Macro | Outlook report

CEE REAL ESTATE

July 2017

Labour force "boomerang"

Tug-of-war for hearts and minds

The emigration of at least 7m mainly young people to Western Europe has negative demographic and economic consequences for the CEE-6 countries. Labour shortages and wage inflation are impacting CEE-6 economies and real estate markets even in 2017. ***We believe that the emigration wave has peaked and that workers will start to return eastwards to CEE-6:*** we term this dynamic the "labour force boomerang".

Every skilled worker returning adds to productivity and growth (good for industrial/office demand), tax take, demand for consumer products (good for retail/logistics sectors as demand from mid-high spend consumers is boosted) and their experiences of living as citizens in Western Europe should aid the progress of CEE societies.

Workers, families and students left the CEE-6 countries to earn higher wages but also to experience what they perceived as a "better life". The economic impulse to move was clear in most cases. As was the desire to try a life in a more "advanced", yet unfamiliar society. We address the pull of the homeland and the "tug-of-war" equation shifting in CEE's favour with a "SWOT" analysis.

Shifting "push" and "pull" factors

Looking at the financials, tighter labour markets in CEE are forcing wage inflation for skilled workers especially. Minimum wages are rising significantly (7%-c.15%) this year in the CEE-6. Currency effects (including a weaker Pound in Brexit Britain) and tax rates are pointing towards a faster closing of the still-yawning net wage differentials over the next 5-10 years. CEE's cost of living is rising but that factor is increasing faster in places such as the UK. The marginal worker should return.

Emotional factors, such as use of native language or education as young people progress into family status are up to each individual to judge. Arguably, some of the prior CEE "push" factors, such as corruption, political instability and institutional weakness have ebbed somewhat. OECD data suggest a deterioration in the "quality of life" in some Western European countries. Despite these "push and pull" factors pointing in favour of a repatriation of CEE workers, employee surveys in CEE still point to a desire of young people to follow their peers westward. Only the governments of Hungary and Slovakia are as yet systematically active in this "tug-of-war", to entice workers back home. ***Is an opportunity being missed by CEE-6 governments?*** Embarking on active policies to retain and attract workers back and continue to improve conditions (and funding) for small businesses, in the physical environment and for society in general would be a good sign.

The exodus

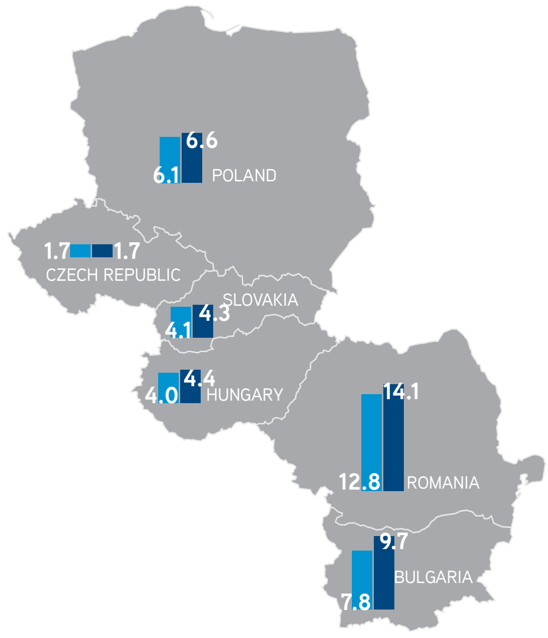
Scope of the diaspora

The westward drift of the populations born in the CEE-6 countries turned into more of a flood after EU accession of the Visegrad-4 countries in 2004 and the lifting of all restrictions on free movement of Romanians and Bulgarians in 2014. The large income disparity between sources and destinations was the prime motivator for the flow of people. Additionally some perception of greater social support/fairness in western European countries, whether true or not, added to momentum.

Western Europe is of course no stranger to inward migration of workers, with previous waves of European Mediterranean, north African, Turkish and UK Commonwealth migrants all entering the workforce and population fabric in previous decades. Whilst not entirely free of prejudice, recpient countries of the workers from CEE have broadly accepted their new co-workers/residents as part of the "European project".

The scope of the disapora to western Europe is wide and is detailed on the enclosed map (page 3). CEE-6 migrants, workers and families, have spread all over the EU and also into the remaining countries of the European Economic Area (EEA, comprising Norway, Iceland and Liechtenstein) and also Switzerland (defined collectively as "Western Europe"). The EEA members and Switzerland are signatories to the EU's free movement of people within the European single market.

Fig. 1: Equivalent % of population of country residing in "Western Europe" 2016



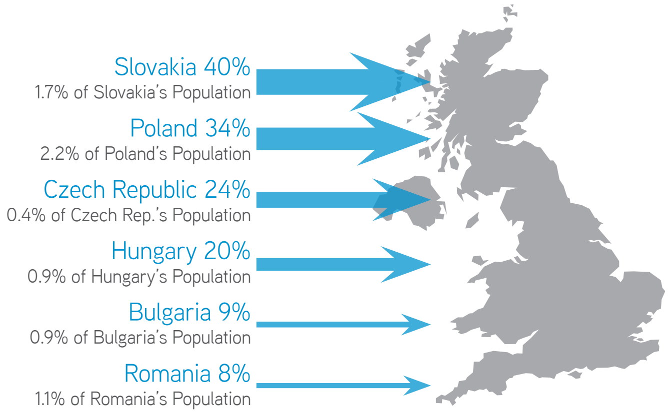
2015 2016 CEE-6 populations in France are from 2013 French Interior Ministry data
Source: Eurostat, French Interior Ministry, ONS, Colliers International

A summary of the migration flows reveals that as of 2016, we estimate that 14.1% of Romania's population are Romanian nationals residing in Western Europe. This figure grew rapidly from 2015, adding an estimated 1.3% equivalent in 12 months.

The rate of change between 2015 and 2016 was even greater in Bulgaria (1.9% added, summing to the 2016 total of 9.7%). Full free movement of people from these two countries to all other EU members was only allowed relatively recently and the income disparities are wide.

Geographically, the 2.79mn Romanians are spread between a number of countries but make up the largest proportion of CEE-6 migrants in Italy (over 1mn Romanians are there), Spain and Austria. The proportion of Poles abroad in Western Europe amounts to 6.6%, which is the second-largest body of people, at 2.49mn. Around 845,000 Poles are estimated to be in the UK at present, a third of their Western European total and equivalent to 2.2% of Poland's population. The percentage of Hungarians and Slovaks residing in Western Europe are significant at 4.4% and 4.3% of their populations and growing more slowly than the SEE peers, whilst the lowest proportion, the Czechs, static at 1.7%.

Fig. 2: % of CEE-6 migrants and % of source country population in the UK



Source: Eurostat, UK ONS, French Interior Ministry, Colliers International

Around 40% of the Slovaks, 24% of the Czechs and 20% of the Hungarians in Western Europe are residing in the UK. "Brexit" has of course dealt the "European project" and its principle of the free movement of people a blow. But thus far, one year after Brexit, there are no real signs of change in the politics of the free movement of people (excepting the UK), including that thus far anti-EU immigrant platforms have not garnered significant political influence in western European legislatures. In the UK, the net immigration from the 8 states that joined the EU in 2004 slowed to just 5,000 in 2016 – a Brexit effect.

Of note is that all of the above data (excluding UK ONS data for CZ/SVK/BUL and France) are from Eurostat and ***may be conservative compared to the reality***. For example, the number of Hungarians-by-birth in the UK is, according to one media source in Budapest, 200,000 people, versus Eurostat's 86,000.

Further illustrating income disparities even within CEE-6, 1.2% of Romania's estimated 2016 population is Romanian-born residing in other CEE countries. This is on top of the 14.1% residing in Western Europe. The portions of Hungarian-born, Bulgarian-born and Polish-born residing in CEE countries are low at 0.3%, 0.3% and 0.1% respectively. The portion of Czechs (0.9%) and Slovaks (2.1%) are higher, with most living in the other country: a legacy of the 1993 "Velvet Divorce".

Fig. 3a: Size and breakdown of CEE populations in Western European countries in 2016

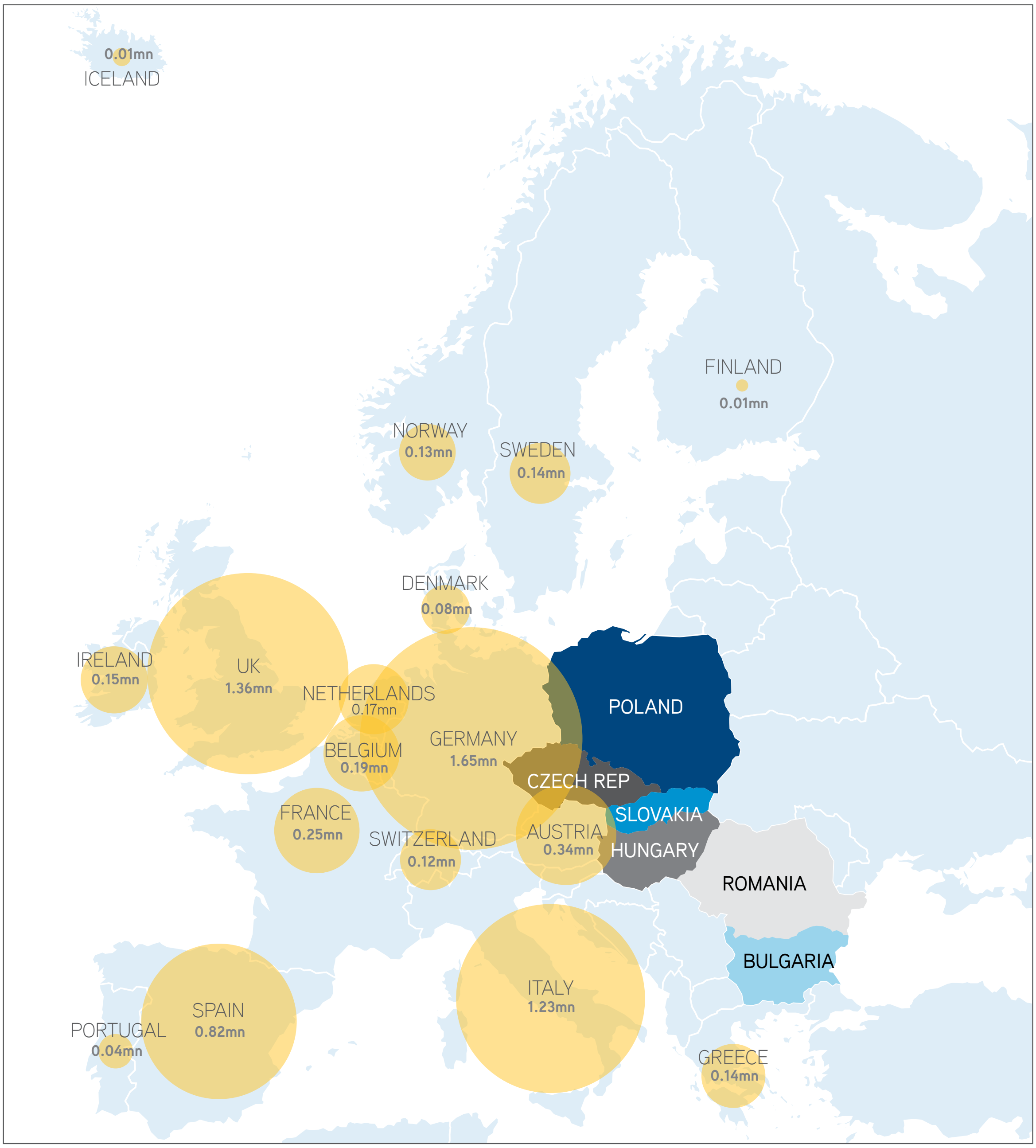
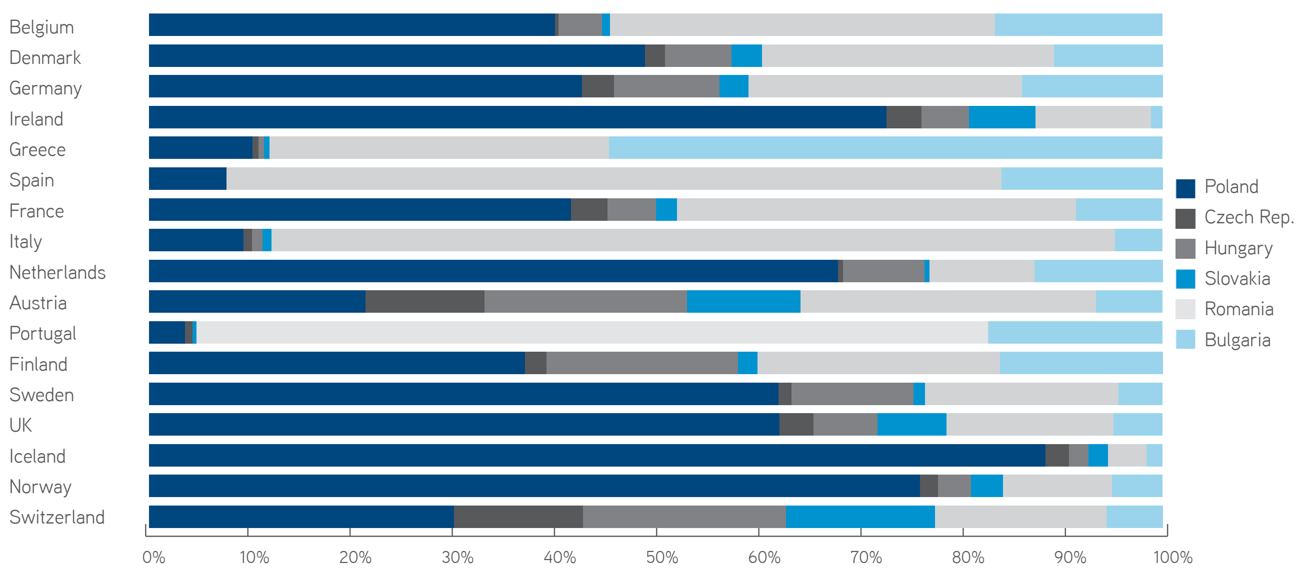


Fig 3b: Breakdown of CEE-6-born residents in Western European countries



Source: Eurostat data 2016 population estimates of EU states by country of birth, except for Czechs, Slovaks and Bulgarians in the UK (2015, UK ONS) and French data (2013, French Interior Ministry)

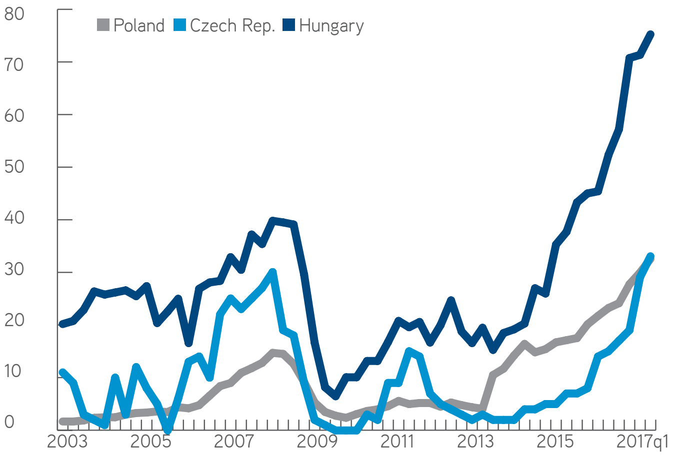
The return?

A labour "boomerang"

A combination of wage rises, low taxes, better governance and legal frameworks, more modern education systems, a more familiar cultural milieu and encouragement from the governments could well be "pull" factors to encourage those who migrated to return. Economic (possible)/political (more improbable) "push" factors in Western Europe may play a role.

With such vast numbers of emigrants, it is no real surprise that there are labour shortages in the very robust CEE economic cycle unfolding presently. Wage pressures are building. Much of the emigration over the last 10 years was young and educated people, leaving a skills gap at home.

Fig. 4: Total unit labour costs % of manufacturing companies seeing labour shortages as a barrier to growth



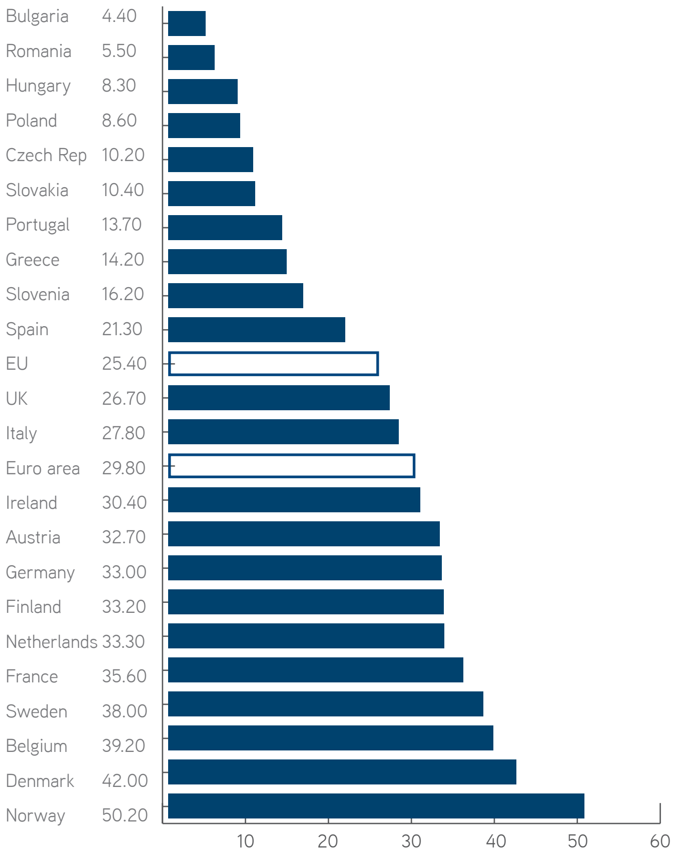
Source: Eurostat, Colliers International

Fully 73% of surveyed Hungarian manufacturing companies have labour shortages. Bulgaria (36%), Poland/ Czech Rep. (35%) Slovakia (24%) face similar issues. Only Romania (7%) is below the EU average of 13%. The same ratio is rising in Germany (to 15%) in Austria, falling in the UK. Gross wage growth topped 14.6% yoy in Hungary in April 2017. Across CEE, we estimate 2017E wage growth in the range of 4%-10%.

Total unit labour costs are what both corporates and workers should examine when making location decisions. The still-wide disparity between the CEE-6, ranging from Bulgaria's EUR 4.4/hour to Slovakia's EUR 10.4/ hour and western Europe remains as the chief cause of emigration. The EUR 25.4/hour average for the EU remains a high bar to clear. At present rates of wage growth, Slovakia and Czech Rep. would be the first of the CEE-6 to reach that present EU level in 2039 and 2040.

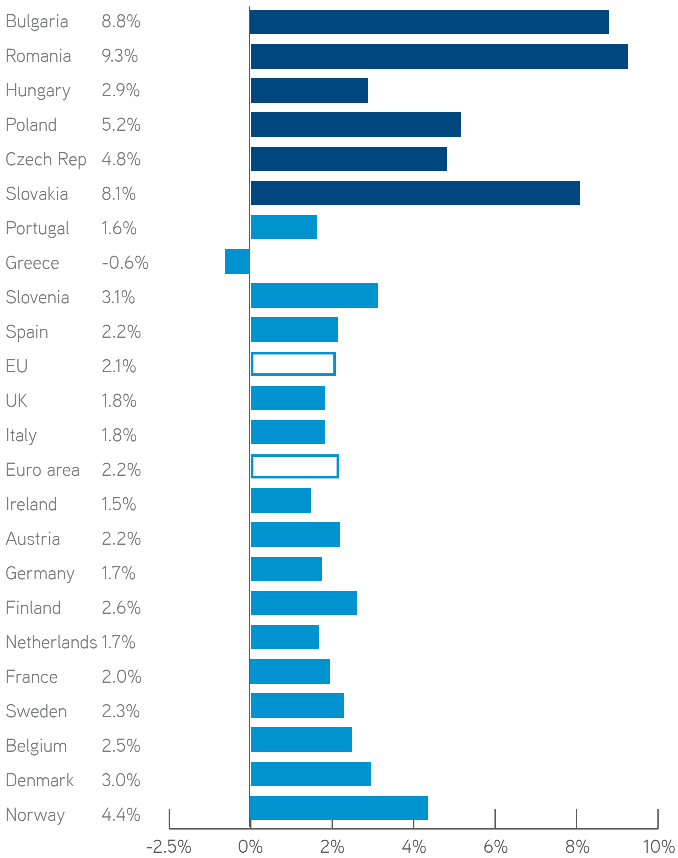
Even so, an argument for workers to stay is that future wages will grow faster in CEE. The far superior rate of wage cost growth historically in the CEE-6, is something that, with low unemployment rates (Czech Rep has the lowest in the EU at 3.4% (Eurostat)) and high GDP growth rates looks very likely to sustain over the next 10 years. This historic wage growth did not halt past FDI and domestic investment in CEE and provided that worker productivity can keep pace with Europe, increased investment in the future should also occur. This should mean higher demand for office and industrial real estate space and increased retail spending.

Fig 5: Unit labour costs across EU (EUR/hour)



Source: Eurostat, Colliers International

Fig 6: Annual unit labour cost growth across EU (EUR/hour) 2004-2016



Source: Eurostat, Colliers International

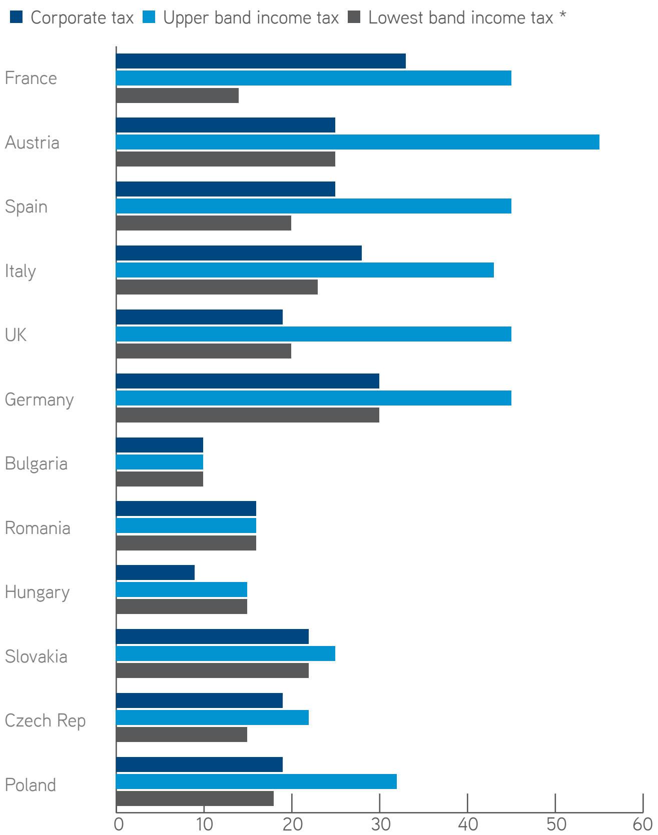
Not only are wages very likely to inflate faster than in Western Europe over the next 10 years but currency effects will also most likely enhance the purchasing power of workers in the home country versus the emigrant. Czech or Polish workers gained 19.4% and 9.4% in purchasing power in EUR terms by being paid in local currencies since EU accession. We expect currency appreciation in the freely-floating CEE currency regimes (CZK, PLN, HUF, RON) in the near to medium term. If 1% per annum currency appreciation versus the EUR is assumed, the wage levels in those countries would hit present EU levels 5-6 years sooner (2035 in the case of Czech Rep, for example). 2% per annum appreciation would mean 8-9 years sooner. Local currency appreciation acts to reduce the purchasing power of remittance flow from the emigrant pool (which has been significant historically). And specifically, the depreciation of Pound Sterling ("GBP") since Brexit (-13.4% vs EUR) and since its period of strength through 2015 (-18% vs EUR) has seen a real hit to emigrant earnings when translated back to local currencies. This matters, as 20% of the whole emigrant pool are of course paid in GBP. And the volatility of the GBP, given all the Brexit uncertainties, shows no sign of abating.

Workers located and paying taxes in CEE are paying income tax at lower rates than Western European peers in the EUR 1,000-1,500/month salary bracket (with the exception of France at this level). If on average one third less tax is paid by each worker, then some of the yawning wage differential between CEE-6 and Western Europe closes further. Some CEE governments recognise this with Hungary for example slashing tax rates in 2017. A counter-argument is that higher taxes pay for better welfare provision but as amply seen in the UK in recent years, the strain of population growth on government services (including health) is huge and contributing to substantial budget deficits in some of the key Western European countries. Higher tax rates look like the future there.

Assessing the change in "quality of life" may be an argument for emigrants to stay in a recipient country or return home. Many will have left the CEE-6 region some years ago and the countries have progressed since. We calculated an average ranking of 24 "quality of life" indicators tracked by the OECD annually since 2013. Whilst that is comparatively recent, the most striking changes in overall ranking are the rise of Germany (to 11th out of the 35 OECD countries) and the fall of the UK (-4 places) and Italy (-3 places). As emigrants grow their wages, so "quality of life" becomes a more important consideration. As of course does raising a family and retaining cultural roots and a native language milieu. So it may be a concern that "quality of life" as measured by these OECD indicators is dropping in the likes of the UK and Italy. What we are not (yet) seeing is the Visegrad-4 climbing the (admittedly stiff) competitive rankings within the OECD group. As populations in CEE countries themselves grow richer, they too are starting to seek change locally for a "better quality of life".

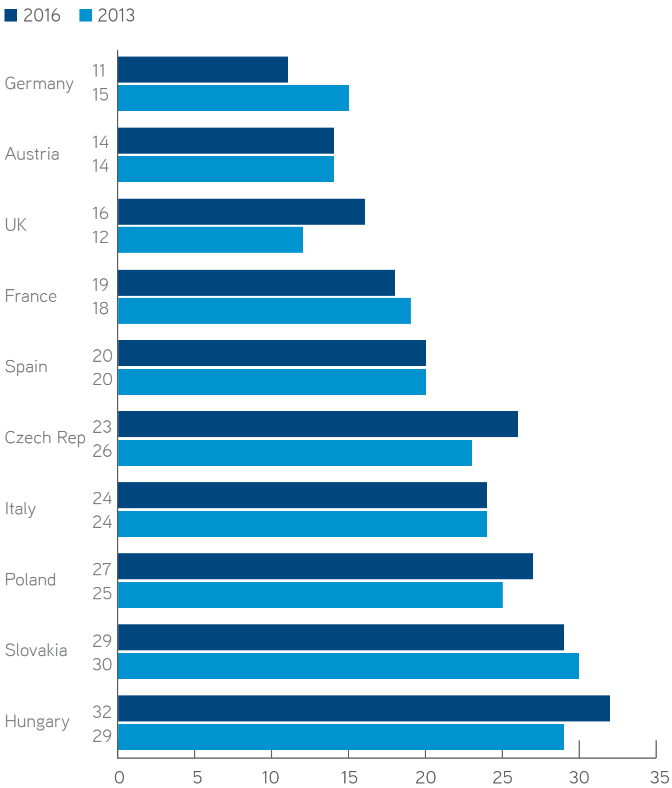
Changes to "quality of life" factors are of course very subjective and, as can be seen even in the OECD surveys, the progression is not clear-cut in every country in CEE. Reasons for leaving Hungary in particular in the last few years stated by some emigrants have included the direction society/governance has taken under the Orban government. But a counter to that is provided democracy itself is sustained (a requirement to be in the EU), governments whose policies populations in the end disagree with can be voted out in elections.

Fig 7: Tax rates in CEE-6 and selected major EU countries (2017)



* Tax rate on monthly salary of EUR 1,000
Source: Real Capital Analytics, Colliers International

Fig 8: OECD quality of life rankings (35 countries)



Source: OECD, Colliers International. A more detailed explanation of ranking and methodology is in the appendix on page 7.

Are governments helping?

Institutional improvement?

In studies of the causes of the emigration to Western Europe, oft-cited reasons for migrants leaving the CEE-6 included weak institutions, corruption, outmoded education programmes, bureaucracy, lacklustre fiscal management and poor job creation programmes. Have things changed?

Romania, which before 2013 suffered from persistent weak governance, corruption and mismanagement, has managed the biggest improvement in the World Bank's "Ease of Doing Business" survey between 2006 and 2017, up 42 places to 36th globally. The highest-placed CEE-6 country is Poland, coming in at 24th, itself improving by 30 places.

Assessing the "rule of law" and "government effectiveness" further World Bank survey data suggests improvements since EU accession in Czech Rep., Poland and Romania. Slovakia's (moderately good) and Bulgaria's (poor) scores are broadly unchanged. Hungary's scores have deteriorated.

Tab. 1: World Bank "ease of doing business" global rank (2017) and ranking change (2006-2017)

	CHANGE IN RANK 2017 VS. 2006	2017 RANK	2006 RANK
Romania	▲ 42	**36**	78
Slovenia	▲ 33	**30**	63
Poland	▲ 30	**24**	54
Bulgaria	▲ 23	**39**	62
Italy	▲ 20	**50**	70
Greece	▲ 19	**61**	80
Portugal	▲ 17	**25**	42
France	▲ 15	**29**	44
Czech Rep	▲ 14	**27**	41
Austria	▲ 13	**19**	32
Latvia	▲ 12	**14**	26
Hungary	▲ 11	**41**	52
Denmark	▲ 5	**3**	8
Sweden	▲ 5	**9**	14
Estonia	▲ 4	**12**	16
Slovakia	▲ 4	**33**	37
UK	▲ 2	**7**	9
Germany	▲ 2	**17**	19
Finland	0	**13**	13
Norway	▼-1	**6**	5
Spain	▼-2	**32**	30
Netherlands	▼-4	**28**	24
Ireland	▼-7	**18**	11
Switzerland	▼-14	**31**	17
Belgium	▼-24	**42**	18

Source: World Bank, Colliers International. A more detailed explanation of ranking and methodology is in the appendix on page 7.

Incentives to return?

Aside from improving the institutional environment, governments have a unique chance to speak to the diaspora. Today it is relatively easy to reach out through social media and communicate in the native language. Knowing about the labour/ skills shortages at home, are the governments acting?

Slovakia and particularly ***Hungary*** appear furthest along the road to putting in place a strategy to attract migrants home. Hungary in particular faces linguistic issues when thinking of sourcing cheap labour from Slavic countries and has the most acute labour shortages. Slovakia's programme is in draft form and is due to be launched by the state-linked SORIO agency in the autumn of 2017. ***Romania*** has tapped EU funds to make up to EUR 30mn available to returning entrepreneurs who might be able to secure up to EUR 40,000 in funding (4.5x annual wages) to set up new businesses. So, the process is starting in these countries. But as yet nothing in ***Poland*** or ***Bulgaria*** and only a specific programme for scientists in the ***Czech Rep.*** Is an opportunity being missed?

Tab. 2: CEE direct and indirect government action

COUNTRY	SPECIFIC PROGRAMMES AIMED AT ATTRACTING WORKERS BACK	GENERAL MOVES TO IMPROVE ATTRACTIVENESS OF LABOUR MARKET TO WORKERS
Hungary	"Youth come home!" programme, targeting young Hungarians in UK	Tax cuts (lower income tax, lowest corporation tax in EU). Minimum wage: 30% hike over 2 years. 13th month salary; sport; travel subsidies
Slovakia	Programme being planned by SARIO government-funded agency to motivate Slovak citizens to return from abroad, especially the UK. 10,000-80,000 people targeted. To start in Autumn 2017	7% hike in minimum wage in 2017
Romania	Returning entrepreneurs able to tap EUR 30mn fund up to EUR 40,000 limit to set up new businesses; A guide to help returning Romanians with administrative steps involved with returning to the country	16% hike in minimum wage in 2017
Poland	None	8% hike in minimum wage in 2017
Czech Rep.	"Navrat" ("Return") programme in place since 2012 aiming to help companies employing young scientists recruit from abroad	11% hike in minimum wage in 2017
Bulgaria	None	Increasing funding for certain programmes (incl. "Career Start"; Funds for unemployed people starting work in another city; compensation for mothers returning early from maternity leave; 9.5% min. wage hike in 2017

Source: Colliers International

Fig. 10: "SWOT analysis on the arguments for CEE workers in Western Europe to return home

S STRENGTHS	» Lower unemployment meaning much more demand for skilled workers » Faster GDP growth » Fast wage growth » Much lower income tax rates at present » Significant improvement in ease of doing business in CEE-6 countries » Currency appreciation vs. British Pound ("GBP"), effect on purchasing power of remittances » Cheaper housing » Cheaper cost of living » Native language » Position in society and opportunity to contribute » EU Structural Funds flows
W WEAKNESSES	» Wage differential is simply too wide and will take decades to close » Physical environment is perceived as harsher (climate, pollution) » Surveys in CEE-6 still pointing to desire of many young people to leave » Weak reputation of governments amongst emigrants » Lower social security support at present than in Western Europe » Rule of law" and "government effectiveness" scores are poor/static in Bulgaria and deteriorating in Hungary » Very little in the way of organized programmes or even "ease of reintegration" help for returning emigrants » Not enough encouragement for SME sector in CEE-6 to thrive through funding, training and education
O OPPORTUNITIES	» Programmes to encourage the diaspora to return » Career progression for skilled workers » Much faster likely future wage growth in CEE-6 versus Western Europe » Likely future currency appreciation versus EUR and GBP » Budget surpluses in CEE-6 mean further possibilities to cut tax rates or increase social/SME spending » Low wage base will continue to encourage investment, create jobs and stimulate faster economic growth » Likely rise in tax rates in Western Europe as national budgets do not balance » "Quality of life" may be deteriorating in Western Europe due to overcrowding, social and economic changes » Growth of demand for all types of CEE real estate as economies grow and populations prosper
T THREATS	» Eventual takeover by robots of manufacturing economy will hit CEE-6 disproportionately vs. parts of Western Europe » Wage growth outstrips productivity growth in CEE-6 economies » Acute labour shortages/sharp wage rises in pockets of Western Europe during phases of the economic cycle sees more emigrant waves happening » The ease of the rise of "xenophobic"/anti-EU political parties and views in CEE-6 » Political instability in CIS countries and/or Middle East worries potential returnees

Source: Colliers International

Appendix

Explanations of Figures:

8: The OECD presently comprises 35 countries after Latvia joined in 2016. The ranking (for example Germany 11) for 2016 and also for 2013 (Germany 15) is that country's position in the order of the 35 countries taking into account 24 data variables. 1 is the highest rank and 35 the lowest. When considering each variable, each country was assigned a rank according to its position from 1 to 35, with 1 being the best (highest life quality) and 35 being the worst. The overall ranking is the simple average of these 24 data ranks. The variables cover housing, income, jobs, the community, education, the environment, civic engagement, life satisfaction, safety and work-life balance and are comprised of publically-available data sets. The first available survey on the OECD website was conducted in 2013.

9: The change in ranking in the global World Bank Ease of Doing Business Index between the year 2006 and 2017 is shown. Taking the example of Romania, the country rank rose from 78th in the world in 2006 to 36th in the world in 2017. This was a rise of 42 places. The Ease of Doing Business Index is an index created by the World Bank Group. Higher rankings (a low numerical value) indicate better, usually simpler, regulations for businesses and stronger protections of property rights. The first survey was conducted in 2001 and is carried out annually. The report is above all, a benchmark study of regulation. The survey consists of a questionnaire designed by the Doing Business team with the assistance of academic advisers. The questionnaire centers on a simple business case that ensures comparability across economies and over time. Empirical research funded by the World Bank to justify their work show that the economic growth impact of improving these regulations is strong.

€2.3
billion in
annual revenue

170
million square meter
under management

15,000
professionals
and staff

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