Investment Market Update
Baltic H2 2012
Region of Diverse Opportunities and Sentiments

DTZ
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8 March 2013

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- The Baltic States are usually perceived as a single region in terms of economic development and investment opportunities. A closer introspection nonetheless suggests sharp contrasts in investment opportunities and sentiments. The only shared trend among the three countries is stabilizing macroeconomic fundamentals followed by an increase in real estate investment volumes.

- Having introduced Euro in 2011, within the region, Estonia exhibits itself as a place of core investments with stable current income and market level returns that commensurate with a low to moderate level of risk. Income is usually expected to make up the majority of the total return performance; the presence of sale-lease back deals is quite pronounced in the country, whereas investment activity is prominent in all three core sub-segments of the real estate market, namely, office, retail, and industrial. In terms of purchaser profile, the country is dominated by institutional investors.

- Latvia, on the other hand, offers plenty of opportunities in any of the real estate sub-segments for those who are ready to undertake additional risks correctable through leasing, re-development, management and/or recapitalization. The range of investment opportunities requiring development activity is also quite abundant. Investment activity is best-pronounced in such segments as hotels and residential.

- Lithuania, similarly as Estonia, is dominated by institutional investors and real estate investment vehicles. The country offers both core and value-added opportunities; the majority of transactions are related to the properties were income is expected to be a part of the total return, yet the highest contribution to return comes from income appreciation. Investment activity is best pronounced in retail segment.

Baltic H2 2012

Macroeconomic Trends in the Baltic States

Estonia

Estonian economy is in quite a good health, with strengthened domestic demand playing the major role in economic development. Nonetheless, despite promising GDP growth, the uncertainty towards surrounding environment is still evident.

Based on the information presented by the Bank of Estonia and Statistics Estonia, in Q3 2012, GDP increase was 3.5% on a year-on-year basis and 1.6% on a quarterly basis, with construction sector being the largest contributor to the economic growth. According to the Bank of Estonia forecasts (published in December 2012), GDP growth shall round up to 2.9% in 2012, is expected to reach 3.0% in 2013 and 4.0% in 2014.

The year-on-year CPI change meanwhile was 3.7% in Q3 2012. Inflation was mainly caused by the increase in food, housing and fuel prices. According to the Bank of Estonia forecasts, the annual CPI change in 2012 would round up to 4.3%, and is expected to slow down in the upcoming two years, with the forecasted change of 3.6% in 2013 and 2.4% in 2014. Such a deceleration however is only possible with no substantial upward changes in the global fuel prices; another underlying assumption is that global food prices that have heavily increased in 2012 will exhibit a decline within the upcoming two years.

Statistics Estonia informs that the unemployment rate within the population group aged 15-74 years dropped from 10.2% in Q2 2012 to 9.7% in Q3 2012. More than one third of these officially registered unemployed have been unoccupied for more than two years already. Most of the unemployed workforce finds occupancy in construction and industrial sectors, as well as in the sector of seasonal works.

Latvia

In 2012, Latvia, the country famous for its austerity measures, has managed to accomplish something unattained by any other country severely affected by the recent crisis, namely, to maintain its currency exchange rate fixed. On top of that, Latvia's economy, after shrivelling by more than 20% from its peak, remarkably outperformed the cautious government forecasts for 2012 of 1-2% growth and rose by more than 5% instead, making it the best performer in the 27-nation European Union.

The budget deficit is also down sharply (1.7% from GDP as compared to 4% at the end of 2011); both manufacturing (10.5% growth within a year, more than 35% growth from December 2009) and exports (22.6% growth within a year, as compared to 12.1% annual growth in import rate) are soaring, and already exceed pre-crisis levels.

Annual inflation meanwhile has reached its historical minimum ever since autumn 2010, and averaged at about 1.6% at the end of 2012, coming primarily from globally evident increase in fuel and food prices.

The problems that still persist are those of high unemployment rate (although it is almost twice as low as in Greece or Spain, the rate of 13.5% is still too large) and social inequality. It is worth mentioning that unemployment was relatively high in Latvia ever since the re-establishment of independence; yet during the last eight years (and thus also during the economic boom) it was also higher than that experienced by the closest neighbours, Lithuania and Estonia.

The commonly held opinion however is that the hardest times are behind. 2013 therefore is expected to be marked with slower, but still one of the highest GDP growth rates in Europe (3-3.8% per year). The average income level, which currently stands at about 60% of EU average (as compared to 30% in 1995), is expected to grow slowly and reach its pre-crisis level, about 711 EUR before taxes. As usual, the income in Riga will be about 15% higher than that in the rest of the country; heavily pronounced segmentation in employment sector will still persist.

The government meanwhile has set the target of meeting Maastricht criteria (inflation not exceeding 2.7%, budget deficit up to 3.0%, debt-to-GDP ratio up to 41.9%) and thus to receive an invitation to join Eurozone in 2013, with the subsequent Euro introduction in early 2014.

Lithuania

Statistics Lithuania informs that in Q3 2012, the real GDP growth was 4.4% on a year-on-year basis. At the same time, the GDP that was produced within the three quarters of 2012 outperformed the same period of 2011 by 3.5%. Central Bank of the Republic of Lithuania meanwhile goes more moderate in its forecasts, and predicts a 3.0% annual GDP growth by the end of 2012, along with the 3.1% increase forecast for 2013 (down from the previous forecast of 3.4%).

Average annual inflation meanwhile stood at 3.2% as of November 2012 (calculated on the basis of HICP, the harmonised index of consumer prices), and is 0.4% down as compared to the annual inflation figure a year ago. The year 2012 is expected to round up with the 3.1% annual inflation rate, as compared to 4.1% figure at the end of 2011. In 2013, the forecasted inflation rate is 2.8%.

The unemployment rate, which stood at 13.3% in Q2 2012, decreased by 1% within a single quarter (12.3% in Q3 2012). The forecasts for the upcoming year are more moderate; by the end of 2013 the unemployment is expected to reach 11.6% figure.

Baltic H2 2012

Table 1

Key Macroeconomic Indicators

	Estonia	Latvia	Lithuania
Population (in thousands)	1,340	2,033	3,008
Urban population	65%	68%	67%
Area (thousand km²)	45	65	65
Population density (per km²)	30	31	46
Capital city	Tallinn	Riga	Vilnius
Population in capital cities (thousand)	401	649	534
Currency	EUR	LVL	LTL
Exchange rate (€)	X	0.702804	3.4528
GDP at current prices (€Bn, 4Q 2011 - 3Q 2012)	16.8	21.6	32
GDP per capita, at current prices (€, 4Q 2011 - 3Q 2012)	12.503	10,618	10,701
GDP growth (%, 3Q 2012)	3.5	5.3	3.5
Inflation rate (%, 3Q 2012)	3.7	1.7	3.2
Unemployment rate (%, 3Q 2012)	9.7	13.8	12.3

Source: National Statistics, Oxford Economics

Baltic H2 2012

Investment Market in Estonia

General Overview

In Estonia, interest in real estate investment opportunities is mainly addressed towards Tallinn, the capital of Estonia. Smaller scale investment activities also appear in such cities as Tartu, Pärnu, Jõhvi, and Narva. The rest of Estonia attracts little, if any, interest in terms of transnational real estate investment deals.

The largest real estate portfolios in Estonia are held by international players, such as *Baltic Property Trust, East Capital, Citycon, Homburg,* and local funds, such as *EEREIF, Eften Capital,* and *Capital Mill.* Financial capital inflows mostly come from Northern Europe; the presence of resources with Russian origin is also distinct.

In Estonia, activity on real estate investment market resurfaced already in H2 2009, picked up in Q2 2010, and remained well-pronounced throughout 2011-2012. The yields meanwhile contracted – while in 2009, office properties were sold at the yields of not less than 10%, by the end of 2011, with improving macroeconomic fundamentals and improving situation on occupational markets, the yields decreased to approximately 8.5%. 2012 henceforth witnessed notable amount of transactions with the yields similar to those in 2011.

Transactions

In 2012, the total real estate investment volume in Estonia was roughly €100 M, quite equally distributed between H1 and H2 2012.

In terms of distribution between different property segments, the largest amount of money was disbursed on office properties. The segment as such absorbed approximately 40% of the total investment volume in 2012; large proportion of these transactions was sale-lease back deals.

Hence in June, a local electricity network constructor *Empower* sold and leased back its portfolio consisting of five properties (in Tallinn, in Mõigu, Tartu county, in Rakvere city, in Jõhvi city, and in Viljandi county) for the total amount of €2,3 M (no information regarding the yield).

In August 2012, Norwegian capital based *Kawe Group* acquired the *Baltika Quarter*, HQ of the clothing manufacturer *Baltika*, for €13 M. While transaction yield was not disclosed, approximate calculations pinpoint towards 8.0-8.5% level.

Other notable transactions in office segment include locally-owned *Capital Mill* acquiring 90% of the shares in the newly developed *Mehhatroonikum* building, located in *Tehnopol*, the Science and Business area of Tallinn.

The retail market absorbed approximately one third of the total investment volume in 2012. The year commenced with German investors acquiring *Merekeskus* and *Lootsi* shopping centres in Tallinn's port area through public offering for €9,8 M (April 2012), whereas in summer, *Capital Mill* acquired *Telliskivi* shopping centre in Northern Tallinn for €2,05 M and *EfTEN Capital* bought *Mustika* shopping centre in Mustamäe city district for €21,5 M.

Industrial segment also was not ignored by property investors in 2012. Hence in January, *East Capital* acquired 40,000 sq m *VGP Warehouse Park* located in Tänassilma industrial park for €24 M at a yield slightly above 9%, whereas in H2 2012, *Capital Mill* bought in Nõmme city district two neighbouring industrial and warehouse properties for €2,2 M.

Yields

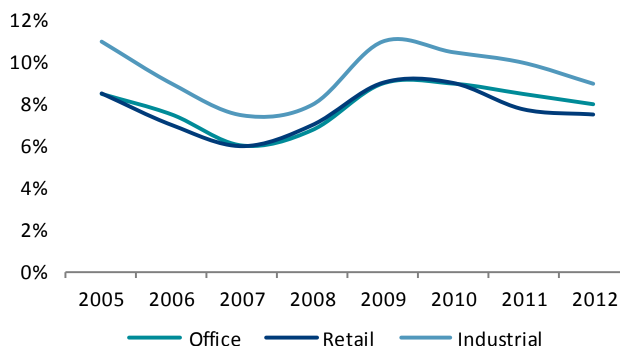
Historically, both investment yields and interest rates fell dramatically in 2006-2007, becoming comparable to those in Northern and Western Europe. In 2008, the yields increased by 150-250 base points, whereas 2009 added another 50-100 base points to the yield level. 2010 was a stable year, whereas in 2011, the yields in retail and office segments bounced back by 50-100 base points. Similar decrease was evident in industrial segment in the beginning of 2012.

Throughout H2 2012, the yields in general remained stable, and exceed those commonly met in Northern and Western Europe by 150-250 base points. Hence the 'low-end' yields in industrial and logistics segment start at 9.0% for a good quality properties with long term rental agreements (usually sale-lease back transactions) with a trustworthy lessee and a guarantee from a bank or from a mother-company. The lower yield limit for retail properties stands at around 7.5%, whereas for office properties at around 8.0%.

Yields in secondary cities – such as Pärnu and Tartu, - are 1-3% higher, depending on the quality and potential of the property. Yields in other parts of Estonia are significantly higher.

Figure 1

Yield Dynamics in Estonia



Source: DTZ Research

Baltic H2 2012

Investment Market in Latvia

General Overview

While in the immediate crisis after-map, internal devaluation and exports have been the most important drivers of recovery in Latvia, in 2011-2012, domestic demand also increased in importance. With the internal imbalances being gradually solved, country's competitiveness is improving, which is also reflected in the foreign direct investment segment, the total volume of which in 2011 increased as much as three times as compared to 2010. The largest foreign direct investment growth came in the wholesale and retail, information technologies and communication, finance and insurance sectors, whereas real estate was standing still.

Preliminary data on 2012 nonetheless is more promising; while the total amount of money spent in commercial real estate and land segments all over Latvia increased only by 4% in the first half of the year as compared to H2 2011, the growth that followed in H2 2012 was already more than 20%.

Transactions

A closer look into the largest real estate transactions in H2 2012 suggests that currently, Latvia is the most sought-after by investors ready to engage into value-added or even opportunistic investments, primarily in accommodation segment, whereas the most active vendors are bank-affiliated real estate companies.

Hence in H2 2012, two hotels and one hotel development project changed their owners. The first is *Elefant* hotel on 90 Kalnciema Street, Riga, acquired by Russian capital for €6.3 M from *Ektornet Commercial Latvia* (*Swedbank* affiliated real estate management company). The second is *Promenade* hotel on 40 Veca Ostmala Street, Liepaja, sold by the same vendor and acquired by the local capital for €1.9 M.

The hotel development project (prone to concept-change into residential) is located in Riga Old Town, the most sought-after geographical sub-segment in Latvia, on 24 Jekaba Street, Riga. The project was disposed by the same *Ektornet Commercial Latvia* for €2.5 M.

In H2 2012, both office and retail sub-segments saw one transaction each. Hence office building in Riga Old Town, on 15 Kalku Street, was acquired for 8.85 M EUR by Italian capital from *Baltic Property Trust* (becoming the largest investment deal of the year), whereas shopping centre on 20 Priedaines Street, Riga, was sold by *Homburg* to its anchor tenant, Lithuanian *Maxima,* for €4.4 M.

In industrial sector, *TKM Latvija* acquired office and warehousing complex for further development on 101 K.Ulmanis Street, Riga (in close proximity to Riga International Airport) for €1.86 M.

To sum up, the total monetary turnover of large deals (exceeding €1 M) in real estate market in Latvia in H2 2012 exceeds €25 M, which is more than double as compared to H1 2012.

2013 is by no means less promising, since confidence in Latvian economy is expected to be substantially strengthened by the prospects of introducing Euro in January 2014.

It should be duly noted, however, that Latvia can hardly be considered a primary target for those seeking for low risk-good return core investments with institutional qualities. The country nonetheless offers plenty of opportunities in any of the real estate sub-segments for those who are ready to undertake additional risks correctable through leasing, re-development, management and/or recapitalization. And although inefficiencies in the real estate and capital markets by far and large have already been solved, opportunistic stashes that require development activity are still abundant. Given that the most active vendors are bank-affiliated real estate companies, the market also offers quite encouraging pre-conditions for negotiating favourable loan-to-value ratios.

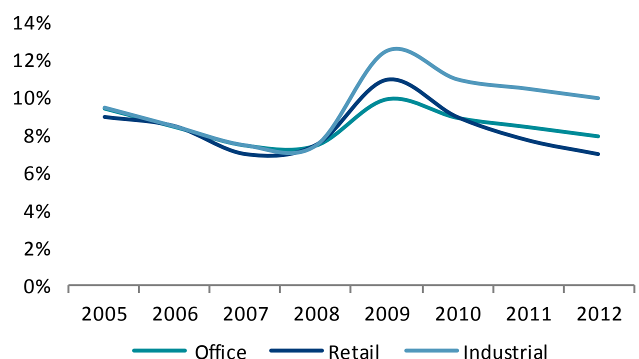
Yields

Given that the absolute majority of recent investment deals on the market involve properties that require additional capital investments and a time of transaction, offer close to none direct cash flow, any speculations about the current yield level on the market are of arbitrary nature.

What nonetheless can be stated with assurance is that the rents in all of the sub-segments have stabilized; year 2013 already promises low to moderate upward pressure in such areas as prime retail schemes, as well as offices in the most demanded locations. Arbitrary yield calculations meanwhile pinpoint towards the following lower boundaries: 10.0% for industrial properties, 7.5-8.0% for office properties, and 7.0% for retail properties.

Figure 2

Yield Dynamics in Latvia



Source: DTZ Research

Investment Market in Lithuania

General overview

In Lithuania, interest in real estate investment opportunities is mainly addressed towards three biggest cities of the country, namely, Vilnius, Kaunas, and Klaipeda.

Investment preconditions on the occupational markets in Lithuania remained fairly stable throughout 2012. The rents in office, retail, and industrial segments remained on the level of 2011; vacancy rates approached their natural levels in industrial sector, dropped by 2-3% in retail segment, and due to new developments, increased on average by 2% in A-class office sub-segment.

Transactions

In terms of purchaser profile, by far and large, the highest interest in real estate investment market in Lithuania comes from German and Dutch investors, where each accounts for approximately 25% of foreign direct investment into real estate properties.

At the same time, real estate investment funds gathering both private and institutional investors under one umbrella are also quite popular. In this respect, a noteworthy development in 2012 was the establishment of €50 M *Lords LB Baltic Fund III* (managed by *Lords LB Asset Management*), which is targeted at capital gains from investments into real estate objects over a long period of time with higher than medium risk tolerance. Following the establishment, the Fund acquired 14,000 sq m *Prisma* shopping centre in Kaunas for €15.7 M.

The presence of Scandinavian capital is also pronounced. Hence the most notable transaction in H2 2012 was the acquisition of 16,000 sq m shopping centre *Gediminas 9* in Vilnius. The property was sold by *Swedbank* affiliated *Ektornet Lithuania SPV 1,* and acquired by Sweden-based closed-end real estate investment fund *East Capital Baltic Property II.*

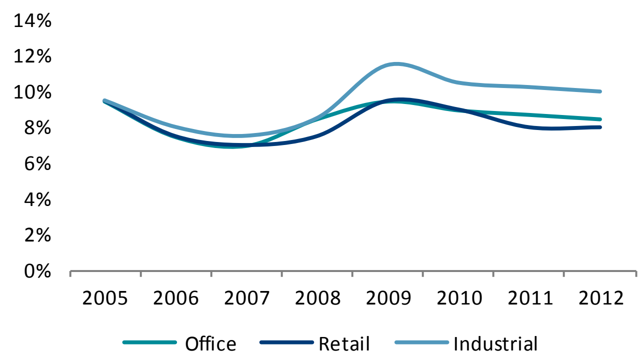
Yields

Due to a small number of investment transactions and little evidence of cash flow from properties sold in 2012, any speculations about the current yield level on the market are of arbitrary nature.

The arbitrary claculations pinpoint towards the following prime yield levels in Lithuania: 8.5% for office properties, 7.75% for retail segment, and 10.0% for industrial segment. The arbitrary yields were on the same level also in 2011.

Figure 3

Yield Dynamics in Lithuania



Source: DTZ Research

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