CZECH REPUBLIC

MARKET OVERVIEW

QUARTER 1 | 2019

ECONOMIC OVERVIEW

Q1 2019 Overview

The Czech economy expanded at a 2.5% pace in the first quarter of 2019, according to the first CSU data release. Presently, this resilience in GDP growth is probably the most important macro factor for commercial real estate players to consider. Yet again, domestic consumption and retail sales, the latter averaging 4.8% year-on-year growth in the first three months of the year, were a driver. More surprisingly, fixed capital formation in industry also contributed to the GDP growth holding up. This data belie the weakness in industrial production, which averaged only in a marginal 0.1% expansion in the quarter, according to the monthly data releases. Will these trends continue?

Aiding consumption growth is very low unemployment and consequent wage growth. The unemployment rate touched 2.7% at the end of April, at the lowest level since 1997. It is below 2% in some districts, especially those connected with car manufacturing, Rychnov nad Kněžnou in the proximity of one of Škoda Auto factories has a rate of just 1.2%.

A low unemployment rate leads to wage growth: CSU data shows the average wage in private sector was CZK35,040 per month (approx. €1,363) in Q4 2018 and CZK37,035 (€1,441) in the public sector. These were 8% and 6% higher than the year before. We believe wage growth will slow to a rate of around 5% in 2019.

All of the above has contributed to relatively high consumer confidence but expectations are worsening. We see this in the consumer confidence indicator, which slid to 103.8 points in April, registering the worst result since July 2016. Consumers appear afraid of a deterioration in the overall economic situation in the short term and especially about the rising prices of food, fuel and general household cost and maintenance.

Those price increases are evident in consumer price inflation, which hit 3.0% year on year at the end of March, ticking down to 2.8% year on year in April. These readings prompted the Czech National Bank (CNB) to increase the base policy interest rate to 2.0% at the beginning of May, after a hiatus of 5 months without a hike.

Outlook

The over reliance of Czech economy on manufacturing and especially on the automotive sector is a risk for the future growth of GDP, especially as the demand for classical vehicle purchase in Europe is shifting towards new modes of transport – hybrid or electric, to which the local manufacturing base has not yet adjusted.

With consumer confidence slowly deflating and higher interest rates trimming demand, we expect a slowdown in household consumption, which was to date one of the chief drivers of GDP growth. A slowing of global trade flows, the trade “war” between the US and China and potential trade conflict between the USA and the EU are all important to the direction of travel for the “open”, trade-dependent Czech economy

FIGURE 1: **INFLATION RATE & UNEMPLOYMENT (%)**

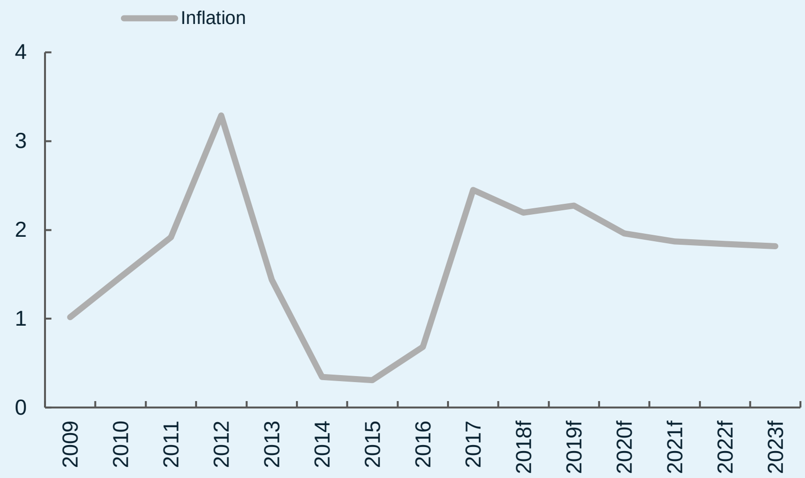


FIGURE 2: **GDP GROWTH & FORECAST**

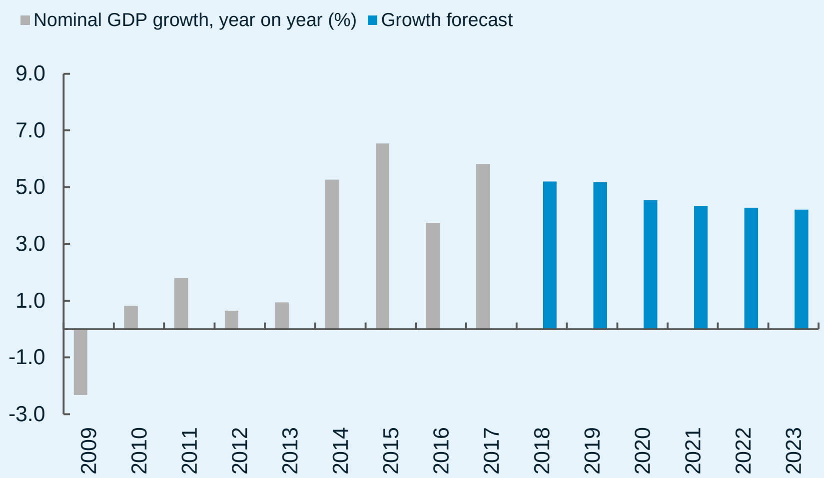
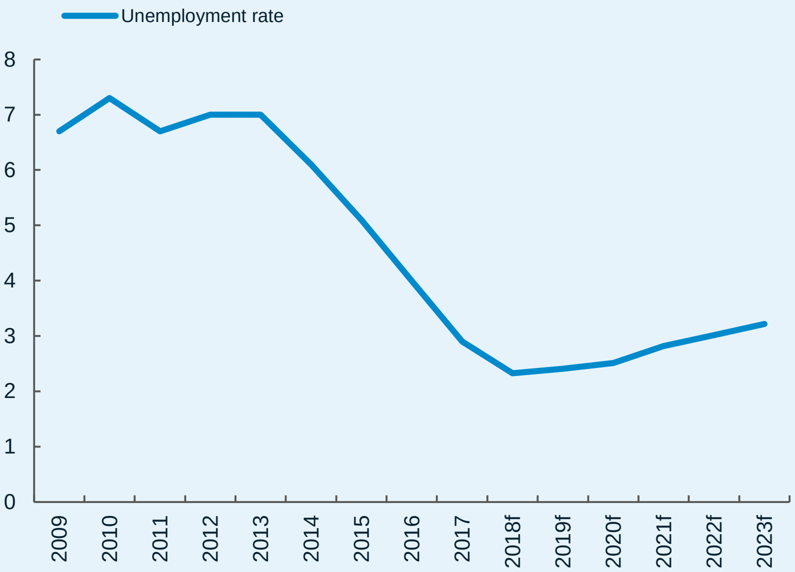


FIGURE 3: **UNEMPLOYMENT RATE (%)**



Sources: Figures 1-3: Focus Economics

INVESTMENT MARKET

Q1 2019 Overview

2019 started with a strong first quarter, for which overall investment volumes exceeded EUR 1 billion. This was in part thanks to two large transactions in excess of €200 million, which were closed in Q1: the sale of the Waltrovka office scheme to Korean Hanwha Investment & Securities for €255 million and the sale of the Intercontinental hotel to the Czech R2G group for €225 million.

The inflow of Korean investors, which started at the end of last year, contributed to further compression of prime office yields to the current 4.5%. These Korean investors capitalised on the positive exchange rate effects between the KRW and the EUR and also the more attractive yields in CEE vs W.Europe.

In terms of capital origin, local investors continued to dominate the market with a 35% market share. The purchase of Waltrovka positioned Korean investors into second place with a 24% market share. The traditionally strong German investors were third with 10%. On the other side of the sales, Czechs were also the biggest vendors with a 37% market share, followed by Slovaks (22%), Germans (18%) and the Brits (15%).

The office sector was dominant with a 49% share on total investment volume (37% based on the total number of transactions). The second strongest sector was hotels, mainly driven by the sale of Intercontinental. The retail and the industrial sectors remained relatively subdued with a 4% and 2% share respectively. In retail we see a limited potential for significant improvement as the majority of the assets on the market are currently either retail parks (with lower lot sizes) or secondary assets in regional cities.

OUTLOOK

After the strong first quarter of the year and with pipeline transactions in excess of at least €1.5 billion, we expect the overall investment volume for 2019 to exceed the figures achieved in 2018. However, the record breaking years 2016 and 2017 will not be beaten this year.

Despite the signs of economic and geo-political clouds and the wider world and European-wide commentary that we are the peak of the economic cycle, the tenant market in the Czech Republic remains very strong across all sectors. Moreover, as the weight of capital from competing capital sources remains high for the best assets, it now looks more likely that there will be some further yield compression.

> *The inflow of korean investors contributed to further compression of prime office yields to current 4.5%.*

Andy Thompson | Head of Investment, Czech Republic & Slovakia

FIGURE 4: **INVESTMENT VOLUMES IN THE CZECH REPUBLIC**

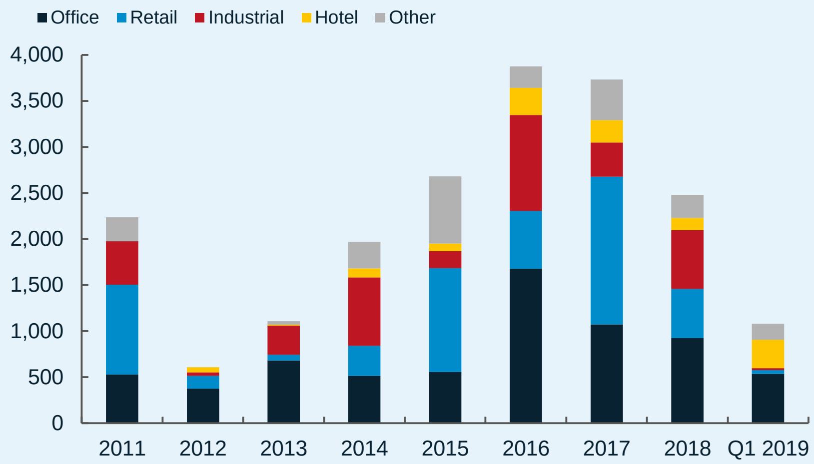


FIGURE 5: **INVESTMENT SHARE PER COUNTRY ORIGIN OF BUYERS AND VENDORS**

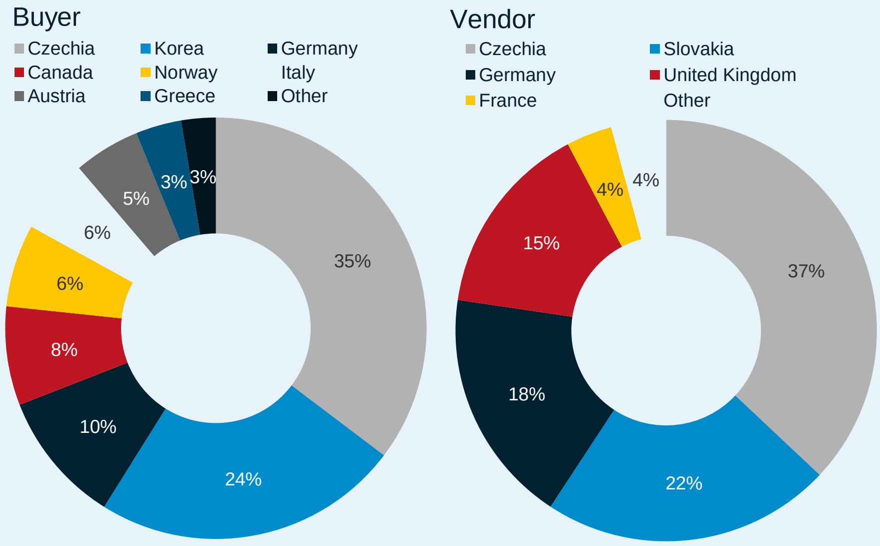
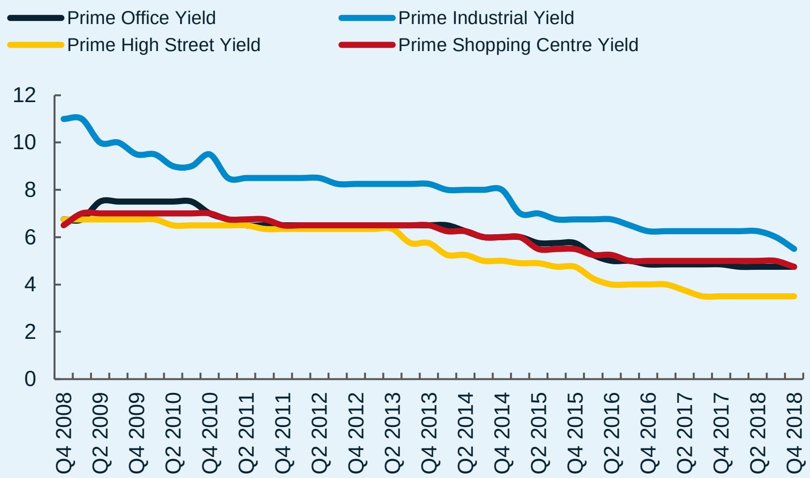


FIGURE 6: **PRIME YIELDS (%)**



Sources: Figures 4-6: Colliers International

OFFICE MARKET

Supply & Vacancy

In Q1 2019, total office stock in Prague reached 3.51 million sq m with some 28,100 sq m added during the first quarter.

New completions include two new properties: Rustonka R3 in Prague 8 with 12,900 sq m of office space and Churchill I in Prague 3 with 15,200 sq m. By the quarter end, the average occupancy of these properties exceeded 91%. That confirms strong start to the year, with overall vacancy rate in the city reaching once again a historical record low with 4.3%. That is an 80 basis points decrease on previous quarter and represents only 152,600 sq m of vacant space spread across the city in commercially let modern office buildings. From previous quarter, the vacant space decreased by 35,000 sq m. Although larger share of the vacant space (64%) is located in Class A buildings, this is lower share than their share on overall office stock (71%).

Demand

Gross take-up in Q1 2019 reached 95,200 sq m, up 16% year on year. Net take-up was identical to the same period of last year with 70,500 sq m.

Quarterly net absorption was similar to net take-up with 70,600 sq m and was the highest since Q4 2015, when it exceeded 80,000 sq m. This further confirms strong demand on the market.

Despite the low vacancy rate, pre-leases took only 15% of the gross demand and surprisingly renegotiations were only 26% of the gross take-up. With decreasing vacancy rate we expect the share of renegotiations to start growing.

RENTS & OUTLOOK

Rents

Prime rents in the City Centre of Prague stand in the range of €21.50-€22.50, Inner City prime is at €15-€17 and Outer City prime rent at €13.50-€15. The mild growth in the prime segment is going to continue and will reflect in the growth of secondary rents as well.

Outlook

By quarter-end, some 337,200 sq m of office space was under construction or refurbishment in Prague. Only one property commenced in Q1, the refurbishment of BB Centrum B. With shrinking vacancy, some 63% of the pipeline under construction is already let to future tenants.

On the basis of our forecast, we can assume that in short to medium term the vacancy rate is going to be stable. However, according to what we have previously considered a positive scenario, the vacancy could further decrease, but it is difficult to consider such scenario as positive: it means the space for lease will further decrease and majority of tenants will have to stick to pre-leases, i.e. the average lease negotiation length is going to grow. Given the constraints in the Czech planning and construction process, any substantial growth in pipeline is unlikely over the course of next 2-3 years.

FIGURE 7: **MODERN OFFICE STOCK & VACANCY IN PRAGUE DISTRICTS**

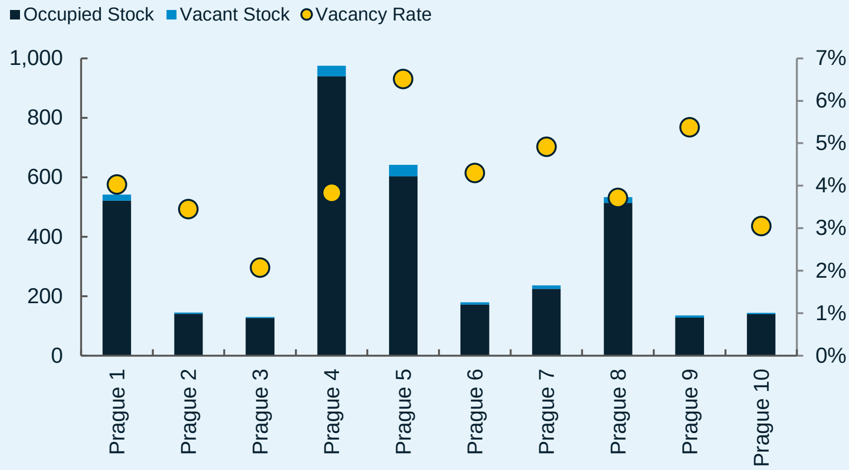


FIGURE 8: **VACANCY RATE DEVELOPMENT & FORECAST**

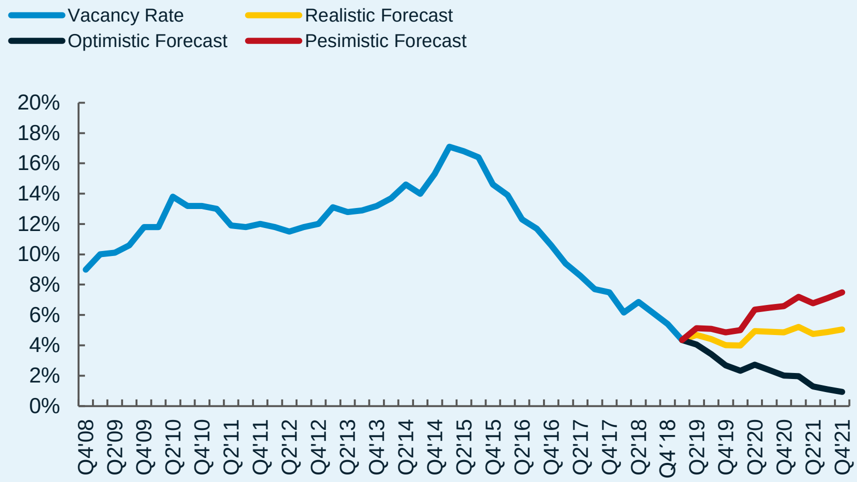
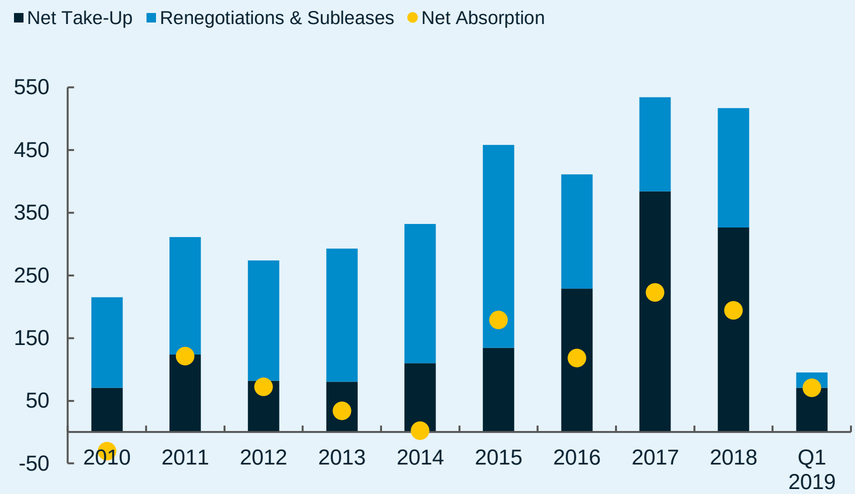


FIGURE 9: **TAKE-UP AND NET ABSORPTION**



Note: Net absorption represents total change in occupied stock and as such can be also negative

Sources: Figure 7: Prague Research Forum (PRF), Colliers International | Figure 8: Colliers International | Figure 9: PRF, Colliers International

INDUSTRIAL MARKET

Supply & Vacancy

During Q2 2019, some 168,300 sq m of warehouse space was completed. In year on year comparison, this was a 20% decrease, but in longer term comparison, the completions level was 25% above 5-year average.

Since the end of 2014, it took just four years and the first quarter of this year to deliver more than 1 million square meters to the market in the Prague area only. Before that, the period to deliver one million square meters was twice as long. This shows how dynamically the market developed over the last couple of years and the strong position Prague has in the country, with 38% of all warehouse space located in and around the capital.

Total stock stood at 7,97 million sq m and nearly hit the 8 million sq m level.

Looking countrywide, average vacancy stood at 4.8% at the end of Q4 2018, an increase of 50 basis points y-o-y. This equated to 380,300 sq m available for immediate occupation. Larger space availability did not change, there were still only nine properties which could accommodate requirements in excess of 10,000 sq m.

Demand

Gross take-up in Q1 reached 384,700 sq m, registering a 24% increase on previous quarter, however, in year on year terms, the gross take-up was 6% down. In net terms, the take-up was 53% higher than in Q1 2018.

Two new deals above 15,000 sq m were struck in Q1 2019: a pre-lease of Schenker in Finapra Mnichovo Hradiště (18,500 sq m) and DHL in Prologis Park Prague D1 West II (16,200 sq m).

RENTS & OUTLOOK

Rents

Prime rents in Prague and Brno stand in the range of €4.25-€4.70/sq m /month, other demanded regions such as Ostrava, Plzeň and Ústí nad Labem have rents in the range €4-€4.35/sqm/month.

Outlook

Around 521,700 sq m of warehouses are presently under construction, with 46% already pre-let. The whole pipeline under construction is scheduled for delivery during 2019, which should bring the annual completions level to 690 thousand sq m. This is below the completions of the last two years but remains above the 10-year average (460 thousand).

With expected (and already appearing) economic slowdown in Germany we expect a shift in demand; manufacturing and automotive industry in general will move from the prime positions in take-up and e-commerce will continue strengthening its position as the main demand driver. We are already seeing first signs of producers seeking cheaper manufacturing locations both in and out of the EU, which will bring second hand space to the market. On the other hand, other producers still perceive the local market as very suitable for both logistics and production; currently there is potentially the single largest warehouse in the country under preparation, which will surpass Amazon by more than a half, if the authorities approve these plans.

FIGURE 10: **CZECH INDUSTRIAL STOCK & VACANCY (in sq m)**

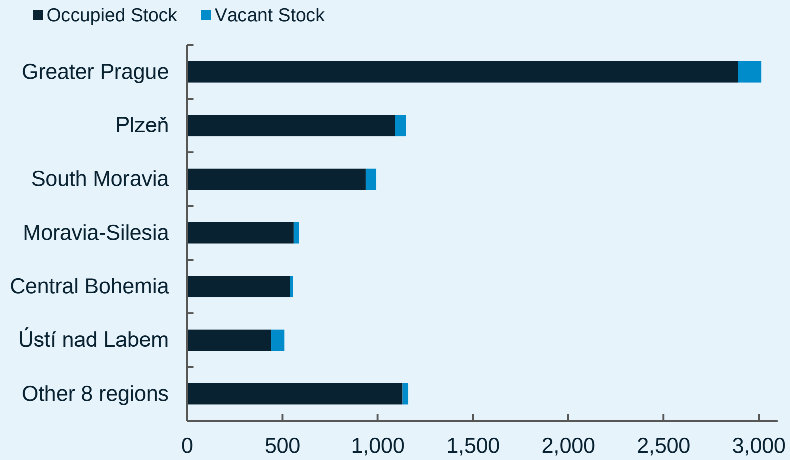


FIGURE 11: **ANNUAL SUPPLY**

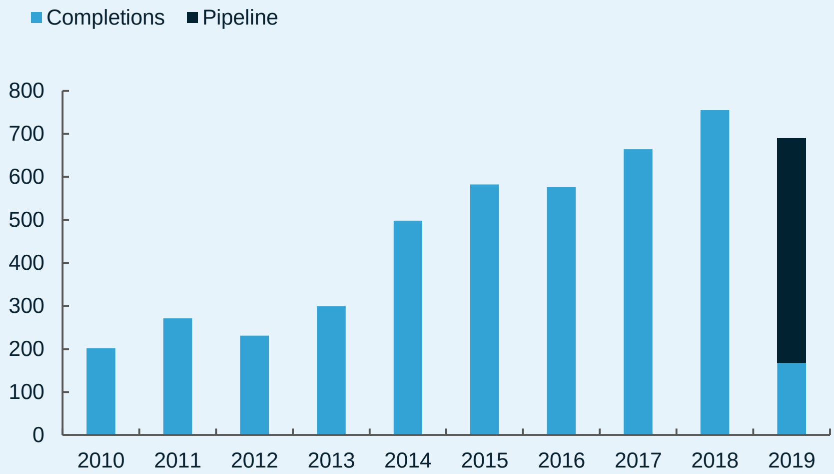
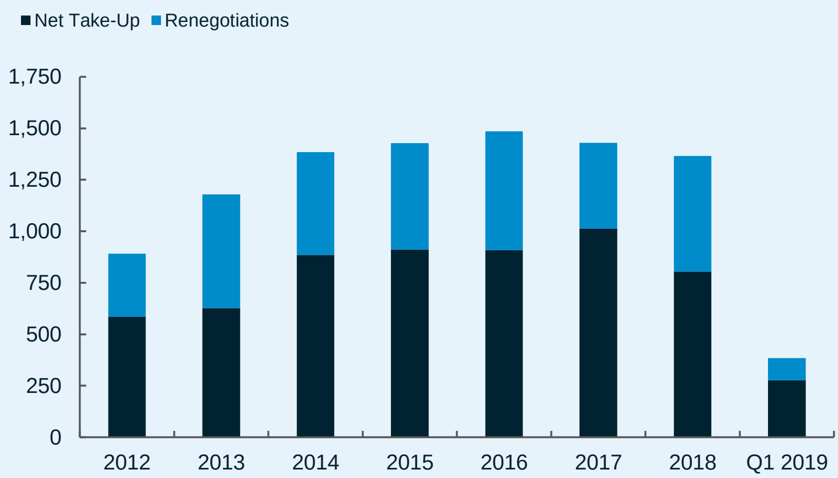


FIGURE 12: **TAKE-UP**



Sources: Figures 10-12: Industrial Research Forum, Colliers International

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