Investment Market Update
Baltic H1 2013
Transaction volumes are growing again

10 September 2013

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- In 2011, Estonia became the first of the Baltic States to join the Eurozone. Neighboring Latvia is on track to make the same step in January 1, 2014. Despite the setback, Lithuania is still pressing ahead with its second attempt to join the Eurozone, eyeing 2015 as a target date. Although overall, there is a remarkable skepticism towards Eurozone, all three countries follow the Maastricht criteria, which guide the markets to more stable environment.
- After a prolonged period of investors' inactivity, transaction volumes started to rise again in 2011 in each of the three Baltic States. Transaction volumes in H1 2013 were especially high in Estonia, whereas in Latvia and Lithuania volume stayed approximately at the same level.
- The region overall is dominated by local institutional players. Danish *Baltic Property Trust* becomes the most active vendor in the market with *BPT Secura* undergoing divestment process and *BPT Optima* pursuing deleveraging strategy. Institutional investors from Estonia set themselves firmly on course not only in their home country, but also towards neighbouring markets, with two major players*, EfTEN Capital* and *Capital Mill*, expanding into Latvia and Lithuania in H1 2013.
- Due to Latvian real estate market attractiveness to the investors from Russia and CIS, the country is targeted by private investors of the above-mentioned origin, who are ready to undertake higher than average risk profile, and hence direct their capital towards residential, hotel, and development properties.

Baltic H1 2013

Macroeconomic Trends in the Baltic States

Estonia

Although the GDP growth has decelerated in 2013, there is a rather positive outlook for 2014 with the recovery of foreign demand and investments.

According to the second estimates of Statistics Estonia, in 2012 the gross domestic product (GDP) increased by 3.2% compared to the previous year, yet only by 1.1% on a quarterly basis in the first quarter of 2013. In Q1 2013, the GDP at current prices was 17.2 billion Euros. In the 1st quarter 2013, the biggest contribution to the economic growth came from the increase in the value added of information and communication, as well as trade and manufacturing segments. The increase in the value added of trade was supported by the increase of retail sales. According to the forecast of the Bank of Estonia (June 2013), the growth in the Estonian economy will decline in 2013 with domestic demand growth, particularly for investments in fixed assets, dropping to 2%. The slowdown will primarily be caused by one-off factors, and growth will return to its equilibrium level when these factors fade out. In 2014 and 2015, GDP growth will accelerate with support from domestic and external demand to a little over 4%.

The consumer price index (CPI) increased by 3.9% in 2012 compared to the average of 2011. In 2013, consumer price index inflation is expected to decrease to 3.0%. The biggest contributor towards prices' increase in 2013 is electricity, which accounts for around one third of the total change. No rapid increase in the electricity price is expected in 2014 and inflation will slow to 2.5%. The pass-through of wage costs into end prices (for services in particular) will push core inflation up and consumer price growth will reach 2.7% in 2015.

According to Statistics Estonia, the unemployment rate was 10.2% in 2012 and 9.3% in the 4th quarter of 2012, and 10.2% in the 1st quarter of 2013. Generally, situation on the labor market continues to improve. Employment growth is becoming increasingly restricted by the shrinking of the working age population. It means that in the next few years, there may for the first time be a drop in employment with unemployment simultaneously falling**.** Unfavorable demographic situation, influenced primarily by ageing population and emigration, will put labor force participation and the efficient use of labor in an ever more important position.

Latvia

Although Latvia is still recording one of the fastest GDP growth rates across EU, in Q1 2013, GDP data in Latvia goes in line with initial predictions and pinpoints towards a substantial deceleration of the national economy's expansion with an annual increase of 3.6% (as compared to 5.1% in Q4 2012). Such a slowdown nonetheless is not a transient weakness inflicted by country specific factors, but rather a logical consequence that falls along the lines of economic realities across Europe and hence can be more reasonably explained than the previous extraordinary growth rate.

The highest contribution to GDP growth meanwhile comes from the household consumption sector, and yet here, too, development is far from being uniform. For example, the most eminent expansion throughout both 2011 and 2012 was in the sub-segment of computer and telecommunications trade (40-60% increase on an annual basis). Latest figures suggest that this segment has reached its point of saturation, and was replaced by more moderate improvements in other segments of the trade, which nonetheless sum up to the highest household consumption growth rate in the EU and hence forces into questioning the long-term sustainability of such a development.

Latvian GDP growth slowdown therefore is not a short-term phenomenon, and in the next few quarters, will remain similar or even fall further; the annual GDP growth forecast stands at about 2.5%.

Given low inflation rate, Latvian competitiveness nonetheless is still holding, as suggested by the real effective exchange rate, which remained stable ever since recession and has shown signs of improvement from the end of 2012.

Unemployment rate is declining quite rapidly and soon is expected to approach its historic average. Employment increased mostly in domestic sector, whereas export-oriented industries naturally enough are wary of hiring, not only due to shrinking growth figures, but also due to investments into machinery (although at a lower rates than in the previous years) with the anticipated increase in productivity and efficiency, and reduced dependency on labour market. And yet, unless the natural level of unemployment is reduced via structural reforms, wage pressures are likely to become more pronounced (similarly to the current situation in Estonia).

Lithuania

According to the Central Bank of Lithuania, country's economy still exhibits strong growth, yet at a slower pace than in year 2012. In the second half of 2012, exports have risen exceptionally strongly, especially due to a good agricultural harvest and intensive re-export, but currently export growth has decelerated, which have had a direct influence on the economic growth in 2013, which is lower than expected. This is, first of all, related to the further decrease in investment volumes. Compared to other EU countries, in Lithuania, the share of investment in nonresidential buildings and structures contribution towards GDP remains quite large; therefore, a decline in this type of spending substantially contributes to lower general investment. Among the most rapidly decreasing segments is government investment in infrastructure objects.

Between 2009 and 2012, approximately 216,620 Lithuanians emigrated, while 47,228 returned to the country. During 2012, there were 21,257 emigrants, which is 44% less than in the same period of previous year.

According to the harmonized index of consumer prices (HICP), the calculated inflation in April 2013, compared to March 2013, was 0.1%. The average annual inflation in April 2013 was 2.6% (in March, the average annual inflation was 2.8%).

It is projected that real GDP, which in 2012 grew by 3.7%, will rise by 2.8% in 2013. Predictions for 2014 stand at 3.5%. If global price trends continue to be favourable, it can be expected that inflation will be much lower than in several previous years. In 2013, inflation is projected to be 2.0%, while in 2014 - 2.4% per annum.

According to Statistics Lithuania, the unemployment rate decreased in the 2nd quarter of 2013 to 11.7% (it was 13.1% in the March 2013, a year ago the rate was 13.2 percent).

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, 2Q 2012 - 1Q 2013)	17.2	22.4	33.0
GDP per capita (€, 2Q 2012 - 1Q 2013)	12,800	11,100	9,200
GDP growth (%, 2Q 2012 - 1Q 2013)	1.1	3.6	3.5
Inflation rate (%, July 2012- June 2013)	3.8	0.2	2.8
Unemployment rate (%, June 2013)	8.1	11.5	11,7

Source: National Statistics, Eurostat, Oxford Economics

Baltic H1 2013

Investment Market in Estonia

General Overview

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

In Estonia, investment activity in real estate market started to grow in Q2 2010, and remained well-pronounced throughout 2011-2012. The yields 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 rental markets, the yields decreased to approximately 7.7%. H1 2013 and especially Q1 2013 showed high activity on real estate investment market.

Transactions

The year started with three significant transactions completed in January 2013. Hence *Mornington Endla* acquired the office building located in the central part of Tallinn city on Endla Street for €5million. Pan-Estonian OÜ, an enterprise belonging to *Collonna Capital Group,* acquired the portfolio of office spaces owned by *Ektornet* (real estate affiliate of *Swedbank*), which consists of 16 properties across Estonia with the total area of 68,000 sq m. The parties did not disclose the transaction price. *EfTEN Real Estate Fund* acquired the office buildings of *Eesti Energia* located in Mustamäe district through the public auction. Transaction prices were €7,2 M and €1,65 M. *EfTEN Real Estate Fund* also purchased *Prisma Peremarket* retail property in Narva for an undisclosed price.

Other investments made by *EfTEN Real Estate Fund* in H1 2013 include acquisition of the property and operator of the hotel *Palace* in a joint investment with *Esraven AS* (part of *Silikaat Group*), which on the seller's side is the exit of *Scandic Hotels AS* from Estonian market. The acquired hotel is rated 4 stars and located in the heart of Tallinn at Vabaduse väljak. Transaction price remained confidential.

Early in July 2013, the fund also acquired industrial portfolio from *Baltic Property Trust (BPT).* The portfolio includes building of hardware store *K-Rauta* in Tallinn, the industrial building of *Hanza Mechanics* in Tartu, logistics facility of *Logistika Pluss* in Tallinn, *Mediq* warehouse property in Saue near Tallinn, and *Stora Enso* industrial building in Saku near Tallinn.

Baltic Property Trust meanwhile acquired the retail and cinema complex *Coca-Cola Plaza* in Tallinn in March 2013 for €11.9 M under *BPT Baltic Opportunity Fund* and disposed a portfolio of 4 commercial properties as part *BPT Secura* divestment process. The properties were acquired by *Capital Mill*; the portfolio includes office centre in Tallinn on Rävala Street, logistics centre in Tallinn on Vedru Street, as well as one property in Vilnius and one property in Riga. Total area of the portfolio amounts to almost 50,000 sqm.

In April 2013, *Kawe Group* acquired property in the centre of Tallinn at 1 Tatari Street in the immediate vicinity to Vabaduse väljak for €3 M. The acquisition was made under brownfield investment strategy, with the intention to replace the existing buildings with a modern energy-efficient office building.

Yields

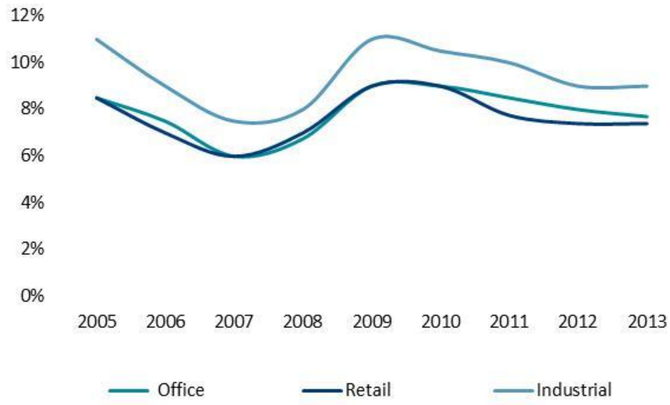
Historically, investment yields fell dramatically in 2006-2007, becoming comparable to those in Northern and Western Europe. In 2008, the yields increased by 150-250 base points, whereas 2009 added a further 50-100 base points to the yield level. 2010 was a stable year, whereas in 2011, the yields in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

Throughout H1 2013, 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), a trustworthy lessee, and a guarantee from a bank or from a mother-company. The lower yield limit for retail properties stands at around 7.4%, whereas for office properties at around 7.7%.

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

Figure 1

Yield Dynamics in Estonia



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Investment Market in Latvia

General Overview

In H1 2013, the total real estate investment market turnover in Latvia exceeded 100 M EUR, which is more than double the annual turnover figure in 2012. More than 90% of the total investment volume was injected into the capital city Riga. The scope of acquired properties meanwhile was very diverse, ranging from empty land plots for development, reconstruction and refurbishment investments, to A-grade office buildings.

In terms of purchaser profile, the trend was twofold. On one hand, institutional investors from Estonia sets themselves firmly on course towards neighbouring markets, with two major players, *EfTEN Capital* and *Capital Mill*, expanding into Latvia in H1 2013. On the other hand, the biggest share of foreign capital contribution to real estate market still comes from private individuals or privately owned enterprises from Russia and CIS countries. Domestic purchasers meanwhile are moderately active in small-scale investment segment, and usually acquire the properties that cannot be treated as real estate investment objects, but rather as owner-occupied small enterprises.

On vendors' side, similarly as in 2012, the biggest market share belongs to the real estate companies affiliated with the banks (ex., *Ektornet* (Swedbank), *Latectus* (SEB)). Another major vendor from the end of 2012 is *Baltic Property Trust*, managing *BPT Secura* fund, which originally contained 11 properties across three Baltic States and is currently in exit with two properties sold in 2012 and four properties sold in 2013 (one in Riga, one in Vilnius, and two in Tallinn). Another fund managed by the same company, *BPT Optima,* is also in the process of disposal as part of overall deleveraging strategy of the fund with two retail properties sold in Estonia and one office building sold in Vilnius. At the same time, *BPT Baltic Opportunity Fund* is actively investing in the region through the sale-lease back transactions (*SKY* supermarket acquired in Riga at the end of 2012).

Transactions

Almost half of the total market turnover in H1 2013 comes from two major transactions, of which the first is disposal of residential complex *Panorama Plaza* (the property includes one residential tower with 120 apartments, one residential tower which is still under construction and a land plot with technical project for the development of additional residential tower) by *Ektornet Latvia* to the investor of Russian origin (price of the deal undisclosed). The second transaction is the disposal of A-grade office building *Valdemara Center* by *BPT Secura* to Estonian *Capital Mill* (price and yield of the deal undisclosed).

EfTEN Capital expanded into Latvia by acquiring land plot for retail development in Jelgava (pre-lease agreement with anchor tenant *Rimi*), followed by an acquisition of an office building in central part of Riga city (Stabu Street 10) that requires additional investments into renovation from *Ektornet Latvia*.

Other major transactions (€2-10 M) include capital inflows of Russian and CIS origin into the following properties: entertainment centre (casino, restaurant, night club) in the central part of Riga city (Terbatas Street 2); B-grade office buildings in central part of Riga city on Alunana Street 2 and on Raina Boulevard 11; residential building in Riga centre on Elizabetes Street 3; medical centre in Riga Old Town on Grecinieku 34 (acquired through the public auction); acquisition of small-scale boutique hotel *Vecais Kapteinis* in Riga district Marupe.

Other major deals in H1 2013 is acquisition of the former headquarters of *Rietumu banka* on Brivibas Street by *Latvijas Pasta Banka* for €7 M; disposal of residential development project on Miera Street by *Latectus* to *Pillar 12* for €2.4 M (real estate company affiliated with the *Aizkraukles Banka*).

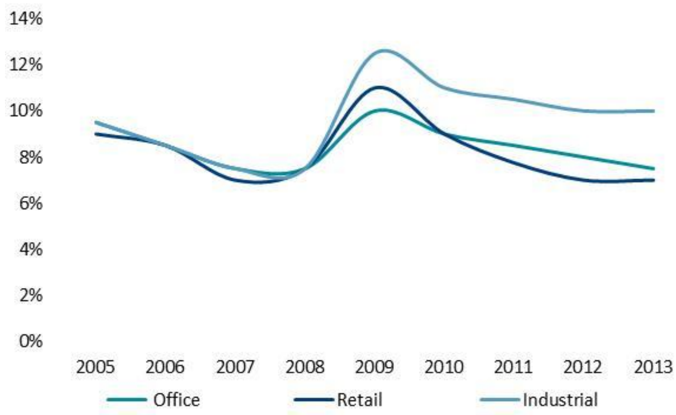
Yields

Given that the majority of recent investment deals on the market involve either residential properties or properties that require additional capital investments and a time of transaction, offer not optimized 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 there exist low to moderate upward pressure in such areas 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 H1 2013, Lithuanian real estate investment market exhibited sustained stabilization qualities, and hence increased in total investment volumes. The interest was mainly addressed towards Vilnius; however, smaller scale investment activities also appeared in such cities as Kaunas, Klaipėda, and Druskininkai. While the largest real estate portfolios in Lithuania are held by international players, such as *Baltic Property Trust (BPT), East Capital, Citycon, EEREIF, Homburg, Deka Immobilien* and local fund *Lords LB*, in H1 2013, the most active players in investment segment were *East Capital, BPT Asset Management and Lords LB Asset Management.*

BPT Asset Management operates four property funds across the Baltic States. While one of the funds (*BPT Secura*) is already undergoing the divestment process, recently established *BPT Baltic Opportunity Fund* is still open for applications from new investors and is planning to allocate the funds into 10 properties across the three countries. Two of the properties have already been acquired, whereas the total portfolio size is expected to reach €100 M and generate up to 25% per annum.

During H1 2013, the rent rates in shopping centres, offices and industrial properties fluctuated and generally, exhibited a slight increase. The vacancy rates slightly dropped in shopping centres, and reached their natural levels in industrial sector. Average vacancy rates in modern (A-class) office segment increased by 2-3%.

Transactions

Listed Finnish property company *Technopolis* has completed the purchase of a 43,000 sqm office complex in Vilnius for nearly €63 M. The asset was acquired from the local group *Icor*. The complex consists of two fully let existing buildings with a rentable area of 31,200 sqm, as well as a third asset which is currently under development and is expected to be completed in October 2013. The new development would introduce additional 11,000 sqm of office space into the market and currently is already pre-let at a rate of 76%. The net market yield of the investment is 8.2%, whereas the net initial cash flow based yield is 7.6%. As a result of the acquisition, *Technopolis* is updating its 2013 net sales and EBITDA growth guidance from 9-12% to 14-17%.

In April 2013, *BPT Optima* disposed *BPT Business Centre* as part of overall deleveraging strategy. The property enjoys A-grade location on Goštauto Street in Vilnius and was acquired by *BPT* back in 2007. The property was recently refurbished and is currently anchored by the Lithuanian affiliate of the international PR company *Hill & Knowlton*, which occupies more than 70% of the rental area of the building on a long-term lease contract. As part of *BPT Secura* divestment process, 20,600 sqm *Zariju Logistics Centre* in Vilnius was sold to Estonian real estate fund *Capital Mill* in Q1 2013. *Žariju Logictics Centre* is currently fully occupied by a single tenant, food retailer *Maxima*.

The total investment volume in H1 2013 amounted to approximately €80 M.

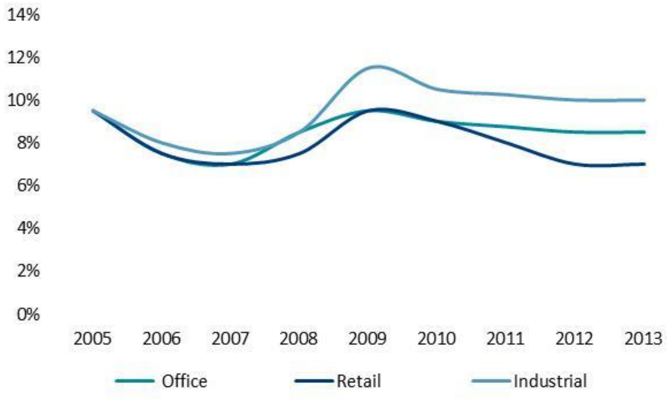
Yields

With a rather limited number of transactions and very limited evidence of cash flows from properties sold in H1 2013, the yields are representative of the overall expectations, rather than reflect particular trends. The ‚low-end' yields in industrial and logistics segment start from 9.5% under the assumption of a good quality property with a long term rental agreement (usually sale - lease back deals), a trustworthy lessee and a guarantee from a bank or from a mother company. The lowest yield for retail are expected to stand at around 7.0%, whereas for office properties at around 8.0%.

The average prime yields meanwhile stand at 8.5% for office properties, 7.75% for retail properties, and 10.0% for industrial properties. Prime yields remained stable in H1 2013.

Figure 3

Yield dynamics in Lithuania



Source: DTZ Research

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