

PROPERTY TIMES

Stabilisation in office segment

Baltic Office Q4 2014

26 March 2015

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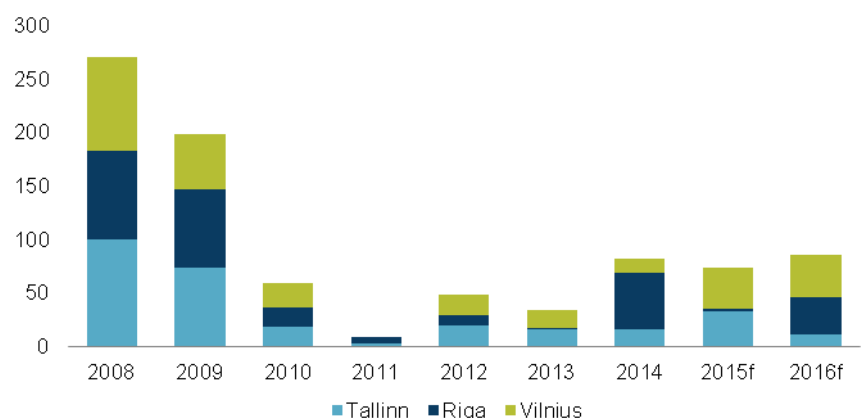
- Rents have been stable or seen a relatively small increase on all markets.
- While Estonia and Lithuania is the most aggressive in terms of new deliveries, Latvia is characterised by a more moderate development pace for new projects, which have been postponed during the recession.
- Positive developments are likely to continue on the office market in 2015-2016 in all three Baltic capitals, promoted by stable demand and new projects in the pipeline.
- With investment activity increasing in the office segment, property yields are likely to decrease, especially in the long term.
- Our forecast for the office markets are:

In Estonia, the upcoming year will be stable with no substantial changes in occupancy rates for the existing and well-established properties. Development pipeline will keep the rents within the current brackets. Prime yields are expected to decrease slightly.

In Latvia, prime rents may increase by 5% based on the decline in availability of modern high quality office space. Vacancy level in office buildings will remain at the same level or decreases slightly. Windows of opportunity are open for investors who are ready to undertake risks that are generally correctable through leasing, re-development, management and/or recapitalization.

In Lithuania, the rental values are expected to increase in Kaunas. Rents in Vilnius will be under the pressure due to new developments. The vacancies in the Vilnius will increase with availabilities will decline in Kaunas and Klaipeda. Prime yields in Vilnius will remain stable but some compression is foreseen in Kaunas and Klaipeda.

Figure 1
 New office pipeline, 000 sq m



Source: DTZ Research

Macroeconomic Trends in the Baltic States Estonia

According to the estimates of Statistics Estonia in the 4th quarter of 2014, the Estonian economy grew 3.0% compared to the 4th quarter of 2013, the annual GDP growth in 2014 was 2.1% compared to the previous year.

According to the Bank of Estonia 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. Economic growth in 2014 will be faster than it was last year but it will only accelerate modestly in future. Estonia is in a different phase of development from that ten years ago and sustainable growth over the long term is 3–4%. Estonian GDP will increase 2.1% in 2015 and 3.3% in 2016.

The change of the consumer price index in January 2015 was -1.3% compared to January of the previous year. Compared to January 2014, goods were 2.3% cheaper and services 0.6% more expensive. Consumer price inflation went below zero in June 2014 for the first time since the crisis. According to forecasts of Bank of Estonia the inflation will pick up in the next two years, but it will remain subdued. Higher labor costs will make the prices of domestic goods and services rise faster than those of imported goods and services. The CPI will be accordingly 0.8% in 2015 and 2.1% in 2016.

According to Statistics Estonia in 2014 the annual average number of unemployed persons was 50,000, which is 9,000 less compared to the previous year. The annual average unemployment rate (7.4%) was 1.2 percentage points lower than in 2013 (8.6%). Compared to the highest unemployment rate of the last decade (16.7% in 2010), unemployment has decreased more than twice. In 2014, the unemployment rate in Estonia was relatively low compared to other European Union countries.

Latvia

According to the Central Statistical Bureau of Latvia, in 2014 compared to 2013, GDP at constant prices grew by 2.4%.

Preliminary data suggests that positive contribution to GDP development came from the households that were the main driver during the first three quarters of 2014 however, this trend cannot continue for the long time. Pessimistic mood and consequences of Russia's embargo caused caution in households and investor plans. Due to geopolitical situation investors prefer not to expend their money for business expansion, but to use already existing resources for production capacity. Another serious negative impact on Latvia's economic progress, particularly affecting the real estate sector and construction are amendments of the Immigration Law and Insolvency Law. The threshold of investments in Latvia's real estate has been significantly increased as well as the latter stipulate the introduction of liberalised personal bankruptcy regime. The prime factors of the development of Latvia economy are external factors and geopolitical situation. According to the Bank of Latvia the GDP growth forecasts for 2015 is 2.0%.

The average annual inflation in 2014 was 0.6%, which is one of the lowest levels in a growing economy in Latvia, and it has been largely caused by external factors - mostly sustained by the global prices and postponement electricity market liberalisation until 2015. Given the variety of low inflation and rising employment and wages in recent years, traders and manufacturers are testing the limits of consumer spending by raising prices. However, the wages will rise in moderate pace but uncertainty related to external factors will increase the savings. Accounting for the latest global oil price dynamics, the revised inflation forecast of Bank of Latvia for January 2015 has lowered to 0.9% (instead of 1.4% projected in December).

The rate of unemployment has declined in Latvia to 8.3% in the December 2014 or 10.6% of all jobseekers from the economically active population. With the pace of economic growth, employment will approach its natural level. Significant decrease of unemployment is expected but only after implantation of motivating measures for labour market.

Lithuania

In 2014, Lithuania's economy continued to grow at a healthy pace supported by domestic demand and, in particular by the growth of private consumption. According to Statistics Lithuania the GDP growth in 2014 was 2.9%. Nevertheless, the development of different sectors is uneven. While the construction activity dropped in previous years, now it is increasing.

The gross fixed capital formation and household consumption remains the key drivers of the economy as it was in 2013. GDP is projected to increase by 3.1 % in 2015 and 3.3 % in 2016. Despite of losses in Russia, Lithuania's total export in 2015 should grow by 1%, due to recovering economy of the euro area and entering new markets. Inflation has been very low and stable for a while, mostly because of consumer-friendly developments in the prices for commodities in the global market and low inflation environment in the euro area. The deflation was 0.3% in 2014. According to Central Bank of Lithuania projected average annual inflation should stand at 0.9% in 2015.

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. According to the Statistics Lithuania, the unemployment rate decreased in 2014 to 10.6% from 11.9% at the end of 2013. Despite improvements in the labour market, structural unemployment remains high, with about half of the unemployed out of work for over a year.

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Table 1

Key Macroeconomic Indicators

	Estonia	Latvia	Lithuania
Population (in thousands)	1,315	2,002	2,943
Urban population	68%	68%	67%
Area (thousand km ²)	45	65	65
Population density (per km ²)	29	31	45
Capital city	Tallinn	Riga	Vilnius
Population in capital cities (thousand)	411	643	529
Currency	EUR	EUR	EUR
GDP at current prices (€ Bn, 2014)	19,5	24,1	36,3
GDP per capita (thousand €, 2014)	14,83	12,04	12,34
GDP growth (% , 2014)	2.1	2.4	2.4
Inflation rate (% , 2014)	-0.1	0.7	0.2
Unemployment rate (% , 2014)	7.4	9.0	9.1

Source: National Statistics

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Estonian office market

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 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 area, Järve-Tondi area and Ülemiste City near airport area.

In the beginning of 2015 total area of modern office space in Tallinn was approximately 620,000 sq m (the premises used by the state and local governments are not included). Approximately 40,000 sq m will be added in 2015.

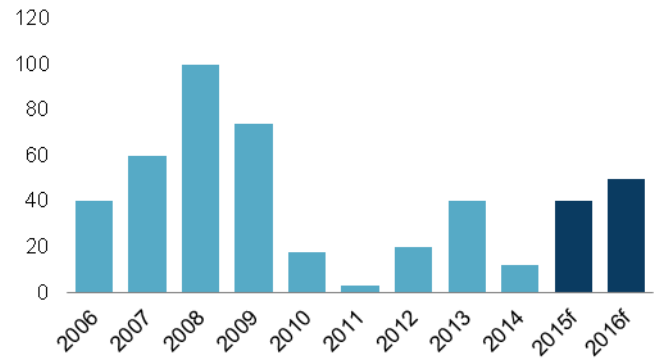
- The office building with lettable area 2,800 sq m at Sõpruse Road known as one of the first office buildings with the green concept was completed in January 2015.
- In 2015, along Pärnu Road in Tallinn at the address 4 Hallivanamehe Str, a new commercial and office building - the Eesti Loto building with lettable area 4,800 sq m will be completed
- The office building at the address 3 Metalli St near the Central District with lettable area 3,800 sq m will be completed in 2015.
- The group of four office buildings with lettable area 12,500 sq m located at 63 Narva Road in the Central district of Tallinn should be completed in 2015.
- The office building at 24 Lelle Street and office-apartment building at 24 Lelle Street, as the first stage of the Järvevana Quarter with total area 20,500 sq m, of which commercial and office area is 14,000 sq m, should be completed in 2015. The anchor tenant of office building Eesti Energia signed agreement to lease 7,500 sq m office space.
- The office building at 102B Pärnu Road on the boundary of Central District with lettable area 1,900 sq m will be completed in March 2015.
- Additional ca 50 000 sq m of new office premises will enter the market in 2016.

In 2013 slight increase in rental fees took place, especially among the top rents. Prime rent remain around 13.0-16.0 €/ sq m pm. The rental fees of new office buildings in the city centre completed 2013/ 2014 are from 14.0 €/ sq m pm up to 16 €/ sq m pm.

The overall average vacancy rate for new office buildings is ca 9%, but reaching to 10-15% in certain buildings. Vacancy is significantly higher in older buildings as the tenants have moved to new premises. There is no statistics regarding the older buildings as these have often lost their position in rental market. 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 5%.

Figure 2

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



Source: DTZ Research

Table 2

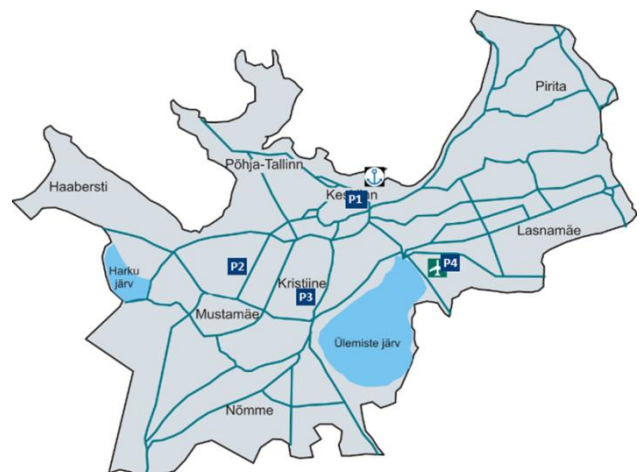
Average rental level in Tallinn, €/ sq m pm

	Rent	2015
A-grade	11.0 – 16.0	→
B-grade (centrally located)	7.0 – 10.0	→
A-grade (periphery)	8.0 – 11.0	→
B-grade (periphery)	4.0 – 8.0	→

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

Pärnu

The main business districts in Pärnu are the city centre, its close surroundings, and Papiniidu district. These districts accommodate not only office buildings, but also other types of commercial properties.

The total amount of modern office space in Pärnu is approx. 50,000 sq m. Only 20% of this space is located in built-on-purpose office buildings, constructed 1998-2003. The rest is distributed among built-to-suit premises and top floors of multi-purpose commercial buildings. New construction and renovation has been on minimal level. Some new office space in multi-purpose buildings is on the pipeline but because of limited volume any remarkable changes in market situation are rather unlikely. Some office space no longer occupied by the city government has been vacant since 2007. There is an idea to bring together all the Central Government authorities located in more than 40 different locations today in the same building. This action can quickly increase the vacancy of B-class office premises but it still takes time at least 3-4 years. The same type of influence in more limited scale is related to moving of Police and Border Guard and Rescue Boards planned to the period 2017-2018.

In 2008-2009, office rental fees in Pärnu were adjusted downwards by as much as 30%, and have only marginally increased ever since. The rentals so far are below former levels, it seems that recovering is rather unlikely and most probably the rentals will stabilise on the lower level.

As a result, within the recent years, the majority of the completed lease transactions were relocation deals, with occupiers optimizing on the quality of the office space. Hence older buildings are gradually abandoned, and their occupancy rates are already close to zero. Average vacancy rates for A-class premises are between 10-15%, whereas vacancy rates for B-class premises are between 15-25%. The vacancy especially in context of A-class premises is rather fragmented and there are no bigger premises which are vacant at the moment. It can be complicated to find even relatively small (ca 200 sq m) office premises.

Tartu

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.

Krause commercial building (5,674 sq m) was introduced into the market back in 2010, whereas the following years saw only reconstruction activities. Hence the former Postal Office (682 sq m) was reconstructed into Bandwick office building, whereas 3-12 floor office premises in Emajõe commercial centre were renovated in 2011 and currently accommodate such tenants as Teadusarenduskeskus, Axinom Eesti OÜ, etc. In 2013, there was no new construction. In 2014 a new office building was built to Näituse Street (1,610 sq m). The rates are around 9-10 €/ sq m pm. Although the rental fees are similar to the City centre rates, the new building locates in Tähtvere borough.

Table 4

Rental fees in Pärnu €/ sq m pm	A	B	C	2015
City centre	5.5-8.5	3.0-5.0	0	→
Suburban areas	3.5-5.5	2.5-3.0	1.0-2.5	→

Source: DTZ Research

Table 5

Rental fees in Tartu, €/ sq m pm	A	B	C	2015
City centre	8.0-15.0	5.0-8.0	0	→
Suburban areas	4.5-6.0	3.5-4.5	2.5-3.5	→

Source: DTZ Research

In September 2015 will be completed the new seven-storey apartment, office and commercial building to Soola Street (4,575 sq m). The first three floors are planned for office and commercial premises with rental fees 11 €/ sq m pm, more than 200 sq m premises 10 €/ sq m pm.

Emajõe commercial centre, as well as modern buildings in its immediate proximity, currently have the average rental fees 10-11 €/ sq m pm. Krause commercial building has one of the highest rental fees (22 €/ sq m pm). The lowest rental rates (6 €/ sq m pm) depend less on the location and more on the access and parking possibilities, as well as on the overall quality of a building and premises. Suburban properties nonetheless still struggle with their occupancy rates.

Overall, the vacancy rates generally ranging between 5-25%. Higher vacancy rates are rather in less demanded properties. The buildings recently reconstructed are predominantly with a low vacancy rates.

Forecasts for 2015

- For the existing and well established properties the upcoming year will be stable with no substantial changes in occupancy rates;
- Development pipeline will keep the rents within the current brackets;
- Prime yields are expected to decrease slightly

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Latvian office market

Riga

Within Latvia, the most important office area is Riga, as in about 50% of total population lives and approximately 70% of GDP is generated in Riga and its region. Most of the other cities are smaller where office use is clearly secondary.

By the end of 2014, the total stock of modern office space in Riga reached 560,000 sq m of GBA, of which only 20% are A-grade offices; nearly 80% of these A-grade office premises are built-to-suit banking headquarters.

The most profoundly developing district is Skanstes Street Area, which also hosts the majority of built-to-suit banking headquarters, has run into the speculative market former Krajbanka HQ at Jana Dalina Street 15 with additional 8000 sq m of rental premises. Two speculative office development completed during 2014, M4A office building in Mednieku 4A (2,900 sq m of B-grade office space in former AB Bank building) and new built office project at Vainodes Street 1 on the left bank in Pardaugava (8,000 sq m of B grade office premises). Another large scale project commissioned in spring 2014 was HQ of State Revenue Service with total area of 44,600 sq m and only 300 sq m of the area was meant for speculative purposes.

New supply of office premises with total area 2,400 sq m is expected in 2015 – the expansion of Hanner project NEW TEIKA. At the same time they have announced their new office building project at Sporta 11. Still under construction is 24,000 sq m of Z-Tower project (possible commissioning in 2016).

Throughout the year 2014, office rental market was mostly dominated by the medium-size (500-800 sq m) relocation and expansion deals. Rather low annual take-up figures are explained by the constrained supply of available premises, especially for the areas above 400 sq m. Cabot established in Upmalas Biroji occupying 1600 sq m of premises on the 5th floor. Another large rental agreement was enclosed for Jupiter Centre 1,100 sq m office premises with AB.LV. LNK Group has changed their location to newly acquired office building at Dalina 15, filling 3000 sq m Latvijas Valsts Mezi has entered a new office building at Vainodes street.

Due to commissioning of new office buildings, slight increase of vacancy rate was observed during limited period in 2014. The C-class office buildings have suffered the most. Due to relocation of State Revenue Service from several different premises to Talejas Street old buildings looks rather abandoned. By the end of the year, the average vacancy throughout the city stood at around 7.0%. While in 2012, occupier demand was mostly focused on established office districts, in 2013 and 2014, tendency to compromise on location and/or quality of the premises for the benefit of single large office space was elicited on the market.

Since the majority of A-class premises across the city are built-to-suit buildings, vacancy rate in this segment amounts only to 3%. Vacancy rates in B-class buildings range between 8-12%, depending on the location of the building and quality of the services offered.

Table 6

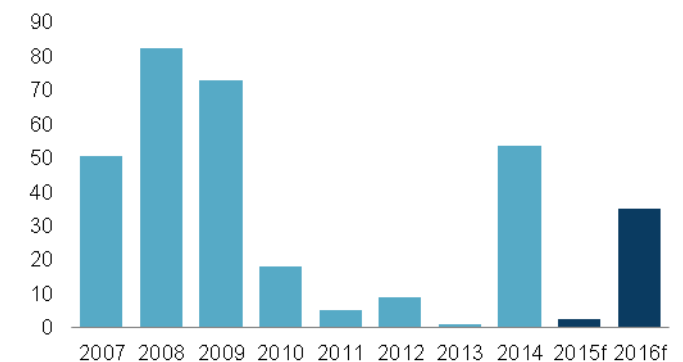
The largest space occupiers in Riga office buildings, 2014

Office	Tenant	Area, sq m	Available area, sq m
VID HQ	State Revenue Service	44000	300
Vainodes 1	Latvijas Valsts Mezi	7300	380
LNK Centre	Exigen	4200	0
Upmalas Biroji	Cabot	1600	0
Jupiter	ABLV	1100	0

Source: DTZ Research

Figure 3

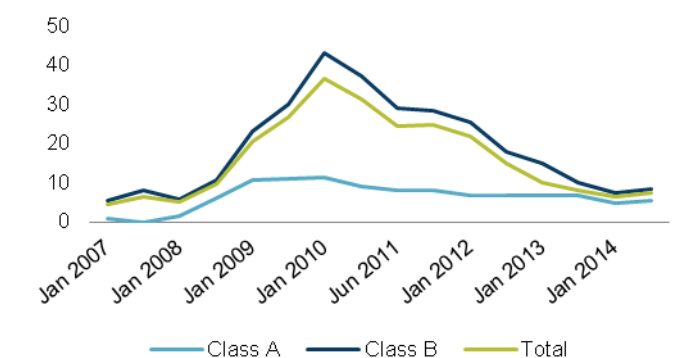
New built office space in Riga, GLA, 000 sq m



Source: DTZ Research

Figure 4

Vacancy dynamics in Riga office buildings, %



Source: DTZ Research

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After the prolonged after-crisis stagnation period, the rents due to the scarcity of supply moved upwards. During 2013- 2014 the rents remain stable since reaching to the rental level of 12-15 €/ sq m pm for A-class buildings, 8-11 €/ sq m pm for B-class buildings in demanded locations (central district, Skanstes Street area, Pardaugava, Riga Airport area), and 6-8 €/ sq m pm for B-class buildings in peripheral locations. Despite potential increase in vacancy rates, the upward pressure on rents is not expected to continue in 2015.

Forecasts for 2015

- Prime rents may increase by 5% based on the decline in availability of modern high quality office space.
- Vacancy level in office buildings will remain at the same level or decreases slightly.
- Windows of opportunity are open for investors who are ready to undertake risks that are generally correctable through leasing, re-development, management and/or recapitalization

Table 7

Average rental level in Riga, €/ sq m pm

	Rent	2015
A-grade	12.0-15.0	→
B-grade (centrally located)	8.0-11.0	→
B-grade (periphery)	6.0-8.0	→

Source: DTZ Research

Lithuanian office market

Vilnius

The office market in Lithuania is active and well developed in the capital city Vilnius. There are several newly build offices in Kaunas and Klaipeda, but it cannot be compared with Vilnius.

The total area of modern office space in Vilnius amounted to 422,000 sq m, of which almost one third is A+ and A class premises, primarily distributed between Business Triangle (11% of the total office stock) and New City Centre (18% of the total office stock) districts. B-class office buildings stretch along major city roads outside city centre, mostly on Ukmerges Street. One more B-class business cluster is located in Naujamiestis city district. An office building GAMA (10 000 sq m in Ozas business park on Kalvariju Street), was commissioned at the end of 2013. Another office buildings with total area 15 800 sq m was added to the market in 2014.

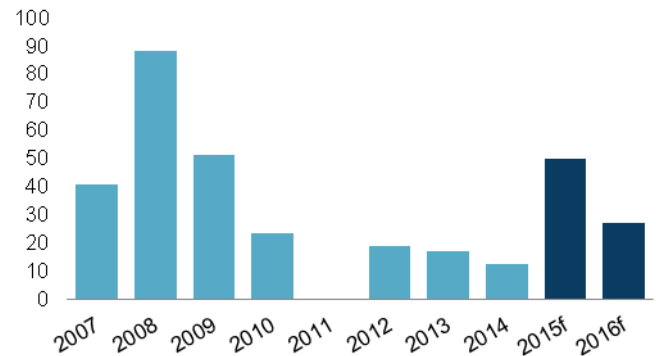
Since the majority of A-class office properties have almost reached to their natural vacancy levels, certain potential occupiers have already considered better quality B-class office premises, which certainly served as an impetus for the recently completed development projects and the ones that are in the active pipeline. In B-class sub-segment, the highest demand is for the properties in close proximity to the city centre in general and Business Triangle district in particular. Due to high demand, new construction can be observed around the city. The pipeline for 2015-2016 is 77,400 sq m (GLA). This might have impact on the rents.

The average vacancy rate across both A-and B-class properties decreased and reached to 6% at the end of 2014. When broken into sub-segments, A-class average vacancy rate is below 1.5%, whereas B-class average vacancy rate reaches to 7%. Taking into consideration that 4 projects with total area of 68,000 sq m will realized during nearest year the vacancy will increase up to 5%.

Rental fees continued to grow in 2014 and range from 5.25 €/sq m pm in B-class sub-segment up to 15.2 €/sq m pm for A-class premises. Similarly as in Riga new buildings are being introduced into the market at higher than current average rates – for example, B+ business centre GAMA is offered for 11.5-14.5 €/sq m pm. Such a rise in rental rates should not be foreseen during the next year.

Figure 5

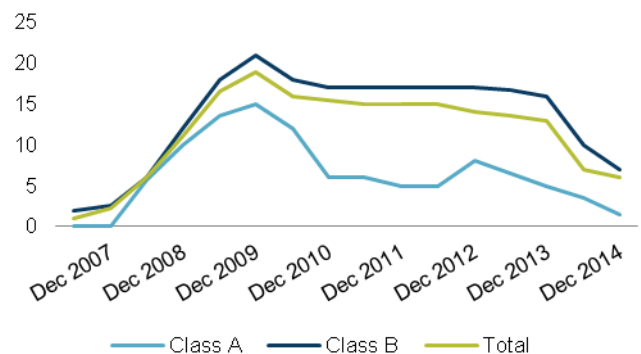
New built office space in Vilnius, GLA, 000 sq m



Source: DTZ Research

Figure 6

Vacancy dynamics in Vilnius office buildings, %



Source: DTZ Research

Table 8

Average rent level (€/sq m pm) in Vilnius	A	B	C	2015
Vilnius city centre (CBD)	14.0-15.0	7.0-9.0	0	→
Outside the city centre of Vilnius	0	5.0-7.0	2.0-4.0	→

Source: DTZ Research

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Kaunas

By the end of 2014, the total area of modern office space in Kaunas amounted to approx. 52,400 sq m. A new 17,000 sq m office building has been delivered for a company Senukai (major DIY retailer).

The highest locally generated demand is for 20-50 sq m premises; the supply of that type of space is already limited. In Kaunas as in Vilnius the development of tenant business has been observed followed by their expansion plans. The rents slightly grew up throughout the period and range between €5-€10,5 / sq m pm. Vacancy rate is close to 5%. The vacancy rate is expected to decrease going forward. It is foreseen that next year 3,500 sq m office building will be constructed on the Savanoriu Street in Kaunas.

Klaipeda

By the end of 2014, the total area of modern office space in Klaipeda amounted to approx. 45,200 sq m.

The vacancy rate has slightly decreased. It is an opposite situation compared to Vilnius and Kaunas. Vacancy rate is close to 12%. The rents in high quality business centres range from 5.8-10.0 €/ sq m pm, whereas office premises in economy class centres are leased at 2.9-5.8 €/ sq m pm. It is foreseen that next year 1,500 sq m office building will be constructed on the Liepu street in Klaipeda.

Panevezys and Siauliai

Panevezys and Siauliai are secondary cities in country's office landscape, primarily populated by converted office premises that usually comply with B-class standards. In both cities, the highest demand is for 30-50 sq m areas. In Siauliai, the premises are leased at 6.0-8.0 €/ sq m pm in city centre and at 3.0-5.0 €/ sq m pm in suburban areas. In Panevezys, rental rates usually fall into a narrower range of 3.5-6.0 €/ sq m pm.

Forecast for 2015

- The rental fees will increase in Kaunas. Rents in Vilnius will be under the pressure due to new developments.
- The vacancies in the Vilnius will increase, in Kaunas and Klaipeda will drop;
- Prime yields in Vilnius will remain stable. Some yield compression is foreseen in Kaunas and Klaipeda.

Table 9

Average rent level	(€/ sq m pm)
Kaunas	4.5-10.5
Klaipeda	5.8-10.0
Siauliai	6.0-8.0
Panevezys	3.5-6.0

Source: DTZ Research



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