PROPERTY TIMES

New Production Exceeds Historical Absorbtion

Baltic Office Q3 2015

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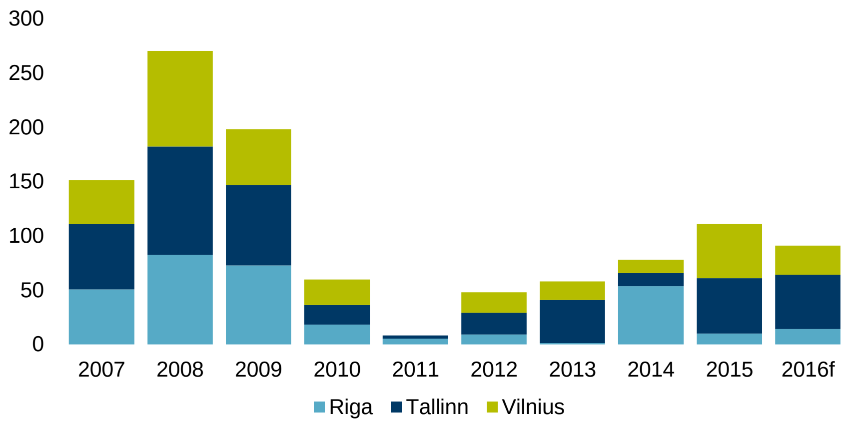
Contents

- Relatively active development of offices continues in 2016-2017 in all three Baltic capital cities. There are still newcomers although the projects announced so far exceed quite a lot new production which has been absorbed historically.
- While Vilnius is the most aggressive in tense of new deliveries, Tallinn and Riga also follow high development activity. As the projects are partly speculative the risks related to growing vacancies exist.
- The rents have been stable or some relatively small increase has been noticed in all markets.
- With investment activity increasing in office segment, property yields are subject to decrease, especially in the long-term perspective.

Figure 1

New built office space in Riga, Tallinn and Vilnius, GLA, 000 sq m



Source: DTZ Research

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Macroeconomic Trends in the Baltic States

Estonia

The annual GDP growth in 2014 was 1.8%. The GDP of Estonia increased 0.5% in the 3rd quarter of 2015 on annual basis. Economy grew in 2014 mainly with support from the domestic market, though the market share of Estonian goods and services in partner countries has also increased. Rapid growth in production from manufacturing and slightly more optimistic expectations for output indicate that economic activity continues to increase. Estonia is in a different phase of development from ten years ago and sustainable growth over the long term is 3-4%. Estonian GDP will increase 1.7% in 2015 and 2.6% in 2016.

The consumer price index (CPI) decreased 0.1% in 2014 compared to the average of 2013. The annual change of the consumer price index was mainly influenced by the 6.2% price decrease of electricity that arrived at homes. The increase in the prices of alcoholic beverages (6.7%) and tobacco (3.1%), and the 3.8% decrease in motor fuel prices also had a bigger impact on the index. The change of the consumer price index in September 2015 was -0.7% compared to September of the previous year. Consumer price inflation went below zero in June 2014 for the first time since the crisis. The inflation will pick up in the next two years, but it will remain subdued. Higher labour costs will make the prices of domestic goods and services rise faster than those of imported goods and services. The CPI will be -0.3% in 2015 and 2.0% in 2016.

The unemployment and employments rates were accordingly 7.4% and 63% in 2014. Compared to the highest unemployment rate of the last decade (16.7% in 2010), unemployment has decreased more than twice. Unemployment has decreased and employment has increased since 2011, but these changes have gradually slowed down.

Source: statistics- Statistics Estonia, forecasts- Ministry of Finance (September 2015)

Latvia

The annual GDP growth in 2014 was 2.4%. Similar growth has characterized current year, in Q3 2015- GDP increased by 2.5% on annual basis. Compared to previous quarter, GDP has risen by 1.2% that is the fastest growth rate since Q3 2013. Growth has been stimulated by continuously expanding domestic consumption, as well as by improvements in export-oriented manufacturing. GDP growth 2.7% in Q2 2015 is a good achievement taking into account the complex geopolitical situation that will remain the main negative risk for further economic growth. Latvian GDP will increase by 2.1% in 2015 and 3.0% in 2016.

The average annual inflation of 2014 was 0.6%, which is one of the lowest levels in a growing economy in Latvia, and it was caused to a large extent by external factors - mostly sustained by the global prices and postponement electricity market liberalisation until 2015. It is expected that inflation will remain weak until the end of 2015 when impact of oil price decrease that started at the end of 2014 wanes. The CPI will be 0.8% in 2015 and 2.0% in 2016.

Unemployment in Latvia continues on a downward trend. In Q2 2015, unemployment rate fell below 10% level for the first time since 2008 and declined to 9.8% that is by 0.9 pp lower than a year ago. With the pace of economic growth employment will approach its natural level.

Source: statistics- Central Statistical Bureau of Latvia, forecasts- Ministry of Finance (July 2015)

Lithuania

The annual GDP growth in 2014 was 3.0%. The GDP of Lithuania increased 1.8% in the 3rd quarter of 2015 on annual basis. The growth of the domestic economy has decelerated due to the challenging external environment. Lithuania's exports to Russia fell by approximately one-fourth in the first months of this year as a result of economic deterioration in Russia. The fall of exports to Russia have substantial negative repercussions for the transport sector. Another segment of the tradable sector, i.e. industry, appears healthier as the country's manufacturers export the bulk of their output to the European Union's (EU) markets. Manufacturing performance is also supported by domestic demand. Domestic demand remains the key factor of economic growth in the country, with the biggest contribution coming from private consumption, which has been growing amid gradual increase in household income and non-increasing saving as household expectations remain robust. Private consumption is expected to continue strengthening consistently as the growth of wages and employment will augment household income. Lithuanian GDP growth in 2015 foreseen to be 1.6% and 3.2% in 2016.

The consumer price level remains below the one observed a year-earlier, mainly due to a slump in prices for energy commodities. Global oil prices have increased somewhat in recent months, but not enough to offset the fall recorded in the second half of last year. Oil prices are kept lower by both weak demand for this energy commodity and by a supply glut. Hence this fall in crude oil prices is likely to be longer-lived. Stripping out energy costs, the growth of consumer prices has been marginal. The average annual inflation will be -0.3% in 2015 and 1.6% in 2016.

The current unemployment rate is quite close to its estimated natural level, which suggests a slowdown in both unemployment decline and employment growth in the future. Lithuanian unemployment rate in 2014 was 10.7%.

Source: statistics- Statistics Lithuania, forecasts- Bank of Lithuania (September 2015)

Table 1

Key Macroeconomic Indicators

	Estonia	Latvia	Lithuania
Population (in thousands)	1,315	2,002	2,943
Urban population	68%	68%	67%
Area (thousand km²)	45	65	65
Population density (per km²)	29	31	45
Capital city	Tallinn	Riga	Vilnius
Population in capital cities (thousand)	411	643	529
Currency	€	€	€
GDP at current prices (€ bln, 2014)	19.1	24.1	36.3
GDP per capita (thousand €, 2014)	14.53	12.04	12.34
GDP growth (%, 2014)	1.8	2.4	2.4
Inflation rate (%, 2014)	-0.1	0.6	0.2
Unemployment rate (%, 2014)	7.4	9.0	9.1

Source: National Statistics

Estonia

The biggest office stock is in Estonian capital city Tallinn, some limited office markets are also in secondary cities Tartu and Pärnu.

Tallinn

Office market in Tallinn is historically mainly gathered to the city centre. However, more and more office buildings have been developed in commercial areas next to larger roads and crossings outside the city centre. There are four main office areas – City Centre, Kristiine-Mustamäe, Järve-Tondi and Ülemiste City. Ülemiste City is located in the immediate vicinity of the airport in the territory of the former military factory Dvigatel. It is a modern environment with large number of innovative enterprises. It covers 36 hectares area and is based on concept of the Smart City. The development began in 2005. There is all together around 80,000 sq m of modern office space and 120,000 sq m of industrial and warehouse space. About 200 companies with approximately 6,000 employees operate in Ülemiste City today.

Until the end of 2015 total area of modern office space in Tallinn was approximately 676,000 sq m (the premises used by the state and local governments are not included). Ca 36,000 sq m new space will be added until the end of 2016 and quite similar amount in 2017.

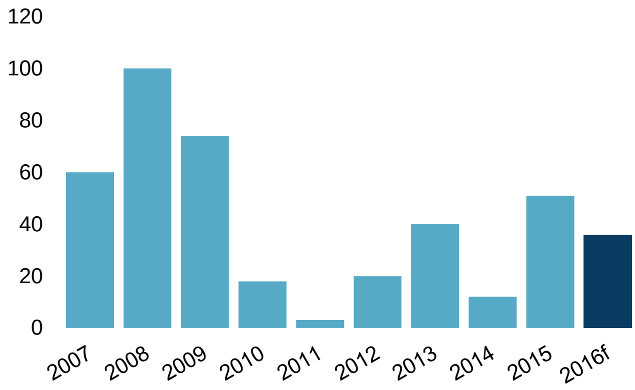
There are several office buildings in the pipeline in suburbs and moderate centre.

- The office building at 102B Pärnu Road in Central District with lettable area 1,900 sq m should be completed by the end of 2015;
- The office building Numeral at 15 Endla Street/ 2 Lõkke Street in Central District with office space ca 6900 will be fully renovated in 2016;
- The office building Norra Maja at 24 Veerenni Street in moderate centre with lettable area 7,700 sq m should be completed in 2016;
- The office building Öpiku Maja at 8 Valukoja in Ülemiste City with office space 14,800 sq m should be completed by the autumn 2016;
- The office building Explorer at 1 Kai Street with lettable area 6,700 sq m should be completed in Central district in 2016;
- The office building at 25 Tartu Road with area 4,400 sq m should be completed in Central district in 2016;
- The office building at 18 Pärnu Road with lettable area 2,100 sq m should be completed in Central district in the autumn 2016;
- The office building Büroo 83 at 83 Tartu Road with area 6,400 sq m in the area between the city centre and airport should be completed in 2017;
- The office building of Eesti Telekom at 3 Mustamäe Street with the area 9,000 NLA sq m should be completed in Kristiine district by the spring 2017;
- The office building Tehnopol 2KV at 2 Mäealuse Street in Mustamäe district close to Tallinn Technical University with lettable area 7,400 sq m should be completed by the end of 2017;
- The office buildings at Piima 6 and 8 with area ca 15,000 sq m should be completed in 2017.

Moderate increase of rental fees has taken place during some last years. It is related especially to the top rents. Prime rent is 15.5 €/ sq m pcm, the highest rents in new office buildings in the city centre completed 2014/15 are up to 16 €/ sq m pcm or even higher. However, those are rather exceptional cases. The overall average vacancy rate among office buildings is 7-8%. Vacancy in CBD and in a few most popular office buildings in vicinity of city centre is clearly below 5%.

Figure 1

New built office space in Tallinn, GLA, 000 sq m



Source: DTZ Research

Table 2

Average rental level in Tallinn, EUR/ sq m pcm

	A	B	C
City Centre	11.5 – 16.0	7.0 – 10.0	-
Suburban	9.0 – 14.0	4.0 – 8.0	3.0 – 4.0

Source: DTZ Research

Map 1

Office districts in Tallinn

Source: DTZ Research

Table 3

No on the map	Name of area
P1	Area in City Centre, including CBD
P2	Kristiine-Mustamäe
P3	Järve-Tondi area
P4	Ülemiste area

Source: DTZ Research

Office areas in other cities

There are two other cities Tartu and Pärnu having remarkable office stock. Those markets are much smaller and less matured compared to Tallinn but some modern office buildings have been built in these cities.

Office properties in Tartu are mostly clustered in the city centre and its close surroundings, as well as in Karlova, Veeriku, Vaksali, Ülejõe, Ropka districts and Ropka Industrial Park. A-class office space is offered at the level of 7- 15 EUR/ sq m pcm and B-class at the level of 5- 8 €/ sq m pcm. Rental levels for less attractive quality and location are much lower.

The main business districts in Pärnu are the city centre, its close surroundings and Papiniidu district. These areas accommodate not only the office buildings, but also the other types of commercial properties. The total amount of modern office space in Pärnu is ca 50,000 sq m. Only 20% of this space is located in built-on-purpose office buildings, constructed 1998-2003. A-class office space is offered at the level of 5.5 – 8.5 and B-class at the level of 3.0 – 5.0 €/ sq m pcm.

Forecasts for Q4 2015- 2016

- For the existing and well established properties the nearest future will be stable with no substantial changes in occupancy rates. The rents will be kept within the current brackets because of extensive development pipeline;
- The problems in sense of growing vacancies and falling rents can arise rather in old buildings and poor locations;
- The prime yields are expected to decrease slightly because of external influences and general trends in European property markets.

Latvia

The biggest office stock is in Latvian capital city Riga, the office market in secondary cities is rather limited.

Riga

River Daugava divids Riga in two main areas– right bank of Riga with CBD of top of it and left bank of River or Pardaugava area. Office market in Riga shows positive trends as the vacancies have been decreased quarter by quarter. Local and international finance and IT companies need the space for relocation to better price performance premises with main focus on quality and location. Newcomers are usually related to IT segment and Riga is like a back-office place for their operations in the other countries.

Most demanded location for international tenants is still Riga center but a lack of available large office premises and parking possibilities give positive impact to B-class buildings located in other neighbourhoods of Riga.

In the middle of 2015 total area of modern office space in Riga was approximately 560,000 GBA sq m of which only 20% are A-class offices; nearly 80% of these A-class office premises are built-to-suit banking headquarters.

There are several office buildings in the pipeline in suburbs and CBD:

- Hanner– A-class office building in Skanstes area, Sporta street 11 with ~14,000 GBA sq m is expected to be completed in 2016;
- Z-Towers is multifunctional building with residential and office premises in “Kipsala” area. Construction works are still ongoing and expected to be completed at the end of 2017;
- ELL will develop an A-class office building on Skanstes area, Skanstes street 25/27 with 2 towers ca ~23,000 GBA sq m. Another A-class office building in ELL development plan is on Remtes street 26 besides shopping center “Spice” with ~10,000 GBA sq m. Both projects are expected to be completed in 2017.

Moderate increase of rental fees has taken place during some last years. It is related especially to the top rents. At the moment prime rent for A-class offices is 16.0 and for B class upper level is 12.0 EUR/ sq m pcm.

The overall vacancy rate among office buildings is ca 5%. It can reach to 10% in certain buildings but it is limited to few office buildings. Vacancy is significantly higher in older buildings as the tenants have moved to new premises.

Investment market of commercial properties has been active in 2015. However, the office market is not the most attractive for investors because of limited size and liquidity. The prime yields have been compressed in all sectors and office prime yields are currently at the level of ca 7.0%.

Map 2

Office districts in Riga

Source: *DTZ Research*

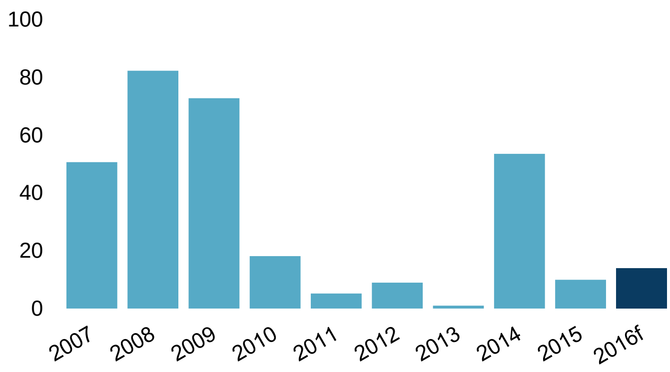
Table 4

No on the map	Name of area
P1	Pārdaugava
P2	Pārdaugava Periphery
P3	Airport area
P4	Central area
P5	Skanste Street district
P6	Right Bank area
P7	Krasta Street area
P8	Mezaparks

Source: *DTZ Research*

Figure 3

Office space dynamics in Riga, GLA, 000 sq m



Source: DTZ Research

Table 5

Average rental level in Riga, EUR/ sq m pm

	A	B	C
City Centre	14.0 – 16.0	9.0 – 12.0	4.0 – 6.0
Suburban		6.0– 8.0	3.0 – 4.0

Source: DTZ Research

Forecasts for Q4 2015 and 2016

- Trend to relocate to better quality buildings will continue;
- Demand for large scale area will be outstanding in the nearest years;
- Rent rates are expected to increase only for buildings with modern and energy efficient technical solutions;
- The prime yields are expected to decrease slightly because of external influences and general trends in European property markets.

Lithuania

The biggest office stock is in Lithuanian capital city Vilnius, the other remarkable office markets are in secondary cities Kaunas and Klaipeda.

Vilnius

The total area of modern office space in Vilnius amounts to ca 400,000 sq m of which almost one third are A+ and A class premises, primarily distributed between Business Triangle (11% of the total office stock) and New City Centre (17% of the total office stock) districts. B-class office buildings stretch along major city roads outside city center, namely Ukmerges Street, Kalvariju Street and Pilaites Avenue, B-class business cluster is located in Naujamiestis city district.

During 2009-2010 the office market was faced to situation with no demand for the offices outside of CBD. There were no new construction in 2011. Situation has been changed and currently there is active development in the New City Centre and its vicinity.

Ca 28,000 sq m will be added until the end of 2015 and up to 45,000 sq m during 2016.

There are several office buildings in the pipeline in New City Centre:

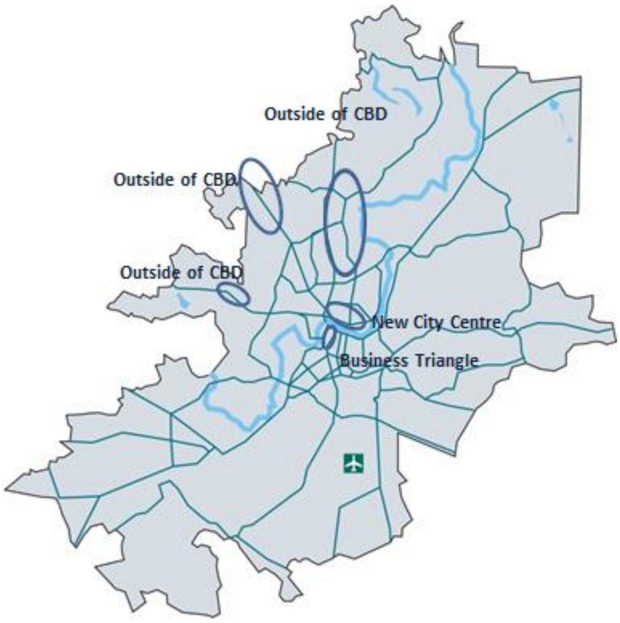
- Konstitucijos Avenue 29 – K29 with lettable area 14,000 sq m should be completed by the end of 2015;
- Sporto Street 18 a new office building with lettable area 8,400 sq m should be completed by the end of 2015;
- Gostatuto Street 12A a new office building with lettable area 6,000 sq m should be completed by the end of 2015;
- Konstitucijos Avenue 21 – Quadrum with lettable area 40,000 sq m should be completed by the end of 2016;
- Narbuto Street 5 a new office building with lettable area 5,000 sq m should be completed by the end of 2016;
- Zalgirio Street reconstruction and extension of existing B-class office building City with lettable area 20,000 sq m should be completed by the end of 2016;
- Zalgirio Street 138 a new office building with lettable area 8,000 sq m should be completed by the end of 2016.

Investment market of commercial properties has been active in 2015. However, it is less active compared to 2014 when three office properties with total area of 84,000 sq m were sold. In 2015 office building Vertas was sold as a part of bigger portfolio that included properties in Lithuania, Latvia, Estonia and Poland. The prime yields have been compressed in all sectors and office prime yields are currently at the level of ca 7.0 - 7.5%.

Moderate increase of rental fees has taken place during some last years. It is related especially to the top rents. The rent is 14.5 – 15.0 €/ sq m pcm, the highest rents in new office buildings in the New City Centre.

Figure 4

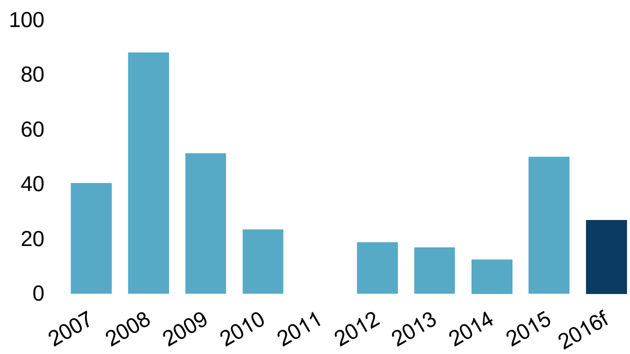
Office space dynamics in Vilnius, GLA, 000 sq m



Source: DTZ Research

Figure 4

Office space dynamics in Vilnius, GLA, 000 sq m



Source: DTZ Research

Table 6

	A	B	C
City Centre	12.0 – 15.0	7.0 – 10.0	-
Suburban	9.0 – 12.0	6.0 – 9.0	4.0 – 6.0

Source: DTZ Research

The overall average vacancy rate among the office buildings is 10 - 12%. Vacancy is significantly higher in older buildings as the tenants have moved to new premises. Vacancy in most demanded areas is marginal; in CBD and in a few most popular office buildings in vicinity of city centre is clearly below 3%.

Office areas in other cities

Kaunas

By the end of Q3 2015 the total area of modern office space in Kaunas amounted to ca 56,000 sq m. The highest locally-generated demand is for 20-50 sq m premises; the supply of that type of space is limited. The rents have grown up slightly throughout the period and range between 8.0 – 10.5 €/ sq m pcm. Vacancy rates vary between 7-20% across separate properties some decrease is foreseen. Construction of 14,000 sq m office building in Donelaicio Street is in the pipeline.

Klaipeda

By the end of Q3 2015 the total area of modern office space in Klaipeda amounted to ca 47,000 sq m. Recently there have not been any new construction. It is planned to build 2,500 sq m office building on Minijos Street. The vacancy rate has increased. It is different situation compared to Vilnius and Kaunas. The vacancies are currently ranging between 10-20% across separate buildings. The rental rates in high quality business centres vary between 6.0 - 10.0 €/ sq m pcm.

Forecast

- Taking into consideration developments in the pipeline increase of rental price is not foreseen;
- Two developments in the pipeline are fully covered with pre-let agreements but the vacancies are still expected to increase;
- Growing vacancies and falling rents are related to older buildings and poor locations;
- The prime yields are expected to decrease slightly because of external influences.

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