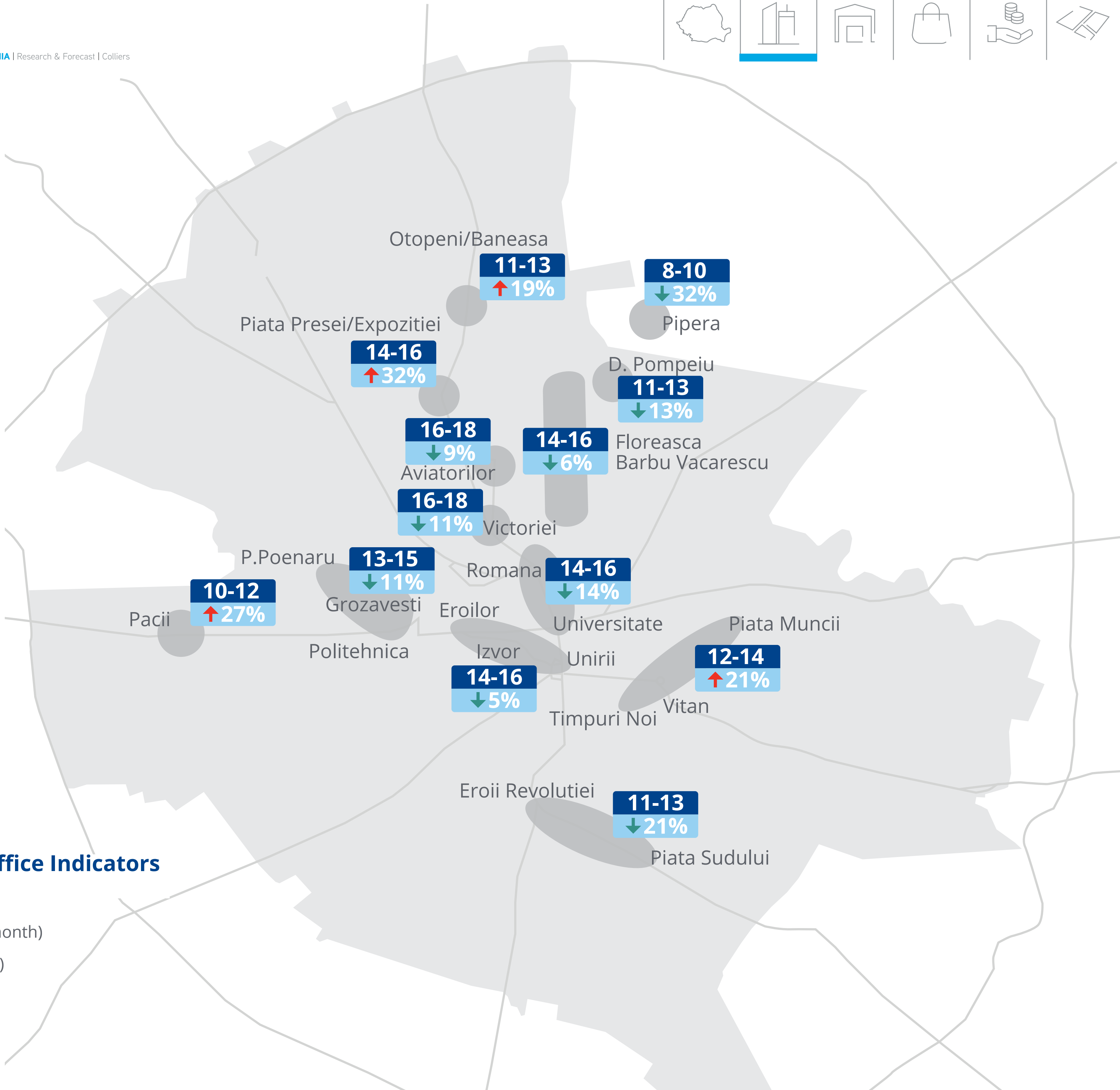


Source: Colliers

Two major intertwined themes are emerging in the post-pandemic period. One is the reorganization of the office space to be more in synch with a hybrid work schedule, something that most companies seem to be tilting towards; for many, this does not necessarily mean cutting back on the office space, rather changing the layout by creating new areas for employees to gather both for work and spending some free time together. The other theme is related to bringing back employees; an attractive office space is clearly a boon in convincing them, but it might not be enough.

Currently, it is rare for companies to see more than 40 to 50% of their employees in the office on a normal day, while efforts are being made to ensure the optimum mix between office and remote work. Long commuting times are a major factor in employees staying away from the offices; in our opinion, this could strengthen the case for developers to look into delivering some projects in residential areas.

Overall, 2022 has been a good year for the local office scene and the best may still be yet to come, but we retain a cautiously optimistic approach, as global economic risks are significant; should a negative scenario come to pass, we would expect the local economy be negatively impacted, with significant risks for a hard landing, meaning a pause and even reversal of recent favourable trends in the office market.



Bucharest Office Indicators (July 2022)

- Rents (€/sqm/month)
- Vacancy rate (%)

Industrial & Logistics Market

Supply

After reaching 5.6 million sqm of modern industrial stock, Romania was just under the 6 million sqm mark at the end of the first semester, following hefty deliveries throughout the country; while Bucharest accounted for almost half of these, we retain our long-standing view that activity will be tilting more towards other parts of the country. In countries with wider physical distances and faster growing regional cities (as is the trend in Romania), this is a necessity. For instance, in Poland, Warsaw represents one quarter of the country's I&L stock versus Bucharest's share of almost half in Romania.

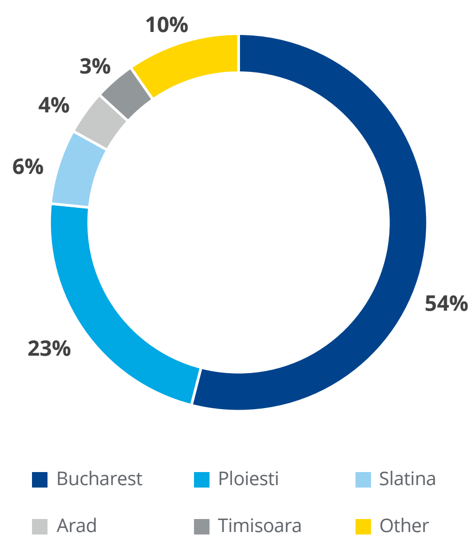
Demand

Due to the nature of the local I&L, with many direct transactions which end up unreported, we have relied in the past solely on publicly available information, even if this measure is incomplete. Still, with nearly 400,000 sqm of leased deals concluded in the first semester, this is more or less comparable to what we saw last year in the first half; however, based on our estimates with a partial view of unreported deals (not public), the actual volume could be at least 30% higher. Overall, a very solid first half and on track for a record-setting year.

Leasing activity continued to take place mostly in Bucharest, but with a share of 54% of leasing deals, this is already a bit smaller than we saw in other years (for instance, in the first semester of 2021, Bucharest's share in the total leasing volume was 69%); of course, this greatly varies from one period to another, mostly on account of what happens with the major transactions. Also, this quarter's biggest transaction was a confidential deal for a retail tenant, located near Ploiesti, totaling close to 88,000 sqm. This was followed at a distance by a leasing deal for Polish online footwear retailer Modivo, which leased 53,000 sqm in WDP's Stefanesti de Jos storage facilities (16,000 sqm renewal + 37,000 sqm extension).

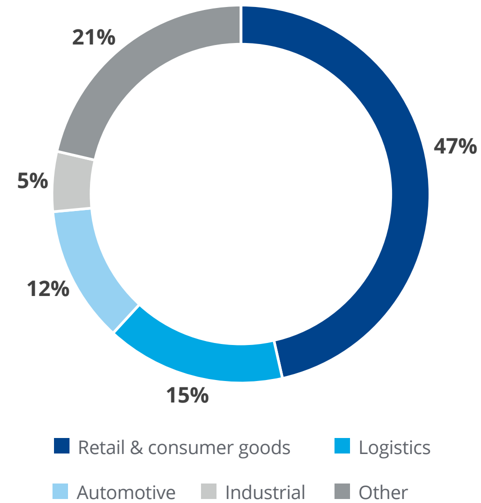
These two biggest deals are also a sign of an industrial leasing market dominated by consumer-

Gross take-up activity in H1 2022 by location (%)



Source: Colliers

Gross take-up in H1 2022 by tenant activity sector (%)



Source: Colliers

oriented tenants. In total, retailers, various consumer brands, FMCG operators, generated close to half of the leasing activity; and since quite a lot of the 3PL companies also act rather on behalf of companies active in such areas, it is safe to assume that consumer-oriented sectors may have supported around two thirds of the market in the first semester of 2022.

While consumption might be slowing, we see no reason to expect a similar slowdown for I&L activity unless the economy tanks; this is because we view the local market as massively undersupplied, with room to accommodate many more millions of sqm of new storage facilities. Our favourite metric to exemplify this is the fact that Romania has roughly a modern I&L stock that is roughly 2 to 3 times smaller than Czechia or Poland's on a per capita basis, while local households consume roughly the same amount of goods as their CEE neighbours (on a volume basis, not spending).

A new trend which has been taking shape in recent years is the rise of facilities designed for SME's and/or last-mile logistics. While the modern stock in Romania is quite small, we consider it will rise, particularly as the e-commerce scene is getting crowded, including for same-day deliveries of food items. In this respect, of particular interest is the fact that we have seen I&L developers looking at land plots within Bucharest (competing with residential developers), likely for future last-mile projects.

Rents & Vacancy

While vacancy is quite subdued, in 5-6% range throughout most of the country, such a small level has not been particularly relevant in pointing out a landlords' market. Quite the contrary, in recent years, due to the intense competition on the supply side, rents had remained more or less constant, around 3.8-3.9 EUR/sqm in the Bucharest area and a whisker lower for other parts of the country. This has been changing during the last couple of quarters; quotes received in the Bucharest area for new prime warehouses are in the region of 4.3 EUR/sqm, climbing towards 4.5 EUR/sqm in exceptional cases (this would be for a "standard" leasing deal, not for SBU/small surfaces that might command even higher levels). The change in rent is mostly on account of the higher construction costs, but it might bring a new era on the local market, with an even more generalized increase in rents (with a bump even for older schemes).

Outlook

All of Romania's real estate sectors are underdeveloped in terms of stock and products and the industrial & logistics space is no exception. We retain our call that we should hit 10 million sqm of modern (leasable) warehouse spaces by the end of this decade, which would be an increase of some 68% versus current levels. And much of this would be just to serve the internal market; it is likely that if Romania emerges more strongly as a regional logistics hub, the need would be even greater.

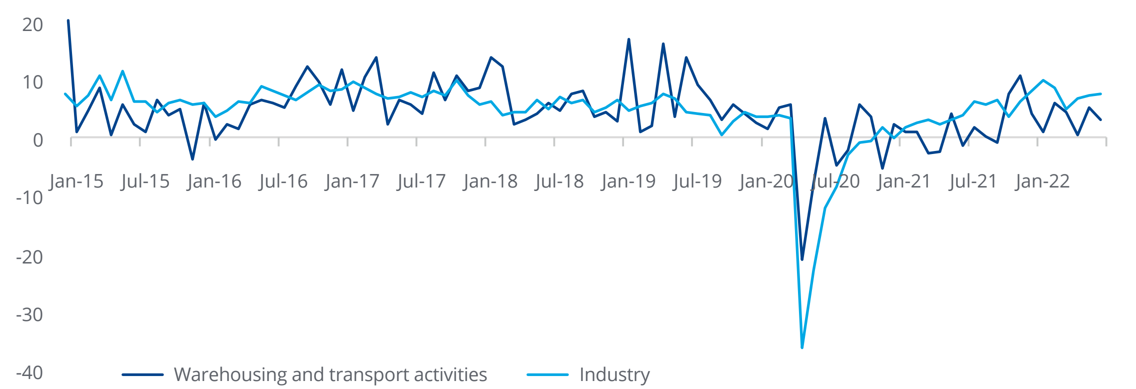
Furthermore, we have yet to factor in the geopolitical shifts taking place currently, which we believe will lead to many Western capital seeking to diversify their risks rather than just seeking absolute returns; this will likely lead to relocations of activity from various parts of Asia (notably China) to locations elsewhere, with the CEE likely to be a prime destination for this reshoring.

But these are rather long-term trends; over the short term, driving forces are influenced to a certain extent by economic factors. And the news on this front is not as good, unfortunately. A slowdown in Romania's/Europe's GDP expansion is the good case; a mild recession would even itself seem like a decent scenario, given that certain imbalances suggest that there is a real possibility for a hard landing, at least in Romania. Such a case would lead to a slowdown in consumption and set back the local economy a few years, which would, in turn, lead to a significantly slower expansion of the local I&L market.

On the positive side, all this talk of a global recession is bringing down the costs of materials; copper, for instance, has dropped over 30% compared to 2022 highs reached back in March and is now comparable to late 2020 levels. This will help alleviate some of the pressures on both landlords and tenants.

Overall, it looks like the local industrial and logistics market is set for a new robust, potentially record-setting, year at least based on recent momentum; consumer-led sectors are expanding, both for traditional brick-and-mortar players as well as online operations. Furthermore, we see Romania as a rising force on the manufacturing side, with many significant investments announced in recent months. That said, the medium term outlook is plagued by many uncertainties and for now, we are only cautiously optimistic about being able to keep this momentum.

Short term hiring intentions in Romania are still above the historic average, albeit not on par with 2015-2018 highs



Source: Eurostat, Colliers

Retail Market

Supply

Just two schemes totaling around 27,000 sqm have been added in the first part of 2022 – the 16,500 sqm extension of the Colosseum Mall scheme in the north-western part of Bucharest, as well as the new Funshop Park Timisoara, a 10,800 sqm retail park owned by Polish developer Scallier. This means that more than 120,000 sqm of new retail schemes are due in the second prat of the year. Still, with quite a lot set to be opened towards the end of the year, this means that there is a chance that some of them may be delayed until the first part of 2022, particularly if the developers meet certain difficulties with the construction or leasing process.

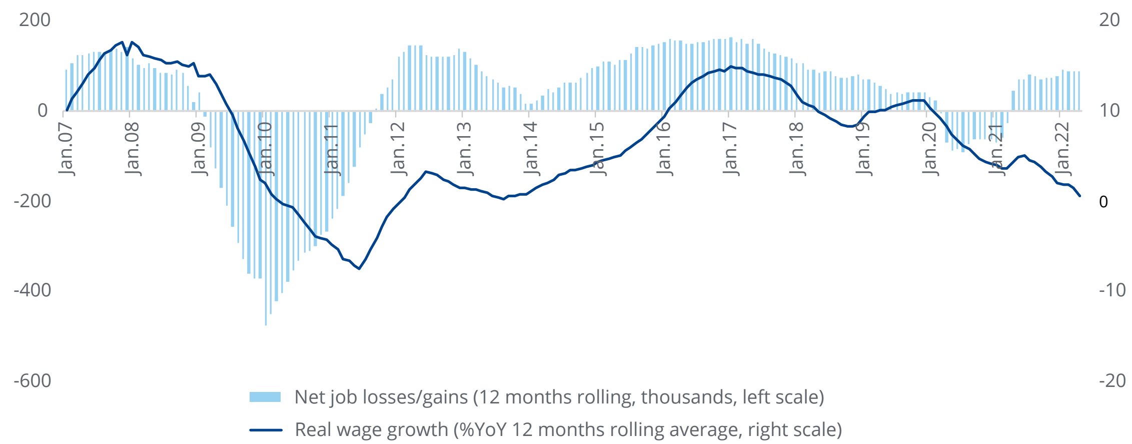
Demand

Before looking at how retailers are doing, we would like to start by saying that the strong consumer has been at the heart of the economic recovery in Romania in the post-pandemic period and, thankfully, we still see good results. This context, in turn, is the result of the very strong labour market, with the total number of employees in the economy already above pre-pandemic levels as of early 2022. Furthermore, hiring intentions over the near term remain fairly decent (albeit showing some signs of wariness in recent months), which means wages will be propped up to a certain extent.

This is where the good news ends on this front, however. While it is good that wages have accelerated in nominal terms, in real terms, however, they are still mildly below the inflation rate as of the last few months; over the last year, real wage growth is barely positive. And if the economic activity is set to slow down on account developments in other countries, this will in turn lead to slower wage growth even as price dynamics remain elevated. All in all, the second half of the year is likely not going to be too good for the consumer; retail sales also seem to be plateauing and although our base scenario for the Romania economy does not entail a hard landing, it does suggest that past growth spurts are unlikely to be returning just now.

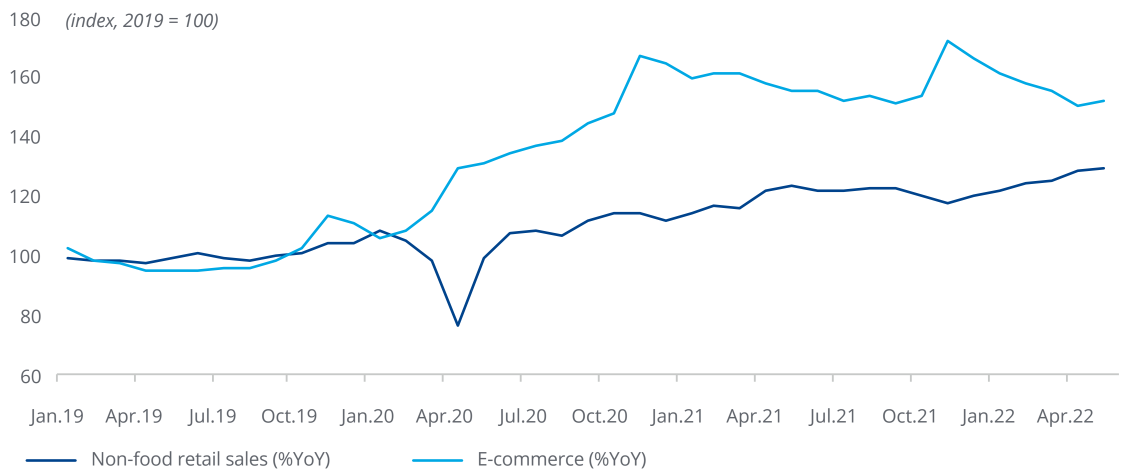
Otherwise, looking at the structure of consumption, it is noteworthy that clothing and footwear sales took off in the second part of 2021 and accelerated in the first half of 2022, with spending on various electrical

Real wages barely growing in the last year, but at least job creation is back in black



Source: National Institute of Statistics, Colliers

Faster clothing, footwear sales dragging overall retail higher, with e-sales peaking



Source: National Institute of Statistics, Colliers

and white goods also doing decently; at the other end of the spectrum, the wider category of goods for home renovations, improvements or decorations has remained unchanged for the past few quarters, possibly on account of the residential real estate market also peaking in sales.

An important aspect we need to note is that e-commerce sales have also hit their peak and are actually marginally below 2021 levels; while official measures are unlikely to capture the full scope of actual e-sales sales, it is an important signal of a more restrained consumer in the big cities, where the vast majority of such sales are recorded. We would not necessarily read this as a sign of e-commerce hitting its highest potential share of total consumption, rather the fact that the boom in this space is finally slowing down and returning to earthly levels.

Otherwise, the large returns the local market offers plus the fast recovery of retail sales (one of the fastest in the EU) has put Romania on the map again. After a two-year calm period in the context of the pandemic, 2022 saw a flurry of new entries on the Romanian market, with a multitude of brands either opening their first store in the first half of the year or announcing it in the near future: Primark, Bath & Body Works, Foot Locker, TEDi just to name a few.

Rents&Vacancy

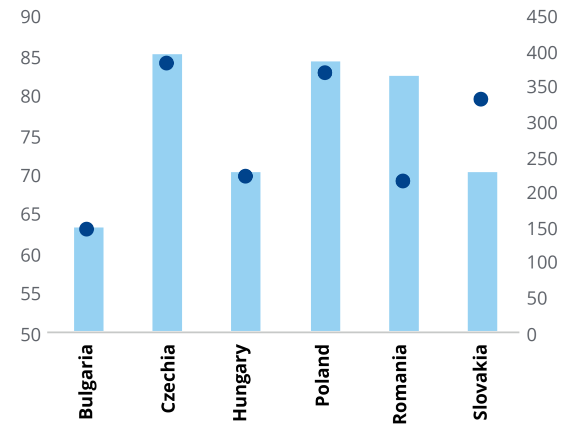
Vacancy remains relatively subdued in most instances, in single-digit territory, with the large dominant shopping centers now rather full. On the rents front, while base rents have remained unchanged and landlords had to offer some discounts (particularly in 2020, but also in 2021) things have gradually returned to normal on this front as well. Meanwhile, after climbing steadily in the last few quarters, turnover rent is now, on average, just marginally lower than it was before the pandemic (maybe by some -5%).

Outlook

With more than 100,000 sqm of new retail schemes set to be delivered in the second half of the year, we also need to acknowledge the fact that some larger schemes are starting to take shape with deliveries over the medium term. And even with deliveries that could start exceeding 200,000 sqm/year of new retail projects, Romania remains a significantly undersupplied market with its over 4 million sqm of shopping centers and retail parks. And this is in comparison to CEE peers, not even Western European countries. For a similar consumption level to Czechia and Poland, Romania's modern retail stock per capita is two times smaller than Czechia's and more than 40% behind Poland's.

This situation has led to an internal backdrop with limited competition among retailers and hence, it explains why Romania offers some of the largest (if not, the largest for many categories of goods) returns in the European Union. Consequently, we would expect this trend of new entries/brands on the local market to remain in place.

Retail stock versus consumption levels highlights big upside development room in Romania



Source: Eurostat, Colliers

Otherwise, while our longer-term considerations for the local real estate market in general and for the retail scene in particular remain very optimistic, we cannot overlook the near-term risks; high inflation, high interest rates, slowing job market and talk of a global recession do not form a backdrop that is good for retail. Consequently, we would expect Romanian households to adjust their spending budget accordingly, with the speed of this change dependant on how the economy will look like.
As such, overall retail sales are likely to shift to a downward moving slope in the second half of the year; given this context, we would expect discounters to come out on top, even as consumers will gradually scale back on spending they deem unnecessary.

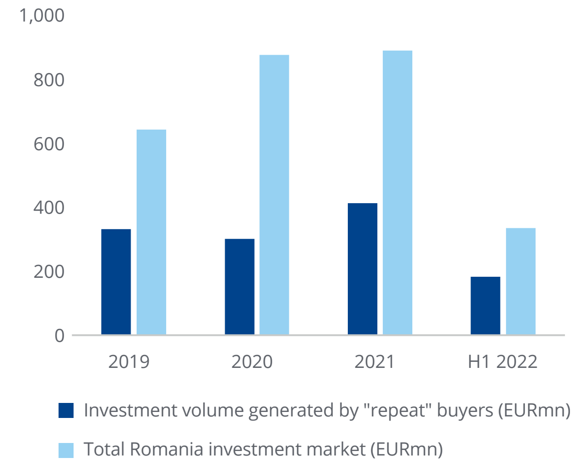
Romanian Investment Market

Prime investment yields, end-June 2022 (and comparison to June 2021)

	Office	Retail	Industrial
Bucharest	6.50% (-0.25ppt)	6.75% (flat)	7.50% (-0.25ppt)
Warsaw	4.35% (-0.35ppt)	6.00% (-0.50ppt)	4.35% (-0.35ppt)
Prague	4.00% (-0.25ppt)	5.75% (+0.50ppt)	4.00% (-0.50ppt)
Budapest	5.00% (-0.25ppt)	6.50% (flat)	5.75% (-0.50ppt)

Source: Colliers

Both new and old investors driving the local investment market volumes



Source: Colliers

Benefiting from some momentum, the Romanian investment market saw a decent first half of the year, with overall turnover at €336 million, up by c.13% compared to the first semester of 2021. Still, the best might still be to come, with a handful of large transactions in various stages, which could close by the end of the year, bringing the total volume closer to (or even higher than) €1 billion. So a lot may depend on the timing of these deals, but the positive aspect is that they remain ongoing in spite of the somewhat uncertain backdrop in the global economy.

The office sector remained the most active by far, generating 63% of the H1 2022 volume, though this share has decreased somewhat compared to other years, with retail also generating approximately 16% of the turnover and I&L – 14%. Hotels round up the rear with the rest transactions up to 100%.

In order to gauge the interest in the local market, we looked at the presence of repeat buyers – i.e. investors that had made purchases in previous years or since then – relative to the total market. With a notable exception in 2020, which also included the biggest real estate deal in history and one not completed by a repeat buyer (AFI Europe's purchase of NEPI Rockcastle's office portfolio, worth over €300 million), the volume generated by new investors and active investors is more or less equal. This is in line with our own view following discussions with various investors, which continue to display a healthy interest for local assets and even though some have not pulled the trigger on any local purchases, Romania is still on their radar.

Otherwise, local investors remain wary of developments in the global economy, particularly those related to the cost of risk and developments on the inflationary front. For now, these shifts have yet to impact materially local activity, but as with any real estate market, the investment scene relies to a certain extent on momentum and if things do not improve soon, we would expect some of the negative sentiment to be transmitted.

Transactions

The first half's biggest transaction saw S IMMO purchase Portland Trust's EXPO Business Park, a newly developed office project in the northern part of Bucharest, for over €110 million. This is also the 5th nine figure transaction completed on the local market in the two and half years since the start of the pandemic, which is more or less comparable to the number of big tickets finalized in the years prior, highlighting both the appeal and the rising depth of the local investment market (as some of these are actually record-setting for the Romanian market).

Among other notable transactions, we note that Alinso Group purchased the METAV Business Park, an in-city industrial scheme in Bucharest, but also the sale of Speedwell's Record Park, an office project in Cluj-Napoca, to AYA Properties Fund for €35 million.

We underscore that while big institutional investors and big tickets still drive the wider market and generate the bulk of activity, an increasing focus can be seen from add-value investors snapping up assets that require capex in order to become competitive. We are likely going to see an increase in such deals, particularly amid slowing economic growth and rising interest rates.

Pricing and funding conditions

While in case of a transaction, exceptional products could see somewhat lower yields than where we view prime yields at (office – 6.50%, retail – 6.75%, industrial – 7.50%), a lack of benchmark deals makes it particularly difficult to gauge where these levels actually are, particularly in the case of retail and industrial assets. For industrial, we have had fairly recently such a benchmark deal close about a year ago, when Fortress purchased ELI Park 1 for a yield in the region of 8%; while some countries in the CEE have seen large yield declines since then for warehouses, we remain comfortable with our prime yield level particularly on account of Romania's worsening sovereign risk.

As a positive, funding remains widely available for real estate transactions, with margins more or less unchanged by local banks, in spite of the somewhat shaky backdrop. Consequently, a good income-producing asset, like an office or industrial project, depending on the sponsor, can receive a 230-250 basis points margin when looking for a loan. This likely underscores two aspects: the long term confidence that banks have in local assets and the perception that even in case of a correction, prices are not overvalued, requiring a deep correction.

Outlook

Since real estate is, in many ways, a reflection of the wider economy, we believe that this sets the bar for the local investment market as well. A robust pipeline of deals, with many big tickets in various stages and which could close in the following quarters, is the result of Romania's favourable economic developments up to this point. In fact, the figures look so well that we may very well see investments hit a peak this year and surpass the €1 billion mark.

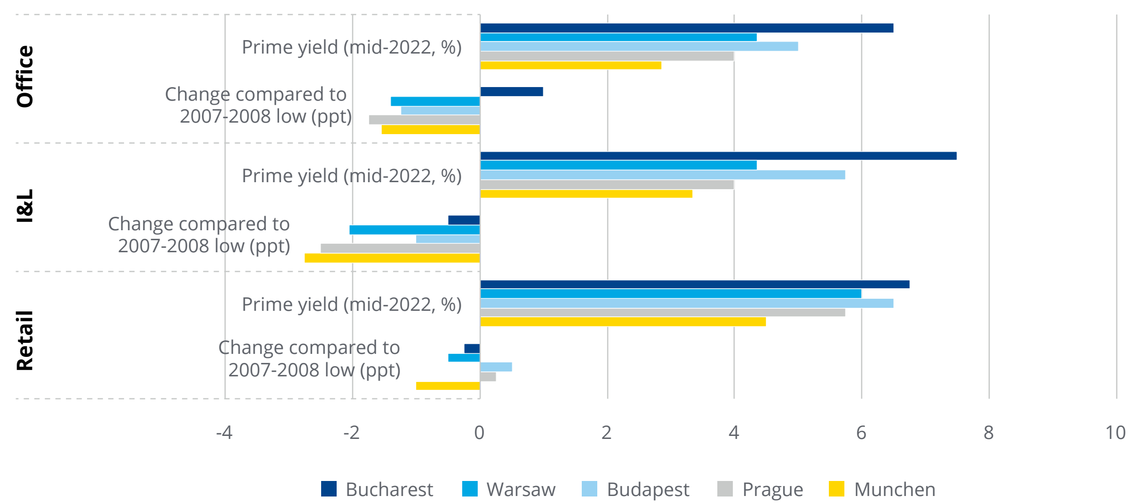
But this result is more about what was than what will be. And given the current context in global financial markets, we cannot help feeling a little concerned. Besides the war in Ukraine and other geopolitical factors generating uncertainties, we have sharply higher interest rates in developed countries (likely to remain in place for a longer period of time) plus the quantitative tightening pursued by the Federal Reserve; the 3-month Euribor rate is already in positive territory as of mid-July. We also need to make a special nod to risks for a new existential crisis taking place in the Eurozone, with Italy's future looking troubled. These are likely to weigh on the overall appetite of investors, though history shows that high interest rates are not necessarily bad for real estate, particularly for prime assets. Consequently, we take this opportunity to restate one of our long-standing calls, namely that the gap between the prime assets and the rest (particularly older and outdated buildings) will widen quite significantly, in terms of yields, rents and occupancy.

Looking at more recent trends, we need to note that prime yields in the core markets have started moving higher as of Q2 (for prime offices and industrial assets) and while Romania has certainly not benefited from the sharp compression seen in the past couple of years, it has also performed noticeably worse with regards to sovereign risk (the long-term government bond yield spread versus Germany is at its widest in more than a decade).

There are presently no implications for local yields from these negative price movements for assets in countries like Germany, as it means that Romanian assets have more of a defensive twist given their relative lag during the last years; that said, should a more aggressive price action take place in core markets, things will change for the worse.

Summing up, 2022 looks like it might be an exceptional year for the local investment market in terms of overall activity. The outlook for 2023 is challenging and a lot hinges on what will happen in global financial markets in the following quarters, but at this current moment, we are leaning towards a more pessimistic outlook.

Local assets have lagged the CEE/Western European moves in the last decade



Source: Colliers

Land Market

Supply

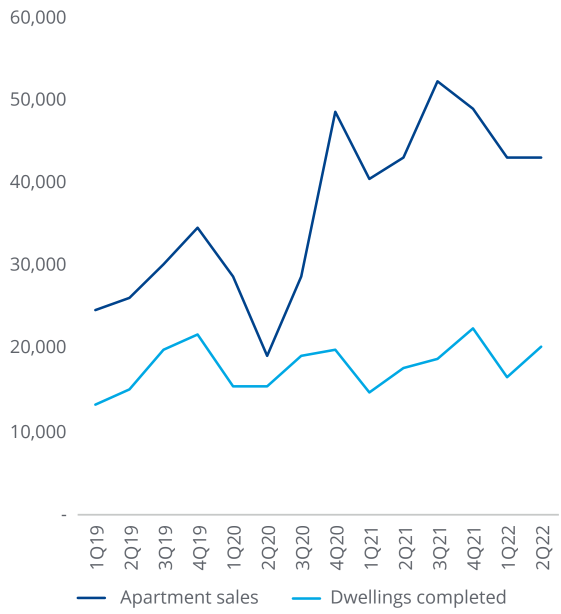
Supply remains adequate in many parts of the country, with a special expectation in the case of Bucharest. Here, the blockages regarding zoning legislation are causing many market players to ditch plans to purchase land plots without zoning already in place; and with no easy fix on the horizon for these issues, residential developers, for instance, remain quite aggressively oriented towards areas just outside of Bucharest, where the land offering is plentiful, prices are smaller and obtaining the permits is not an issue. Otherwise, we still have new additions to the land market, with quite a few companies seeking to sell their assets for brownfield/urban regeneration projects.

Demand

On the demand side, things have been in the first semester of 2022 more or less on par with how they were for the past couple of years, when the market hit its best levels since 2007; 2021 saw total volumes for land plots for commercial real estate projects (residential, offices, retail, hotels etc., excluding industrial and agriculture) surpass the €800 million mark. This means robust market turnover so far this year, with only a minor negative impact from external events (like the Russian invasion of neighbouring Ukraine or the episodes of turmoil in global financial markets).

While it is difficult to gauge where the total market turnover lies – we try to include only closed deals, not just those signed – it looks like residential is still seeing the strongest focus, albeit with some cooldown in deals closed. That said, there is a significant number of deals in various stages in Bucharest, where the closing depends on obtaining authorizations/zoning, so we would not necessarily read too much into this.

Mind the gap: deliveries have not kept up with increased demand



Source: National Institute of Statistics, Colliers

We would rather be looking at the darkening clouds on the horizon for the residential market, as these will likely dampen the mood a bit more. With sharply higher interest rates (and the c.bank still suggesting it will not be stopping soon), inflation chipping away at purchasing power and uncertainties plaguing the near-term outlook, we would likely look for softer sales in the second part of the year. Still, as long as we do not see a sharp landing of the economy, we would not expect too sharp of a pullback in either sales or prices. The former because deliveries had already fallen behind demand to begin with throughout the country and the latter, because prices are not in bubble territory, just a bit on the expensive side in certain areas of the country/certain types of real estate products.

A special note should be made about the upper/luxury segment of the residential market, where sales of units and interest from developers remains as elevated as ever.

Otherwise, retail developers' land purchase intentions remains as strong as it was in the recent past, with new projects looking particularly outside of the Capital. We are even seeing new entries on this sector, notably local players. That said, following years of hefty expansion, this retail submarket may not be a straight home run as it was in the past, with a large number of small- and medium-sized towns already targeted for retail parks, but there is still a lot of untapped room that just requires a more careful approach. Just to exemplify, Romania and Poland have similar consumption levels per capita and while Poland is roughly two times larger than Romania in terms of population, its modern retail stock is around 3.5x larger than Romania's.

Meanwhile, office developers remain a limited presence on the market, but we would think that if the current leasing recovery proves sustainable, we could see a gradual return over the following quarters. However, given the current situation in Bucharest, we also think that they might face an very difficult task in finding land plots that would allow for a project to start sooner than, say 3 years, given the zoning-related issues.

An interesting trend we note is the arrival of industrial developers in urban settings (notably in Bucharest), likely chasing future in-city logistics projects, sometimes competing with other “traditional” developers for such locations (notably residential, but also maybe retail). Given the very limited modern warehouse projects for last-mile or small business units we have and the booming e-commerce scene during the last decade, we will probably see more deals like these.

Prices & Transactions

Prices have been more or less constant during the first half of the year, with only case-by-case changes either upwards or downwards. We have noted that developers have tried to coax landowners into offering some discounts, particularly as they are facing sharply higher construction costs, yet for now, no or very limited concessions have been made by the sellers. Rather they do not feel any particular pressure even in this current market. Otherwise, land plots with zoning in place continue to sell at a hefty premium compared to similar plots which do not benefit from this, with this premium exceeding 20-30% in many instances.

Outlook

Overall, we will likely continue to see large transactions in various parts of the country, less so in Bucharest, as investors turn to other big cities for large scale projects, besides the interest for smaller retail parks in less populated towns; at the same time, interest for land plots within the boundaries of Bucharest is likely to peter off; as a result, we will probably see a bigger share of regional cities in total land sales than in the recent years, when the Capital usually made up three quarters of the market.

Another important aspect to keep track of is that of legislative changes with regards to taxation, particularly given the tight fiscal situation faced by the Romanian government. Property taxes are set to rise sharply, while VAT legislation is changing to become less supportive for the purchase of residential properties. This should also negatively impact the residential sector, which is the biggest demand-side force for land sales by far.

While our view on the overall macroeconomic story is that of a cautiously optimistic approach, we cannot overlook the significant impact that the rising cost of risk/loans is having on overall investor sentiment as well as the heightened risks of a recession hitting Romania eventually. Consequently, we could start seeing more and more instances of land price drops as activity could cool down in the second part of 2022 and through 2023, even though these price declines should not be generalized. To a certain extent, the construction activity is also set to slow on account of aforementioned factors, as well as higher construction costs and, for Bucharest in particular, the fogginess regarding future zoning. We still have no clear view on the Bucharest situation other than that it seems like it will not be a quick fix, which means that there will be upside pressures on the price of existing assets, which, in turn, could lead to affordability issues and reallocation of capital resources.

Usual land asking prices by city/number of inhabitants (EUR/sqm)

	Central	Semi-central	Periphery
Bucharest	900-3,000	250-1,000	100-450
Cluj-Napoca, Timisoara, Iasi, Brasov	350-1,000	200-400	100-250
200-300k	250-800v	150-300	50-200
100-200k	200-500	100-200	50-150
50-100k	150-300	100-200	30-100

(Price intervals are indicative and are based on Colliers’ transactions and/or market expertise. They highlight the most targeted type of land plots. As usual, the prices are influenced by size, destination, building parameters, status of the permitting process.)

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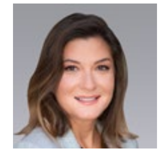

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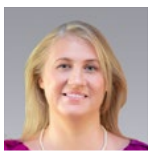

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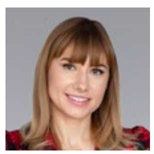

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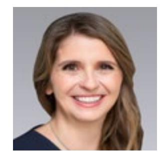

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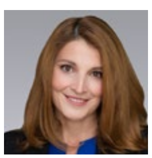

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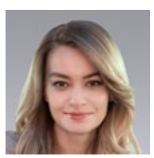

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