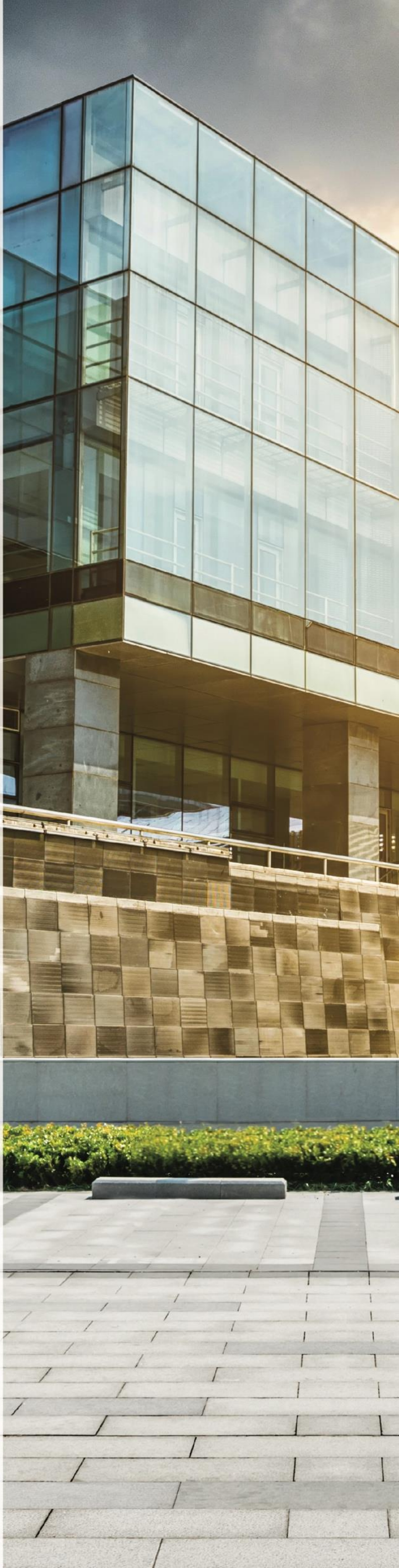

TBC CAPITAL

Commercial Real Estate: **Wind of Changes**

SECTOR REPORT

DECEMBER 2021

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Executive Summary

The COVID-19 affected all sectors of the economy, including the commercial real estate sector. Commercial property owners in retail saw a drastic reduction in rent revenues as their tenants suddenly became unable to pay rents. Additionally, "stay at home" orders negatively affected office operators. As a result, the COVID-19 crisis triggered changes in activity and prices of street retail properties, shopping malls and offices.

Street retail

In Tbilisi, street retail rents (in USD) fell by 29% YoY in Q2 2020, as the majority of landlords proposed rental holidays and discounts during the first (and most strict) lockdown. Since the lifting of restrictions in Q1 2021, street retail rents have been recovering. In Q3 2021, weighted average rent was 13.3% lower compared to same period of 2019.

Considering the revival in economic activity, high inflation of construction materials and retailers' expectations we project the weighted average rents to recover towards the end of 2023.

Sale prices of street retail properties in Tbilisi were more resilient than rents. Prices started to decline during the second lockdown imposed towards the end 2020. In Q3 2021, sale prices of retail properties (+15.9%) and restaurants and cafes (+0.7%) were higher compared to 2019's levels. However, average sale price of universal properties was 10% below its 2019's level.

Sale prices of street retail properties in Tbilisi were more resilient than rents. Prices started to decline during the second lockdown imposed towards the end 2020. In Q3 2021, sale prices of retail properties (+15.9%) and restaurants and cafes (+0.7%) were higher compared to 2019's levels. However, average sale price of universal properties was 10% below its 2019's level.

Consequently, yields on street retail properties in Tbilisi stood noticeably below their pre-pandemic levels. Nevertheless, this type of commercial real estate still provides high returns compared to FX long-term deposit rates and even residential rental yield. The yields vary – from 7.4% (restaurants and cafes) to 8.9% (retail properties). Didube, Samgori, Didi Dighomi and Isani provided the highest rental yields compared to other districts in Q3 2021.

Vacancy rates in Tbilisi street retail increased from 9.3% in 2019 to 12.8% in 2020. A drastic decline in international tourism and prolonged street rehabilitation projects were the major drivers of rising vacancies.

In 2020-9M 2021, total area of issued permits for construction of street retail properties in Tbilisi was by 72% higher than five-year average. However, this conclusion might be overstated due to upcoming law on "Energy Efficiency of the Buildings". Didube (43% of total) and Samgori (30%) accounted for the biggest part of street retail construction pipeline.

New trends emerged in Georgian street retail during the pandemic. The market is moving towards more turnover-based models. In addition, larization of lease agreements is slowly but steadily increasing. Large retailer chains (most of them) started to focus more on the regional development rather than expanding in Tbilisi. At the same time, some high streets in Tbilisi are losing their attractiveness for retailers and shoppers. The pandemic also accelerated e-commerce adoption in Georgia, however as restrictions were lifted and shoppers returned to the streets, the share of e-commerce in retail sales fell to the pre-pandemic levels.

Shopping malls

The impact of COVID-19 on performance of shopping malls was stronger compared to the street retail, as shopping malls faced stricter and longer regulations in 2020-2021. Nearly all lease agreements in modern shopping malls include turnover-based models (with minimum fixed rent), which automatically reduces rent revenues when tenants do not perform well. As a result, weighted average rents halved in Q2 2020 and stayed at the low level during the whole year. In Q3 2021, rents were 19% lower compared to 2019's level.

In contrast with street retail, vacancy rates remained stable in 2020 and are expected to increase only marginally in 2021, as operators try to maintain their malls occupied and high exit penalties prevent the drain of tenants.

The GLA of existing shopping malls in Tbilisi is expected to increase by more than 80,000 SQM in 2022-2023. The pressure on rents and vacancies will be particularly high in Didi Dighomi, where the current density of modern shopping malls per population is several times larger than in other districts.

We project rents to fully recover towards the end of 2022, while vacancy rates will temporarily increase in the upcoming years due to opening of new malls.

Offices

Economic crisis, closure of businesses, multiple lockdowns and mobility restrictions drove office demand down in 2020. Despite the removing of restrictions and revival of economic activities in 2021, demand on offices did not fully recover. It seems that pandemic will have a lasting impact on office demand in Georgia, as increasing share of employees work from home and will continue doing so in the future.

In addition, the pandemic triggered some other changes on office market. Flexibility of leases and workspaces became an important factor for tenants when choosing the offices to rent. In order to cut costs, businesses started to think about optimization of office space. All these stimulated the demand on co-working spaces, which now attracts not only individual remote workers or startups, but increasing number of medium and large companies.

In 2020, weighted average rent in Tbilisi business centers increased by 4.8% YoY. This is explained by increasing share of high-class (and more expensive) offices in the total stock of existing offices. Combined with high inflation of construction materials, it will drive weighted average rent up in 2023 (+9.2% vs 2019).

Vacancy rates in Tbilisi business centers increased by notable 11.3 pp in 2020 and constituted 24%. The increasing stock of office space in combination with the lasting impact of COVID-19 on office demand will drive vacancy rates beyond 25% in 2022 and 2023.

In Q3 2021 rental yield on offices constituted 8.4%, which was 0.2 pp lower than in the same period of 2019. However, rental yield on offices was by 1.3 pp higher than residential yield.

On district level, offices in Saburtalo provide the highest yield (9.3%), while the lowest yields were observed in Vake (6.7%) and Mtatsminda (6.8%).

The existing office stock in Tbilisi is expected to increase by 60,000 SQM in 2022-2023. 32% of this area is concentrated in Saburtalo.

Introduction

The COVID-19 made an unprecedented impact on the global economy in recent history. Pandemic immediately affected all sectors of the economy, including the commercial real estate sector. Virus containment measures and lockdown restrictions particularly affected businesses operating in the retail and hospitality sectors. Consequently, commercial property owners in these subsectors saw a drastic reduction in rent revenues as their tenants became less able to keep up payments. Additionally, "stay at home" orders negatively affected office operators. As a result, the COVID-19 crisis triggered a sharp correction in activity and prices in some types of commercial real estate (CRE) - retail, hotel and office.

This contrasts with the residential real estate (RRE) market and other types of CRE (logistics assets, data centers), which performed comparatively better to date. The different performances of CRE and RRE during the pandemic can be explained by several reasons. First, the CRE market, in general, is more sensitive to economic fluctuations than the RRE market. While demand on CRE follows the business cycle and economic outlook, demand on RRE is more stable as it, together with other factors, depends on population demographics.[1] Second, imposed virus containment measures affected some sectors more than others. Limited mobility and activity restrictions levied on retailers, shopping centers, offices exacerbated the negative dynamics in certain types of CRE. Contrary, the pandemic increases demand for housing services and attract more buyers into the housing market, as households were forced to spend more time at home.[2]

The analysis of the CRE market and its development is important due to its strong linkages with the real economy and financial stability. Any deterioration in market conditions or investors' sentiments about the future affects economic growth, as it affects investment decisions in commercial real estate, which is a part of investments in construction. In addition, the downturn in the commercial real estate market might adversely affect the capital of banks through the potential increase in mortgages defaults and related collateral losses.

On the global market, today's pressure on CRE market performance is primarily caused by the shock of demand rather than supply, which makes it different from the previous crisis.[3] Therefore, the recovery process depends on the rebound in demand. However COVI-19 might have the lasting impact on tenants needs and their demand on CRE, which makes the analysis more interesting and, at the same time, challenging.

This report is divided into two parts, which describe the recent developments in the most affected by pandemic CRE types: street retail and shopping malls, and offices. Our analysis is based on available secondary data and information (both quantitative and qualitative) gathered from representatives of the retail sector, and operators of shopping and business centers. In addition, the analysis of Georgian CRE market is supplemented by overview of the global trends in CRE and future implications for the sector.

Street retail and shopping malls

Global Trends and future perspectives

COVID-19 impact on global retail

Even before COVID-19, vacancy rates in the US and European markets have been rising for many years as retailers have been closing physical stores, despite sustainable economic growth over the past decade. An increasing share of shopping has moved from physical stores online. In 2019, more than a quarter of so-called “core retail” sales were conducted through e-commerce channels, a threefold increase since the end of the last recession.[4]

Additionally, more and more spaces in shopping malls have been occupied by non-retail uses such as entertainment centers, medical centers and office spaces. This trend reflects the change in consumers expenditures, which have shifted from the types of goods traditionally sold in shopping malls. Households have started to spend more money on medical care, housing, and entertainment, while spending on clothing, furniture, and other retail goods has been reducing.[4]

Faced with weakened consumer demand, retailers have been closing stores at a rate normally only seen during severe recessions. COVID-19 health crisis, imposed restrictions and its negative economic impacts accelerated the pace and magnitude of existing changes in consumer behavior and the retail sector. Among retail sectors, malls are experiencing the hardest setbacks, as tenant demand is weaker than on high street. Despite reopening of economies. and lifting most of the COVID-19 related restrictions, vacancy rates continued to rise in the first half of 2021 reaching the levels close to the recession of 2008-2009

An increase in the vacancy rate and a decrease in the confidence of landlords led to lower rents in 2020 - the first time in a decade of negative rent growth in the retail sector. Rental fees remain an important topic in the retail sector as rent deferrals, abatements, and lease restructurings became an everyday business process for landlords.
However, by the end of 2021 retail sector has seen promising results. Retail sales have seen significant growth, event compared to 2019 figures, as an unprecedented level of household savings and strong government stimulus offered brighter prospects for the sector’s performance. At the same time, foot traffic almost recovered to 2019 levels.[5] Consequently, store closures and vacancies, and rents have stabilized by the end of 2021.

2022 and beyond: trends that are here to stay

E-commerce and digitalization

As lockdowns and curfews became the new normal retailers and consumers went digital, driven by the convenience of e-commerce and other online activities during the pandemic. In 2020, the growth of e-commerce significantly accelerated, increasing by 2-5 times faster than in the pre-pandemic period.[6] Consequently, the share of e-commerce in the global retail trade increased from 14% in 2019 to about 17% in 2020.[7]

The COVID-19 accelerated not only e-commerce and its role for retailers but the digital transformation of businesses as a whole. Digital solutions became a necessity to continue some economic and social activities during the pandemic. The major areas of digitalization are remote work, remote education, remote care. As the economy reopens, these virtual practices may decline, but they continue to be much higher than before the pandemic.[6,9]

Customer experience

With e-commerce and digital retail experiences permanently changing consumers shopping habits, the retailers' future success will depend on how well they can combine and enhance the traditional shopping experience with digital alternatives.

Bringing the in-store shopping experience to customers' homes becomes an important direction for retailers in enriching customers' experiences. The concept is based on the integration of VR, AR and 3D technologies into the shopping process by offering consumers:

- Virtual try-on of clothes and footwear;[10]
- The ability to see how products (furniture, décor) would look in their homes;[11]
- Make customizations to the products themselves using 3D technology.[12]

Merging physical and digital experiences is another new trend in retail, which allows retailers to link a digital retail experience in-store with an individual's mobile device by sending offers as customers walk past products, providing shoppers with real-time inventory information and providing virtual fitting service. The retail sector entered the era of "phygital" shopping, in which there is no clear distinction between brick-and-mortar and online retail and digitization improves the shopping experience in the store.[13]

To further enhance customer experience, retailers should create a safe in-store shopping environment. Redesigning the physical shopping process to make customers feel safe became the necessity for retailers as shops reopened after first lockdowns. Perspex screens, sanitizers, self-checkout systems and contactless payments are the amenities valued by customers. Shoppers also put retailers under increasing pressure to enforce the mandatory wearing of masks and limit in-store number of clients.[14]

The provision of home delivery, click-and-collect and curbside collection services creates additional important safety measures, convenience and a better shopping experience.

Rethinking the malls

With the sharp reduction in personal and business travel, the destination retail industry has also experienced a sharp decline. As high-end catering and luxury retailers are particularly dependent on tourists and business travelers, the future of this retail segment does not look bright. Meanwhile, households are becoming more interested in local shopping.[15] In markets and neighborhoods where malls traditionally rely on tourists, this means more emphasis on local catchments. Malls have reduced the number of branded stores and changed tenant structure by increasing stores targeted at the local audience.

Additionally, an increasing number of geographically distributed small shopping facilities is replacing the historic trend of favoring increasingly large out-of-town shopping centers. In the past, such small centers (about 50,000 thousand SQM of GLA) were considered uncompetitive, however currently malls are fine-tuning each location to suit what local customers need.

Landlord-tenant relationship

COVID-19 changed the essence of commercial real estate for both landlords and tenants. Property owners now run a higher operational risk compared to the pre-pandemic period. The last two years showed that, landlords and tenants (retailers and offices) share the negative economic impacts of COVID-19 and multiple imposed lockdowns: landlords cancel or postpone payments, temporarily reduce rents, introduce flexible leases and move to more turnover-based models.[16,17]

ESG Agenda

Environmental, Social and Corporate Governance (ESG) agenda is becoming a priority for all in the real estate industry.[18] The increasing importance of ESG is a reflection of how society and its attitudes are changing in a face of the climate crisis. Public sentiment is driving this agenda, as people are expecting companies to provide environmental, social and financial returns. Retailers and non-retail occupiers became very focused on the ESG agenda and are seeking green spaces.

Introducing “green clauses” into lease agreements became a popular practice - landlords and tenants include obligations under their leases such as energy efficiency measures, reduction in water usage and green waste management policies. Off course, construction of “green” CRE is more expensive, however property owners with the highest standards in sustainability can gain a substantial premium in rents, while “non-green” CRE may experience lower rents or higher vacancy rates.

Overview of retail sector in Georgia

The retail sector in Georgia followed the global patterns and was mainly influenced by changes in household consumption/saving behavior and the timeline of COVID-19 related restrictions.

Consumer spending saw a deep reduction in the first months of the pandemic resulted mainly from cutbacks to in-person services caused by lockdowns, curfews, travel restrictions and health fears. Simply, there

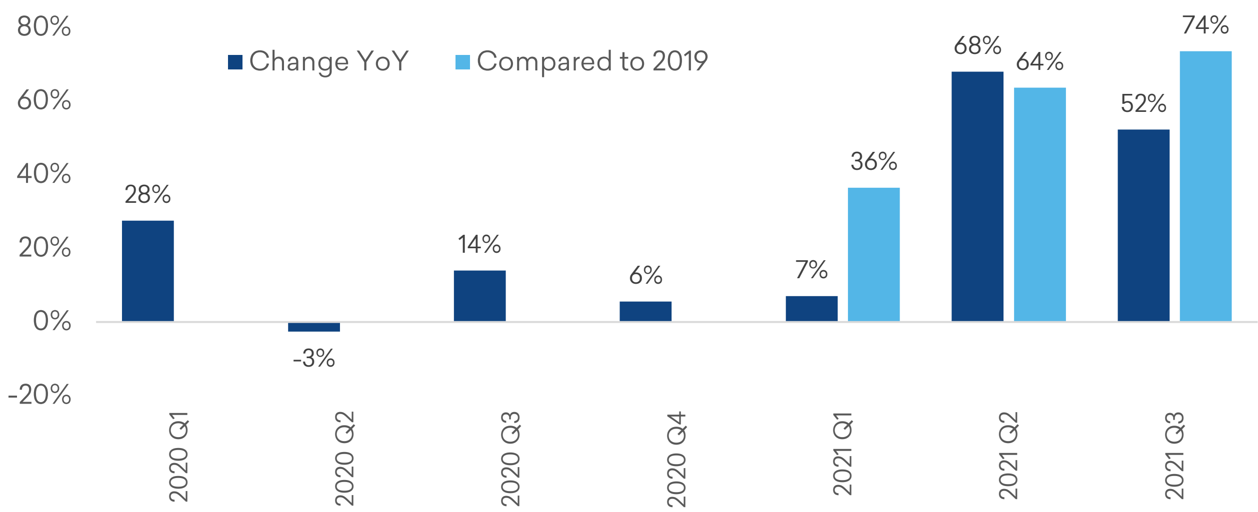
was little or no possibility to spend on services or non-essential consumer goods, like public transport, shopping malls, street stores, fitness centers and gyms, hotels and restaurants, which were closed by government orders.

Consumers' spending was rebounding in periods between COVID-19 waves when mobility and activity restrictions were partially lifted and stagnating during times of re-imposed measures. Additionally,

closed international borders and halt in the tourism industry, "costs" Georgian retailers about 3.5 bn. GEL.[19] It should be mentioned, that reviving in domestic tourism, partially compensated for those losses. "As Georgians cannot travel to Europe for shopping, increasing number of local customers buy luxury and premium brands' product." (Perfume/beauty store representative).

FIGURE 1

RETAIL NON-CASH SPENDING (YOY CHANGE)



Note: Data on non-cash spending through TBC Bank channels might not reflect the overall picture as it tends to show higher annual growth of spending due to a) increasing penetration of TBC Bank' cards, b) increasing usage of credit and debit cards in Georgia.

Source: TBC Capital

Logically, spending on essential goods – groceries and pharmaceuticals, showed a strong resilience during the pandemic with some panic buying observed in the beginning. Consumer expenditures on construction materials, furniture and appliance were also robust in 2020. Spending on electronics also showed resilience, as broad adaptation of remote work and education practices in Georgia increased demand on gadgets. Other spending categories - entertainment, restaurants and cafes, fitness, apparel and accessories, and personal care - saw a significant YoY decrease in 2020.

"Our sector was comparatively successful in 2020, as demand on smartphones, tablets and laptops increased with a large part of the population working remotely and children receiving education online. Families with two or more children faced the necessity to buy multiple devices". (Electronics and home appliance store representative).

As a result, Georgian retail experienced the most challenging and unstable year in recent history. However, beginning from Q2 2021, when authorities lifted almost all mobility and activity restrictions and Georgia reopened its borders for international tourists, the performance of the retail sector rebounded and even reached higher than pre-pandemic levels (see Figure 1). Rising consumer confidence, accumulated savings and pent-up demand stimulated retail sales further.

Another important factor, which affected retail sales in Georgia during the pandemic, was high inflation. In 2020, annual CPI inflation stood at 5.2%, while it reached 9.2% in 2021 (based on 11-month data). Despite its negative impact on quantity demanded by consumers, rising prices "inflates" retailers' revenues measured in GEL (the overall impact depends on price elasticity of demand, which may vary across products). "There is a tendency of increasing prices on our products. In 2020, we sold slightly more smartphones and laptops compared to 2019, but revenues showed double-digit growth". (Electronics and home appliance store representative).

Our interviews suggest that the impact on retailers revenues differs case-by-case and varies from a +15% to -25% YoY change in 2020. All respondents mentioned that their turnover fully recovered to or in some cases significantly bypassed 2019 levels in Q2 2021. However, as underlying causes of current inflation are supply-side factors (more expensive logistics, inputs and higher operational costs due to safety measures and COVID related restrictions), the impact on businesses profitability was negative. "We did not fully reflect exchange rate depreciation and increasing transportation costs in the final price of our products. At the same time, COVID-19 increased our operational cost. Coupled with seasonal and occasional sales provided to attract a rare customer, all these factors reduced our profit in 2020-2021". (Pharmacy representative).

Street retail in Georgia

In Tbilisi, weighted average rent fell by 29% YoY in Q2 2020, as the majority of landlords proposed rental holidays and/or massive rental discounts. Rents in contracts renewed or concluded during the pandemic were on average by 5%-15% lower compared to 2019.

Considering increasing supply of GLA, revival in economic activity and high inflation of construction materials we expect the weighted average rents to recover towards the end of 2023.

Vacancy rates increased by 1.5 pp in 2020 and constituted 12.8%. Considering the pace of recovery in tourism and future supply in street retail, vacancy rates will gradually decline to 9.6% in 2023.

As it was expected, the pandemic had a negative impact on yields, as correction in rents was greater than in sale prices. However, street retail still provides high returns compared to FX LT deposits and residential real estate.

Rental yields significantly varies by districts. Didube, Samgori, Didi Dighomi and Isani provided the highest rental yields in Q3 2021.

In 2020-9M 2021, total area of issued permits for construction of street retail properties in Tbilisi was by 72% higher than five-year average. However, this conclusion might be overstated due to upcoming law on “Energy Efficiency of the Buildings”.

Didube (43% of total) and Samgori (30%) accounted for the biggest part of construction pipeline in street retail, followed by Saburtalo (12%), Isani (7%) and Krtsanisi (4%).

Large retail chains continued expanding in Tbilisi, as physical presence in every neighborhood became important. In addition, increasing number of retailers put bigger emphasis on the regional development.

High streets in Tbilisi started to lose their attractiveness for tenants and shoppers. Prolonged street rehabilitation works, change in transport flows, emergence of new malls and standstill in tourism industry are the main causes of this trend.

Another important changes triggered by pandemic in Georgian street retail is moving towards turnover-based models and larization of rents.

The pandemic has accelerated the growth of e-commerce in Georgia. However, as restrictions were lifted and shoppers returned to the streets, the growth of e-commerce slowed down, while its share declined to 2019 levels.

Major Indicators

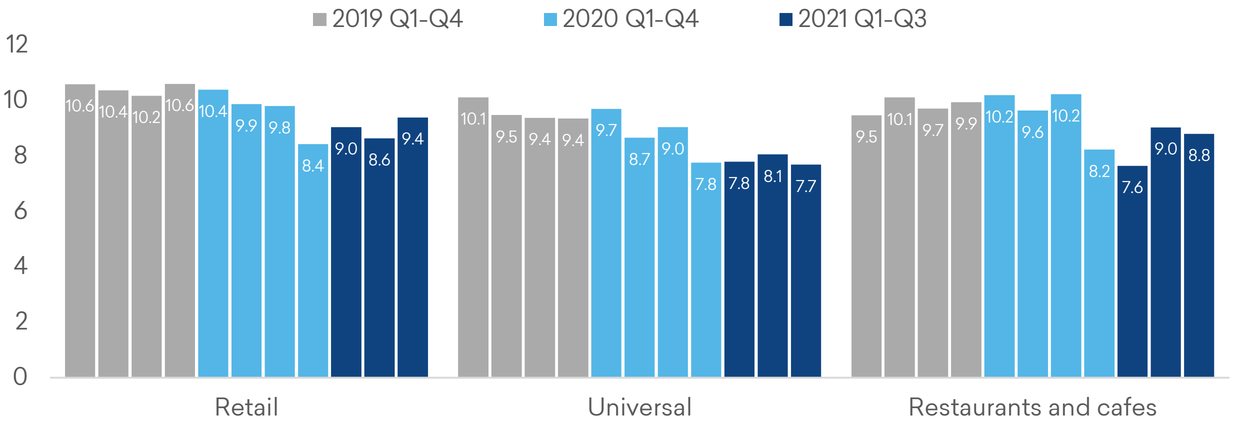
Rents

Weighted average rents of listed street retail properties in Tbilisi started to decline in Q2 2020 (see Figure 2). Listed rents on retail properties reached their minimum in Q4 2020 (-20.5% vs Q4 2019), while restaurants and cafes saw the lowest listed rents in the following quarter at 7.6 USD per SQM (-20.5% vs Q4 2019). Rents on both type of property started to recover in 2021 and were down only by 7.7% (in case of retail) and 9.4% (in case of restaurants and cafes) in Q3 2021 compared to the same period of 2019. Rents on universal properties (properties which can be used as both, retail or office space), which dominated listings in terms of total listed area, also fell during the first hit of COVID-19 and stayed at the low level in the following quarters (-18% in Q3 2021 vs Q3 2019). Weighted average rents of listed properties in Tbilisi districts followed the average pattern, however with a slightly different speed of recovery. In Q3 2021, Chughureti, Krtsanisi and Nadzaladevi observed higher listed rents compared to the same period of 2019. Didi Dighomi, Isani and Gldani districts were the slowest recovering districts in terms of listed property rents (for more details see Figure A1 in Annex).

Primary data on actual retail rents collected from retailers showed that rents (in USD) were decreasing even before the pandemic (see Figure 3). This trend was probably driven by GEL depreciation, which caused partial price adjustment in USD. In addition, despite the general view, that rents are fully dollarized, this is not completely true. According to our data and conducted interviews, 70%-80% of rents in street retail are denominated in USD, up to 5% in EUR and the rest are in GEL. Furthermore, retailers, who already have more than 5-year negative experience of GEL depreciation are trying to include currency risk hedging

FIGURE 2

WEIGHTED AVERAGE LISTED RENT, TBILISI (USD PER SQM)



Source: myhome.ge; TBC Capital

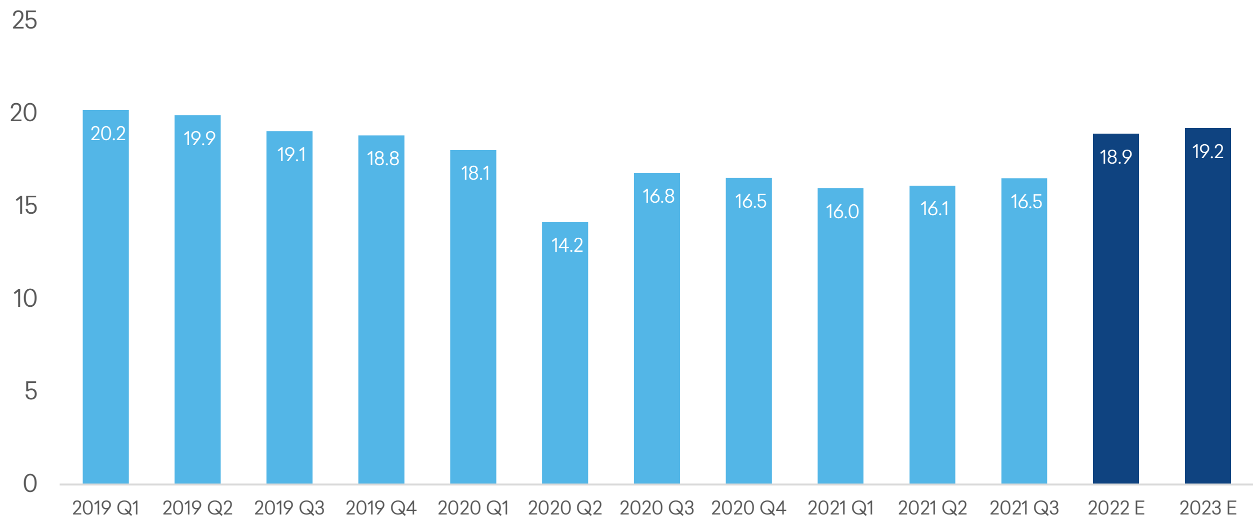
mechanism in lease agreements. This mechanism means fixing the rent's rate for USD/GEL rate intervals. For example, if the market exchange rate varies from 3.0 to 3.3 GEL per USD, retailer's exchange rate will be 3.0; if actual exchange rate varies from 3.3 to 3.6 GEL per USD, retailer's exchange rate will be 3.3, etc. Therefore, USD/GEL fluctuations have a high impact on rents.

Nevertheless, rents slumped by 29% YoY in Q2 2020, as the majority of landlords proposed rental holidays and/or massive rental discounts during the first (and most strict) lockdown. As restrictions were temporarily lifted, actual rents slightly picked up in Q3 2020. However, re-imposed restrictions, caused an immediate decline in the following quarters.

Since Q1 2021 street retail rents have been recovering. In Q3 2021, weighted average rent stood at 16.5 USD per SQM in Tbilisi, a 13.3% decrease compared to the same period of 2019. GEL depreciation (of 6.9%) is one reason of such decrease: "In some locations new rents (fixed in USD) stayed at the same level, in others it slightly decreased, however we are paying more in GEL." (FMCG store representative). Some retailers still benefit from the temporary rental discount in some locations. These benefits will expire in 2021.

FIGURE 3

WEIGHTED AVERAGE ACTUAL RENT,TBILISI (USD PER SQM)



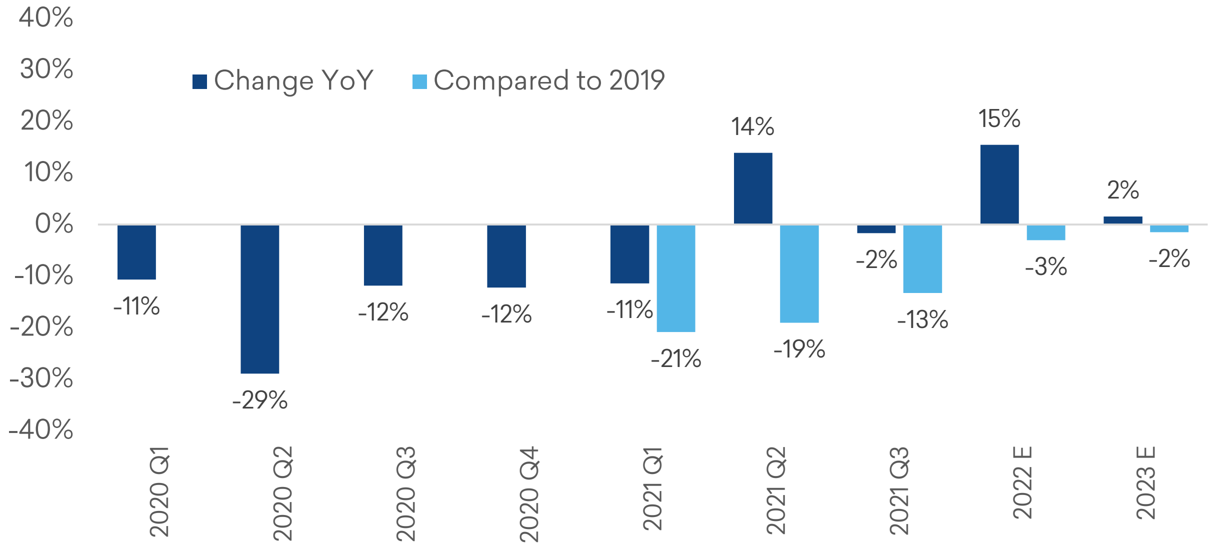
Source: TBC Capital

Importantly, rents in contracts renewed or concluded in Q2 2020 – Q1 2021 were on average by 5%-15% lower compared to the pre-pandemic levels. Increasing supply (see section below) also will drive rent down. However, revival in economic activity and high inflation of construction materials will put upward pressure on rent.

Considering all these factors we expect the weighted average rents to recover towards the end of 2023, averaging 19.2 USD per SQM.

FIGURE 4

GROWTH RATE OF WEIGHTED AVERAGE ACTUAL RENT IN STREET RETAIL, TBILISI

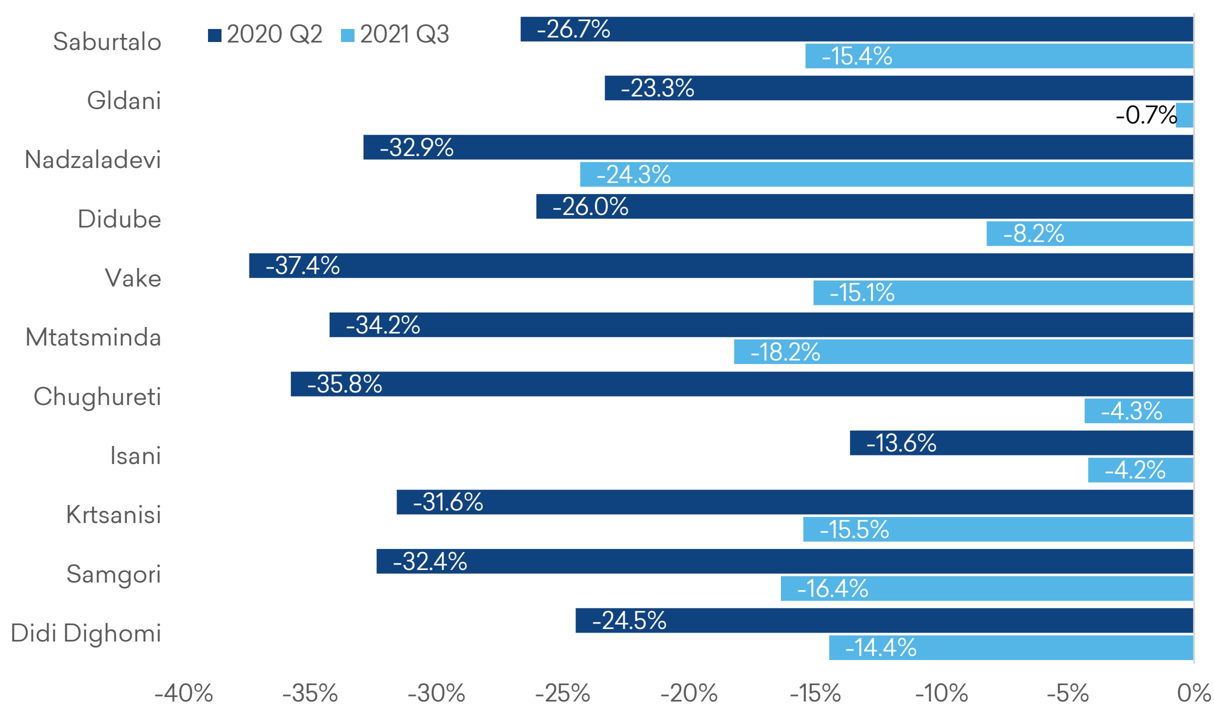


Source: TBC Capital

Pandemic hit rents in prime districts harder (see Figure 5). Rents in Vake, Mtatsminda and Chughureti slashed by more than 30% YoY in Q2 2020. As for today, Gldani is the only district, where rents recovered to the pre-pandemic level, while Nadzaladevi is the worst performer with rents by 24.3% lower compared to 2019 Q3 (for more details see Figure A2 in Annex).

FIGURE 5

WEIGHTED AVERAGE ACTUAL RENT, TBILISI DISTRICTS (USD PER SQM, YOY CHANGE VS SAME PERIOD OF 2019)

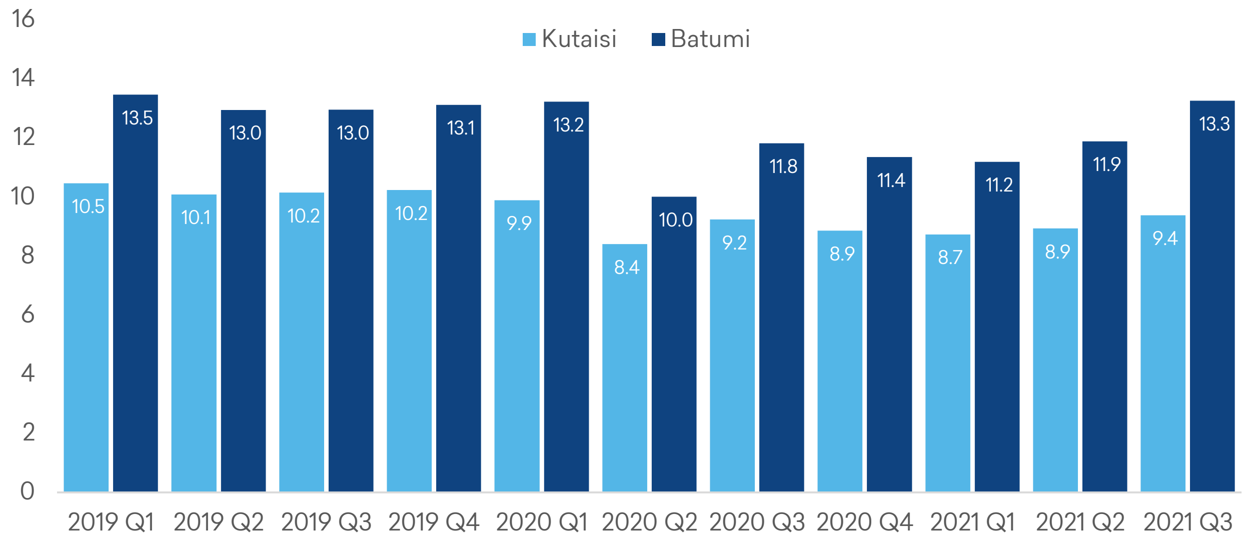


Source: TBC Capital

Actual rents in Kutaisi and Batumi showed patterns similar to one observed in Tbilisi: minor reduction before the pandemic, fall in Q2 2020 (-16.7% YoY in Kutaisi and -22.7% YoY in Batumi) and upward trajectory since Q1 2021. In Q3 2021, weighted average rent stood at 9.4 USD per SQM in Kutaisi (-7.6% vs Q3 2019) and 13.3 USD per SQM in Batumi (+2.4% vs Q3 2019).

FIGURE 6

WEIGHTED AVERAGE ACTUAL RENT, BATUMI AND KUTAISI (USD PER SQM)



Source: TBC Capital

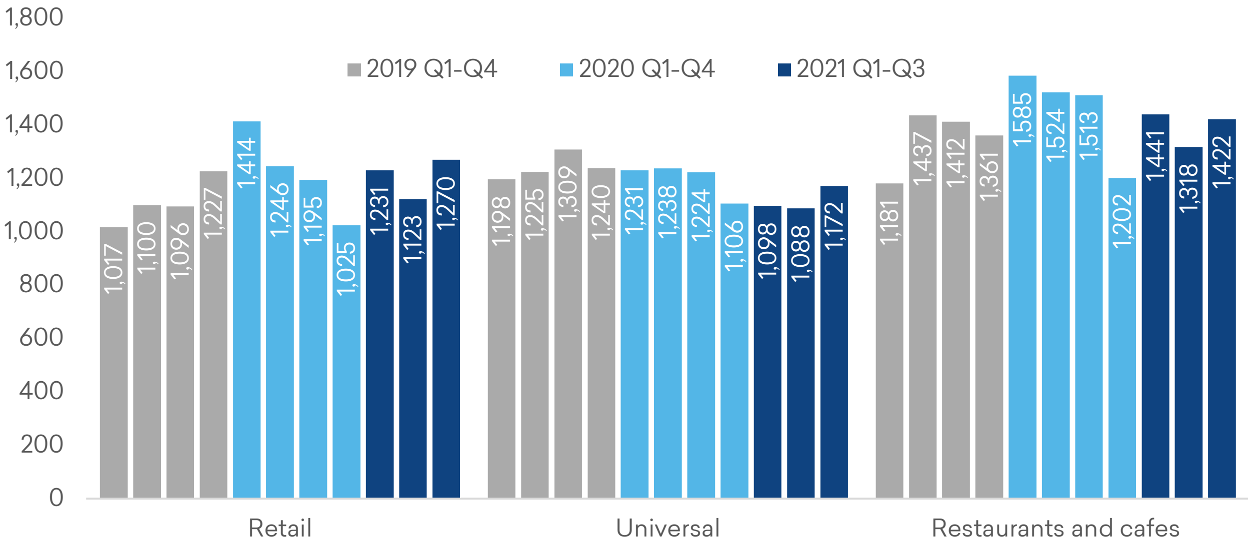
Sale prices

Listed sale prices of street retail properties started to decline only in Q4 2020 – two quarters later compared to rents (see Figure 7). Market expectations that COVID-19 was a short-term phenomenon could be the one reason of “stickier” sale prices. However, as COVID-19 second wave hit Georgia in Q4 2020, expectations adjusted and sale prices went down by 16.5% YoY (retail properties), 11.7% YoY (restaurants and cafes) and 10.8% (universal properties).

Starting from the following quarter prices started to recover on retail properties and restaurants and cafes, which were already up by 15.9% and 0.7% in Q3 2021 vs Q3 2019. However, average sale price on universal properties was - 10% below its 2019 level.

FIGURE 7

WEIGHTED AVERAGE LISTED SALE PRICE, TBILISI (USD PER SQM)



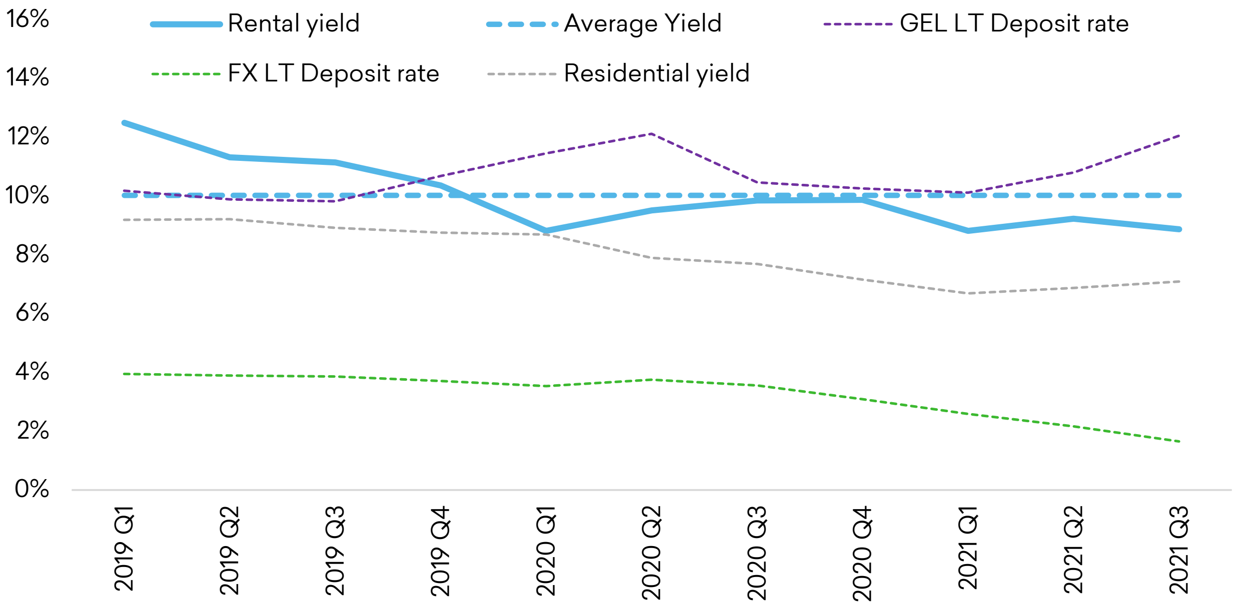
Source: myhome.ge; TBC Capital

Yields

As it was expected, the pandemic had a negative impact on yields, as correction in rents was greater than in sale prices (see Figures 8, 9 and 10). Rent-to-price ratios for retail, universal and restaurants and cafes, seem to have more or less similar dynamics, revolving around their average. Comparing the yields, retail takes the top, with an average of 10%, followed by universal, with 8.9% and lastly, restaurants And cafes, with an 8.1% average. The figures in 2021 stood noticeably below their pre-pandemic levels. For example, as of Q3 2021, yield for retail stood at 8.9%, which was 2.3 pp lower than in the same period of 2019.

FIGURE 8

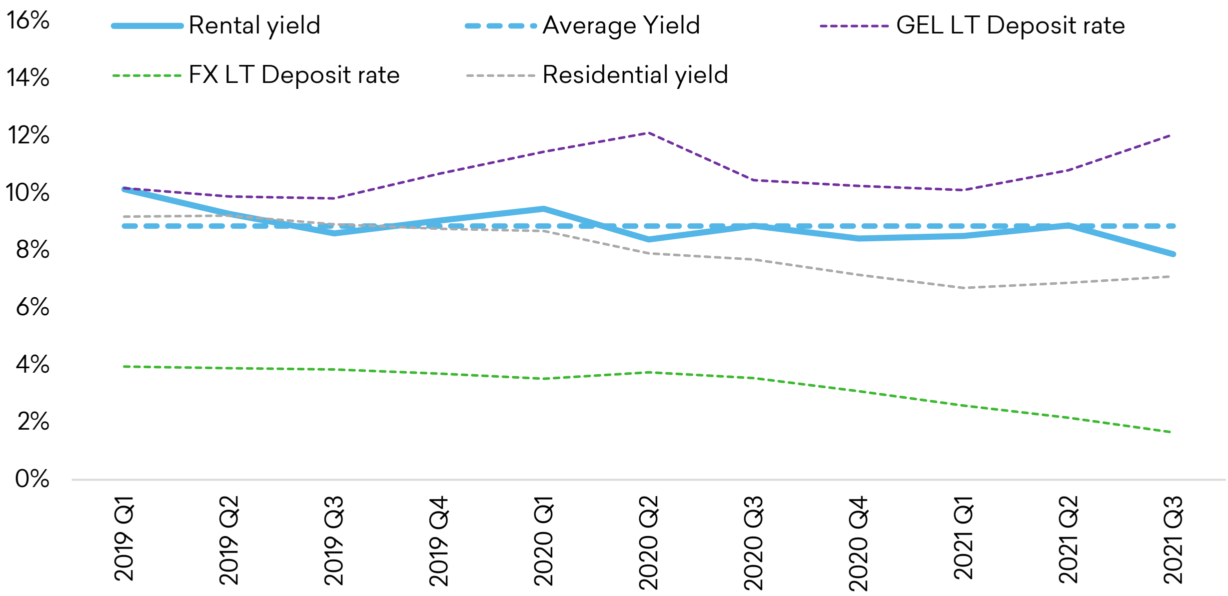
RENTAL YIELD, RETAIL PROPERTIES



Source: myhome.ge; NBG; TBC Capital

FIGURE 9

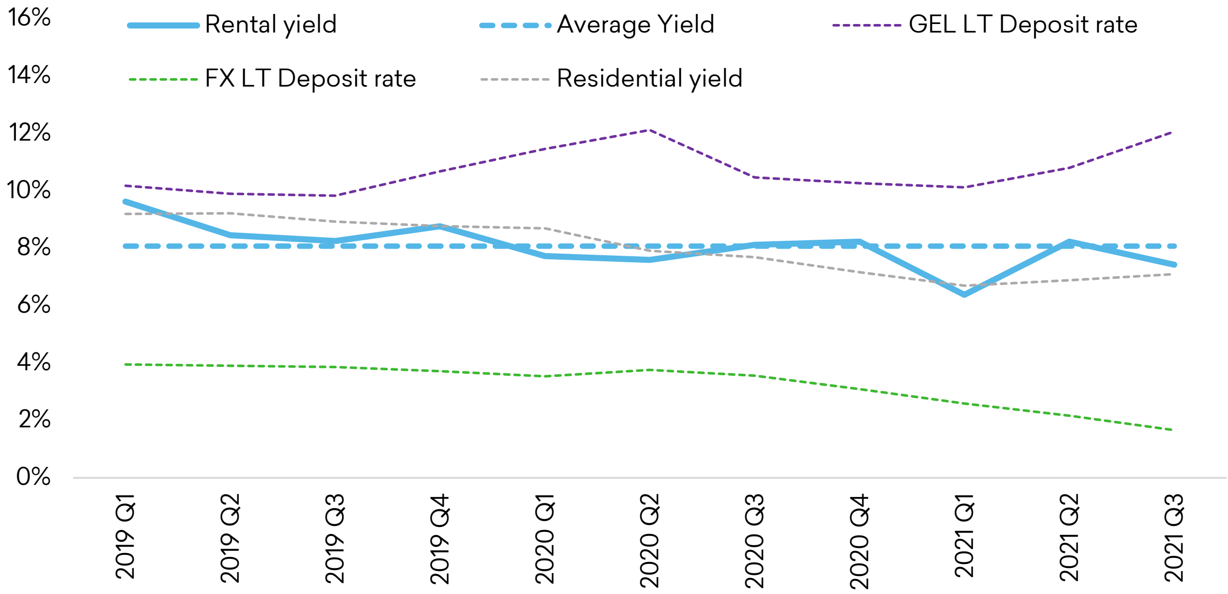
RENTAL YIELD, UNIVERSAL PROPERTIES



Source: myhome.ge; NBG; TBC Capital

FIGURE 10

RENTAL YIELD, RESTAURANTS AND CAFES



Source: myhome.ge; NBG; TBC Capital

Despite the negative impact of COVID-19 on rental yield on street retail properties, these types of CRE still provides high returns. The gap between rental yields and foreign currency long-term (FX LT) deposit rate even increased. In Q3 2021, the gap was 6.2 pp (+1.5 pp vs Q3 2019) in case of universal properties, and 5.8 pp (+1.4 pp vs Q3 2019) in case of restaurants and cafes.

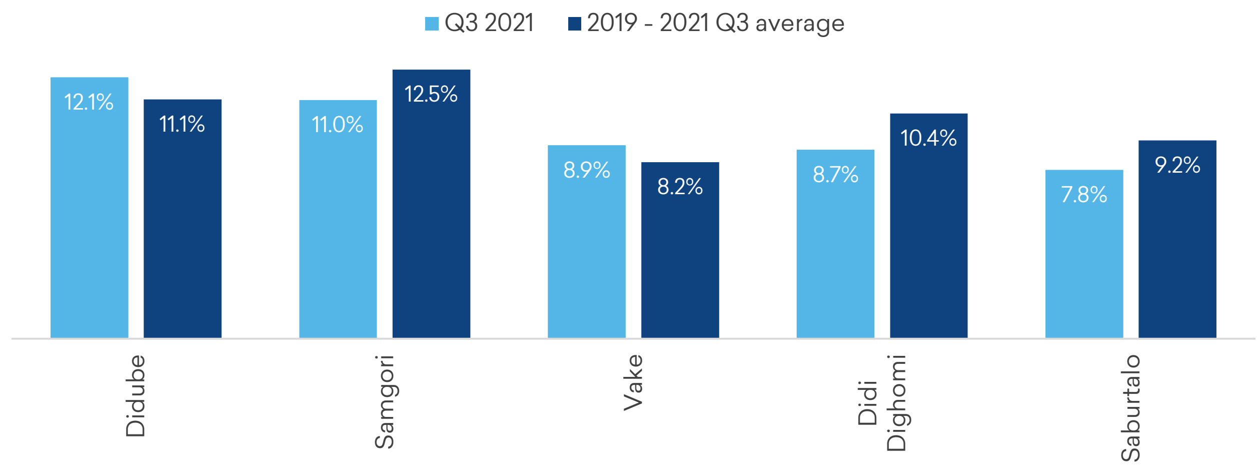
The gap between retail properties and FX LT deposit rate stood at 7.2 pp (-0.1 pp vs Q3 2019) - the highest in street retail. In Q3 2021, rental yields on street retail was higher even compared to residential yield.

Rental yields in Tbilisi significantly varies by districts. Figure 11 and 12 show rental yields for retail and universal properties for districts, which have sufficient number of observations (greater than 20 listings for rent and sale per quarter).

Didube (12.1%) and Samgori (11.0%) had the highest rental yield on retail properties in Q3 2021. As for universal properties, highest rent were observed in Didi Dighomi (9.7%), Isani (9.0%) and Samgori (8.8%).

FIGURE 11

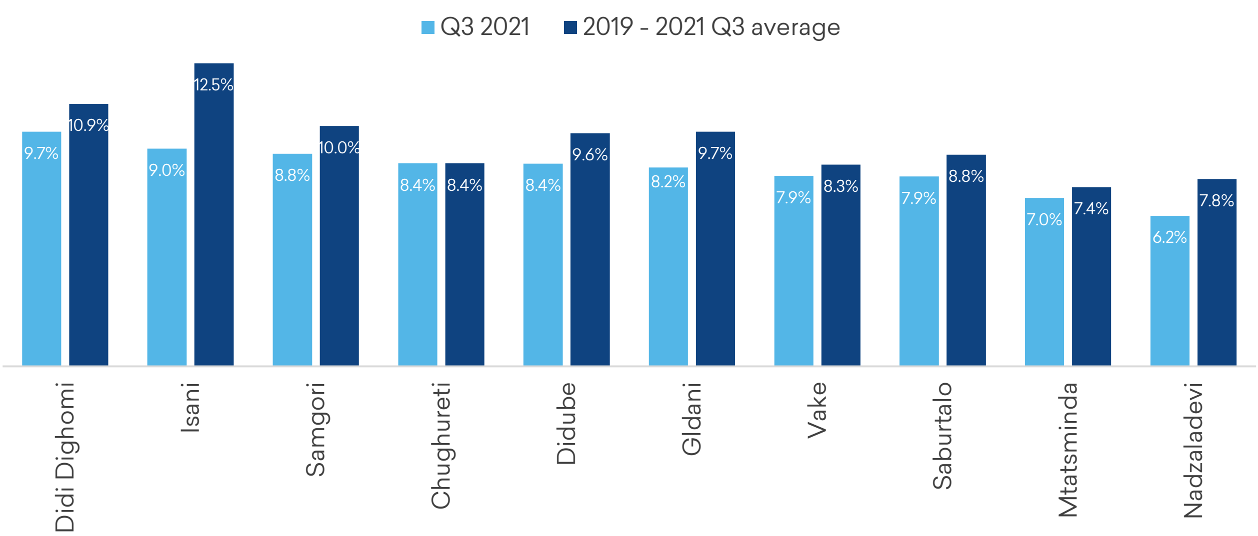
RENTAL YIELD BY DISTRICT, RETAIL PROPERTIES



Source: myhome.ge; TBC Capital

FIGURE 12

RENTAL YIELD BY DISTRICT, UNIVERSAL PROPERTIES



Source: myhome.ge; TBC Capital

Recent data on permits for construction of street CRE (see section below) shows that investors are still interested in this type of CRE in Tbilisi. However, globally investors' sentiments towards retail has changed.[16] Investors are looking for alternatives, which provide stable income - sectors that benefit from strong demographic drivers. The top alternatives are energy infrastructure, life sciences, logistics facilities, data centers and health care. From traditional real estate sectors, only industrial and residential is showing good investment prospects, while retail parks and high street shops are on the bottom of the list in terms of investment and development prospects.

Vacancy rates

Pandemic's impact on expansion strategy of large retail chains seems to be limited according to our sample data. It should be noted that data collected from retailers is dominated by FMCG, Pharma, and Financial and Clothing sector. Therefore, our findings might be not representative for other sectors in terms of total leased area and properties. However, as these sectors are major tenants in street retail, observed trends in rent prices reflect the overall market dynamics.

The total number and area of rented retail properties in Tbilisi was increasing before the pandemic and continued to do so afterwards. Therefore, no signs of massive closures and weakened demand are observed.

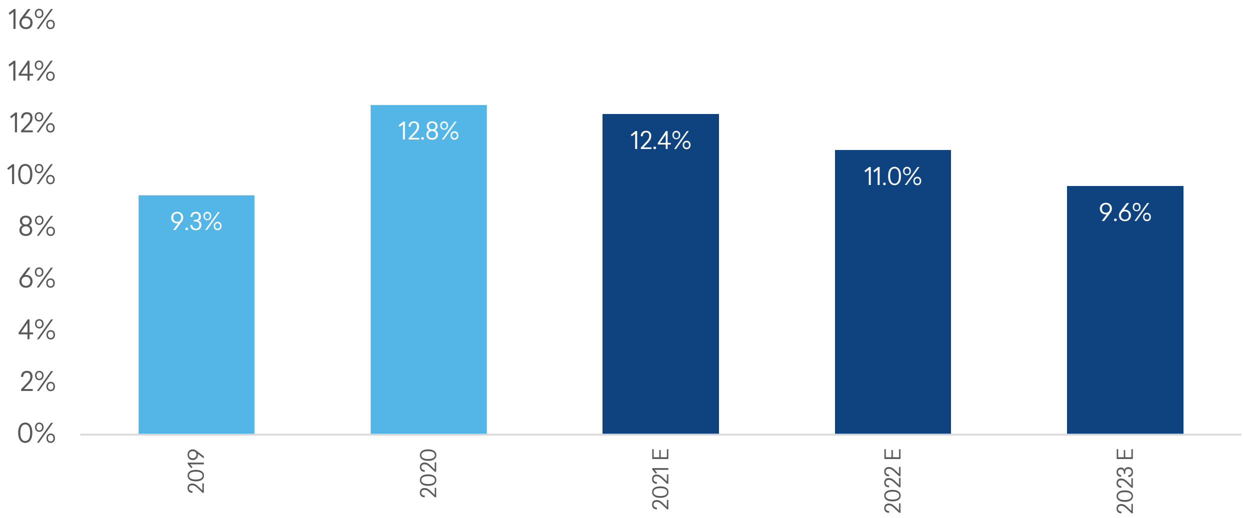
"We closed couple of stores in 2020 and beginning of 2021 due to extreme decline in foot traffic and landlords refusing to provide any discounts. Other than that pandemic did not affect our plans and we expanded our retail chain." (FMCG store representative).

However, the overall impact of COVID-19 on vacancies in Tbilisi was negative. Due to the crisis in tourism sector, vacancies on Rustaveli and Agmashenebeli Avenues increased from 5% and 10% in 2019 to 13% and 16% in 2020 respectively. The similar impact was observed in other touristic locations/streets.

As economy is recovering, we project vacancy rates to be 12.4% in 2021 – a marginal improvement compared to 2020 (see Figure 11). Considering the pace of recovery in tourism and future supply of retail properties (see the section below), vacancy rates will gradually decline to 9.6% in 2023.

FIGURE 13

VACANCY RATES IN STREET RETAIL, TBILISI



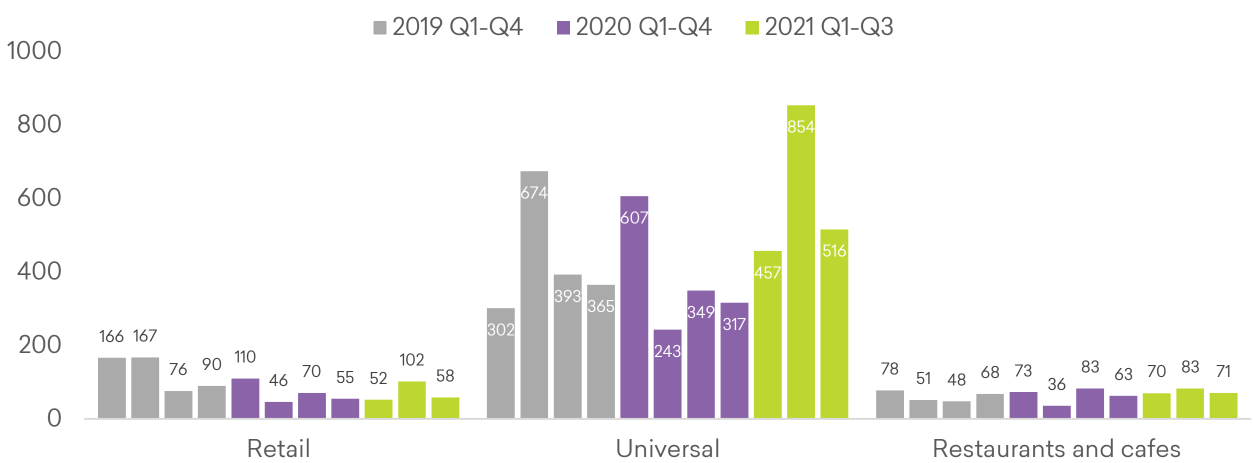
Source: Colliers International

Supply

Total listed areas of street retail real estate for rent showed high quarterly fluctuations without any clear pattern in supply change during or after the pandemic (see Figure 12 and 13). 588 retail properties with a total area of 58,000 SQM, 428 restaurants and cafes with a total area of 71,000 SQM, and 3,985 of universal properties with a total area of 516,000 SQM was available in Q3 2021 for rent in Tbilisi. Saburtalo, followed by Mtatsminda, Vake and Didube were the leading districts in terms of rental listings (for more details see Figure A3 in Annex).

FIGURE 14

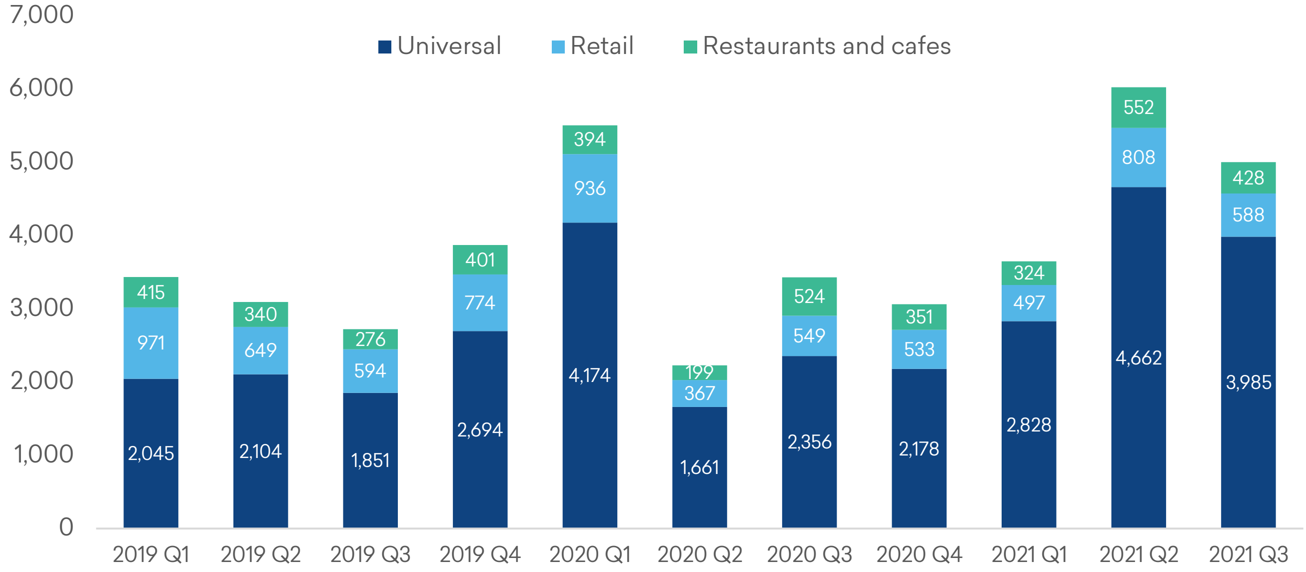
TOTAL AREA LISTED FOR RENT, TBILISI (000' SQM)



Source: myhome.ge; TBC Capital

FIGURE 15

NUMBER OF LISTINGS FOR RENT, TBILISI

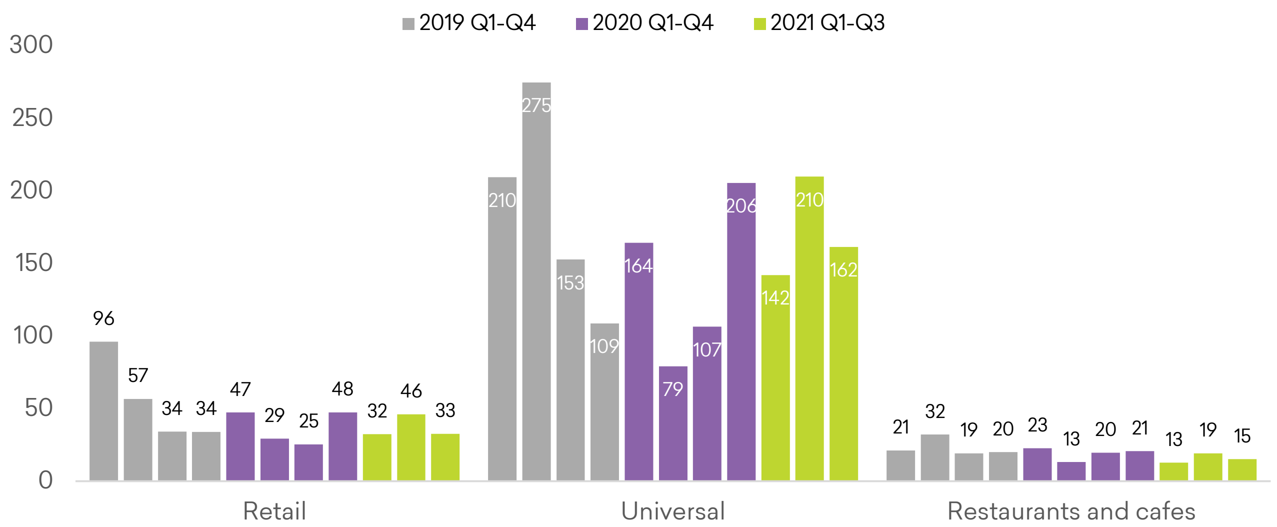


Source: myhome.ge; TBC Capital

No signs of COVID-19's possible impact was observed in data on street retail real estate listed for sale (see Figures 14 and 15). 301 street retail properties with a total area of 33,000 SQM, 93 restaurants and cafes with a total area of 15,000 SQM, and 1,175 universal properties with a total area of 162,000 SQM were listed in Q3 2021 for sale in Tbilisi. Saburtalo, followed by Vake, Nadzaladevi and Mtatsminda, were the leading districts in terms of sale listings.

FIGURE 16

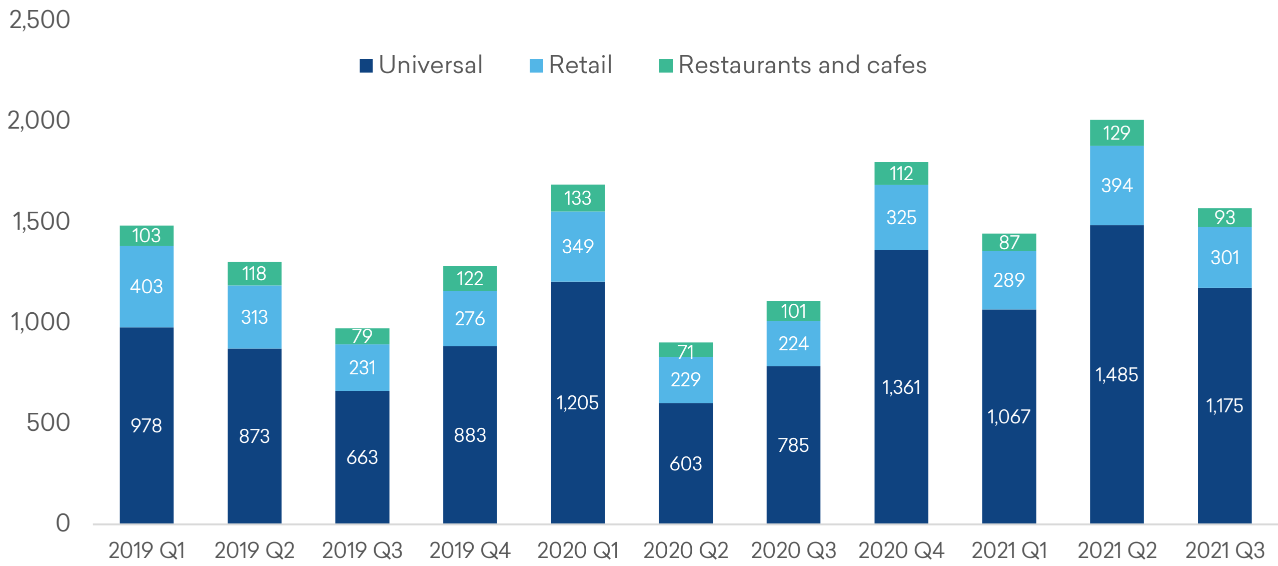
TOTAL AREA LISTED FOR SALE, TBILISI (000' SQM)



Source: myhome.ge; TBC Capital

FIGURE 17

NUMBER OF LISTINGS FOR SALE, TBILISI

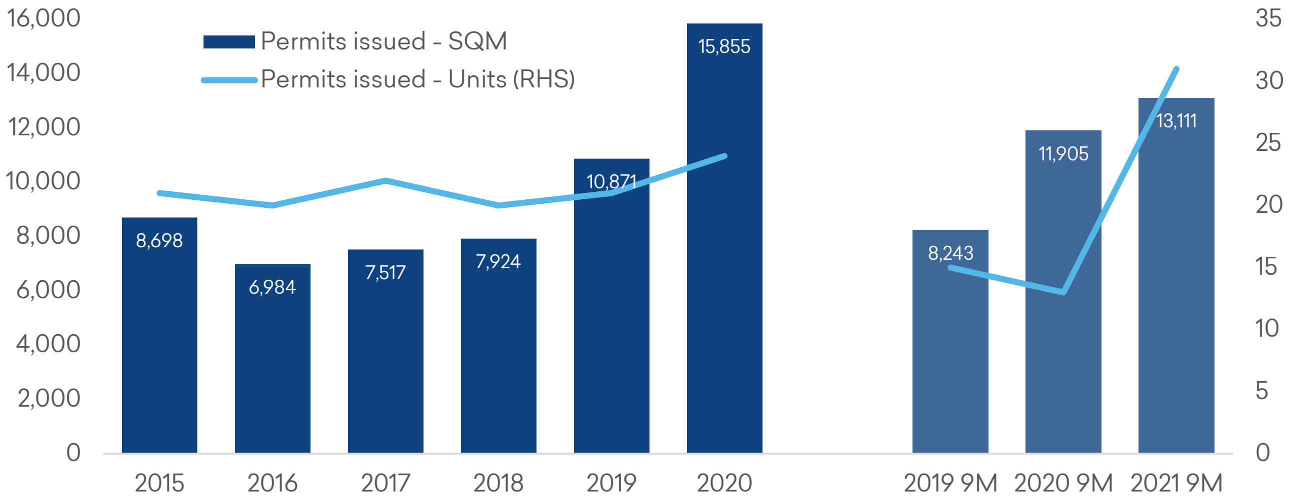


Source: myhome.ge; TBC Capital

The supply of CRE is an important factor, which affects market's major indicators, such as rent and vacancies. Data on permits issued for construction of CRE might be used to determine the supply of CRE in 2 years – an average time of construction completion.

In 2020 - 9M 2021, total area of issued permits for construction of street retail (shops) properties in Tbilisi was 72% above five-year average, respectively. It indicates that street retail real estate market could be at risk of oversupply in 2022-2023. This puts a downward pressure on rents and property values. However, data on permits might be inflated by the law on "Energy Efficiency of the Buildings" (adopted in May 2020), which comes into force in July 2022. In addition, increased construction costs, which were 36% up in October 2021 vs 2019 average, will put upward pressure on rents and property values in the upcoming years.

FIGURE 18
PERMITS ISSUED FOR CONSTRUCTION OF STREET RETAIL (SHOPS) PROPERTIES IN TBILISI (AREA, UNITS)



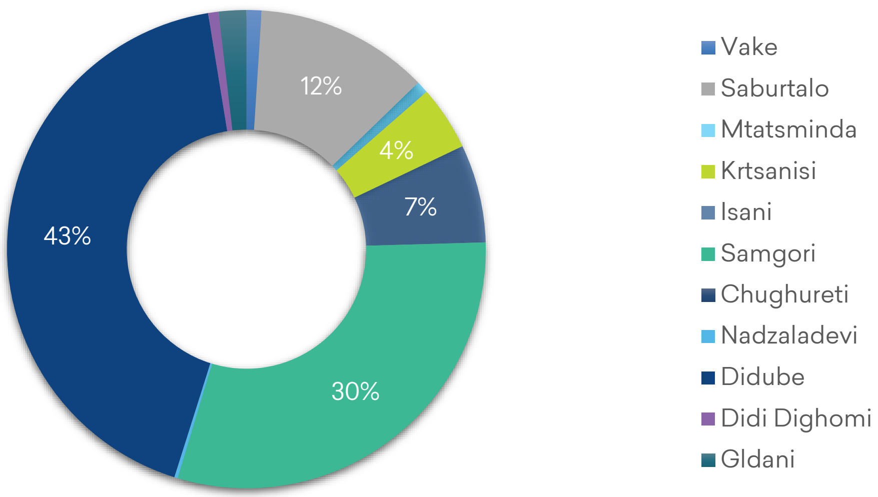
Source: Tbilisi City Hall, TBC Capital

On district level, Didube (43% of total) and Samgori (30%) accounted for the biggest part of total area for construction of retail (shops) properties in 2020-9M 2021 period, followed by Saburtalo (12%), Isani (7%) and Krtsanisi (4%).

It should be noted that construction pipeline is concentrated in the districts with highest rental yields (Figure 13 and 14).

FIGURE 19

DISTRIBUTION OF TOTAL ARE ISSUED FOR CONSTRUCTION OF STREET RETAIL (SHOPS) PROPERTIES IN 2020-9M 2021



Source: Tbilisi City Hall, TBC Capital

Emerging trends in Georgian street retail

Long-term development strategy

According to our data and conducted interviews, COVID-19 has limited impact on retailers' long-term development strategy. The expansion plans existing prior to the pandemic were largely unaffected. "Pandemic has slightly delayed our projects, but our decisions on opening new stores were not affected." (Electronics and home appliance store representative).

Foot traffic, neighborhood, access to public transportation and parking space, proximity to competitors, degree of presence and rent prices were the major factors for retailers when choosing rental property. These factors did not change during or after the pandemic. However, lockdowns and mobility restrictions showed the retailers the value of "neighborhood" or "corner" stores. Pharma and FMCG sector representatives mentioned that COVID-19 increased the importance of presence in the area and the number of physical stores: "We saw the demand for that and will accelerate the expansion of the chain in the future. We will try to be present in every neighborhood of Tbilisi." (Pharmacy representative).

At the same time, most of the retailers put bigger emphasis on the regional development as their penetration in Tbilisi is already high. Batumi, Kutaisi, Rustavi, Telavi, Zugdidi and Poti will be the most popular cities in terms of future openings of retail chain stores in upcoming years. Respondents mentioned that regional expansion decisions are made on analysis of e-commerce data and customers' feedbacks during COVID-19 outbreaks. Political unrest, frequent protests and road closures are additional factors negatively affecting retailers in Tbilisi, while these barriers are mostly non-existed in the regions.

Redefining high streets in Tbilisi

High streets in Tbilisi are losing their attractiveness for retailers and shoppers. According to Colliers, vacancy rates nearly doubled in 2020 vs 2019, as 169 tenants left Tbilisi high streets, with the total area of 11,385 SQM.[20] At the same time, rents of new/renewed contracts nearly halved in 2020 vs 2019.

However, this dynamic in rents and vacancies started even before pandemic. Street rehabilitation projects, change in transport flows and emergence of malls in central districts of Tbilisi, all affected high streets. The pandemic only exaggerated these trends by causing greater impact in touristic locations.

Chavchavadze Avenue was mainly affected by prolonged street rehabilitation works. Nowadays, changed transport flows and complicated access for shoppers with personal cars are the major factors affecting the attractiveness of this location for tenants. However, retailers emphasized that "Chavchavadze (in terms of sales and opening on new shops) is recovering faster than other high streets in Tbilisi". (Clothing and footwear store representative).

The opening of Galleria Tbilisi shopping mall seems to have a negative impact on street retail on Rustaveli Avenue. In addition, Rustaveli and Agmashenebeli Avenue (in particular) were affected by decline in number of tourists during the pandemic. Therefore, the recovery of rents and vacancies on these streets will be largely dependent on rebound in the tourism industry.

The attractiveness of Pekini Avenue for shoppers was simultaneously affected by redesigning transport flows, decreased number of parking spaces and proximity to newly opened City Mall Saburtalo. "Foot traffic on Pekini Avenue is decreasing and the street is losing the role for the traditional retail". (Clothing and footwear store representative).

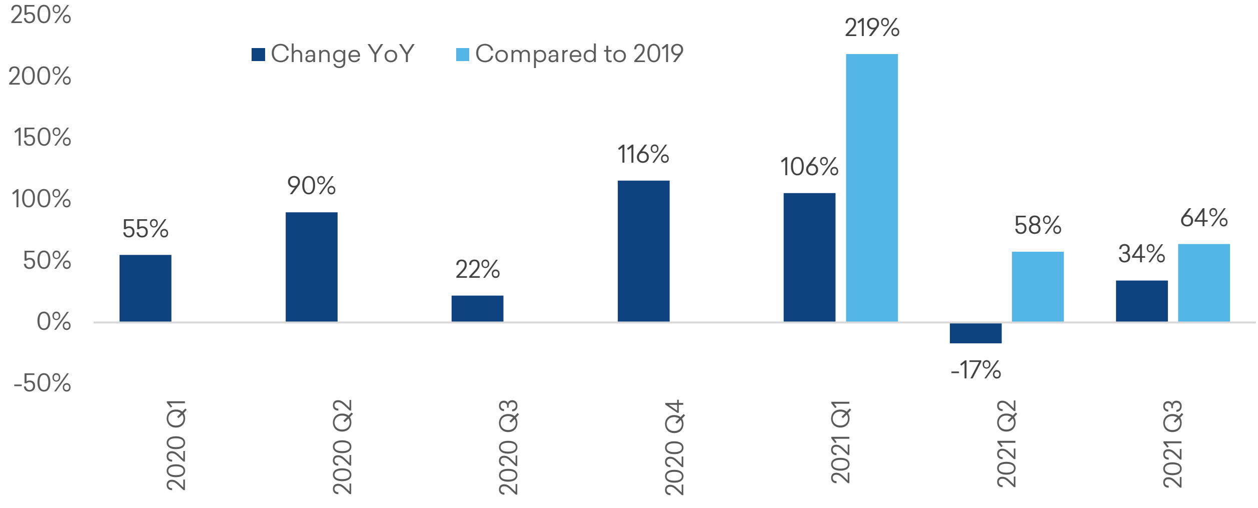
E-commerce in Georgian retail

Similar to global trends, the pandemic accelerated the growth of e-commerce in Georgia (see Figure 18). Lockdowns, curfews and mobility restrictions encouraged consumers to shop online. In some periods, it was the only option to purchase products (except groceries and pharmaceuticals). As a result, the demand on e-commerce significantly increased in Georgia.

However, the retailers, except some big players with already expanding e-commerce offerings, were largely unprepared for such drastic changes. Overnight, retailers were forced to shut stores and rapidly escalate their shift to e-commerce. This transition was often chaotic with a number of new challenges for nearly all companies. The most common challenges were insufficient time and financial resources to develop a dedicated web-page for online sales and providing timely delivery service. "We don't have enough time and resources to create a web-page; instead we provided e-commerce through our call center" (Perfume/beauty store representative). "The delivery service was the main obstacle to our online sales - instead of promised 3-5 days delivery, it would take up to 10 days" (Furniture store representative).

FIGURE 20

RETAIL E-COMMERCE SALES GROWTH



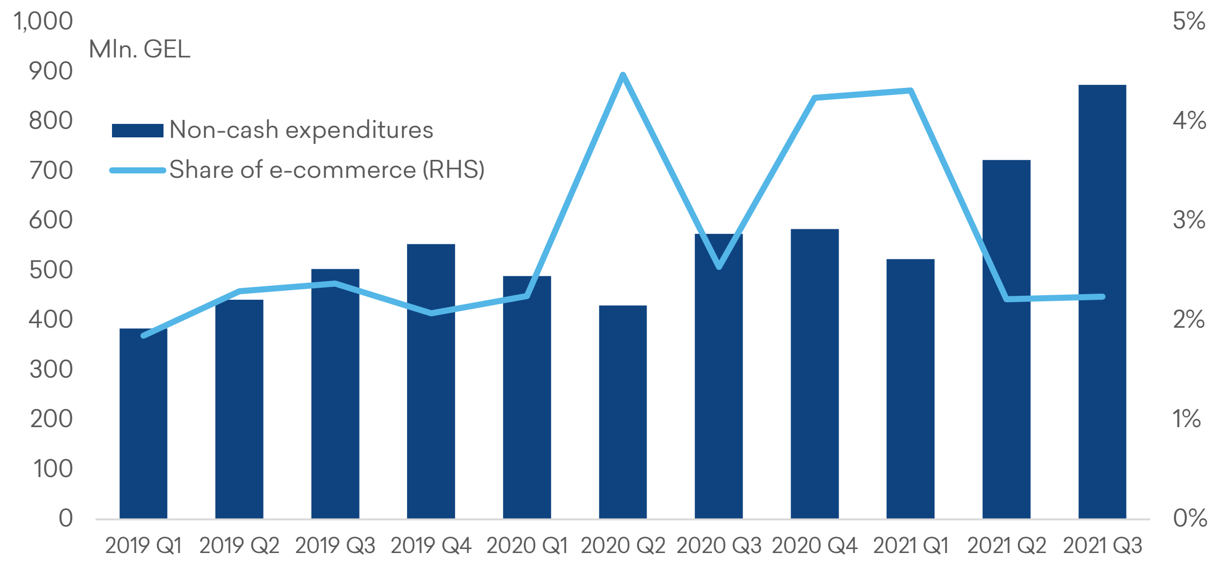
Source: TBC Capital

Nevertheless, online sales in Georgia spiked in 2020 and reached 3.3% of total retail sales (share of online sales in non-cash expenditures through TBC Bank channels).

However, as restrictions were lifted and shoppers returned to the streets, the growth of e-commerce slowed down, while its share declined to 2019 levels.

FIGURE 21

SHARE OF E-COMMERCE IN RETAIL SALES



Source: TBC Capital

Based on the recent trends in Georgian e-commerce, we do not expect that it will have a notable impact on CRE in the upcoming years. "E-commerce development in Georgia is still at a very low level. Customers still prefer physical shopping and will continue so in the near future." (Electronics and home appliance store representative).

Lease agreements

The pandemic and inability of some retailers to pay monthly rents drove changes in landlord-tenant relationship on Georgian street retail real estate market. These changes are in line with global trends.

First, the majority of property owners shared the negative economic impacts of COVID-19 and imposed lockdowns with their tenants by providing rental holidays or temporarily discounted rents during 2020 and 2021.

Another important change is moving to turnover-based models: a) Turnover rent - a flat or stepped percentage of the tenant's turnover, b) Mixed rent - combination of turnover rent with minimum rent, which is fixed at some level. Such rental agreements are a common practice in malls. However, the willingness and ability of street retail real estate property owners to switch to turnover-based models are lower due to the reporting nature of the provision. Landlords, usually physical persons, are not able to check their tenants' turnover.

Therefore, landlord-tenant relationship in turnover-based models depends on the trust between parties. In the absence of such trust, they increase landlords' costs of external audit services. Despite these challenges, the share of turnover-based models is steadily increasing in street retail according to our interviews. Tenants want to ensure their businesses survive the fluctuating market conditions, while property owners are trying to keep their properties tenanted.

Retailers also mentioned that the share of GEL denominated lease agreements in street retail is expected to rise in the future. "As vacancy rates increased in the last two years we have more bargaining power in negotiation with landlords to fix new contracts in GEL." (FMCG store representative). At the same time, high dollarization of mortgages is the major factor driving investors' desire/necessity to receive rental income in USD. Therefore, future changes in Larization of mortgages will determine the popularity of GEL denominated lease agreements.

Shopping malls in Georgia

The impact of COVID-19 on performance of shopping malls was stronger compared to the street retail, as shopping malls faced stricter and longer regulations in 2020-2021. Shopping malls provided rental holidays and discounts to their tenants for the periods when their operation was prohibited or restricted. In addition, nearly all lease agreements in modern shopping malls include turnover-based models, which automatically reduces rent revenues when tenants do not perform well.

Weighted average rents halved in Q2 2020 and stayed at the low level during the whole year. In Q3 2021, rents were 19% lower compared to 2019's level. At the same time, vacancy rates remained stable in 2020 and are expected to increase only marginally in 2021, as operators try to maintain their malls occupied and exit penalties prevent the drain of tenants.

According to issued construction permits, the GLA in shopping malls in Tbilisi is expected to increase by 80,000 SQM in 2022-2023. Increased supply is expected to have a greater impact on vacancies in Didi Dighomi, Nadzaladevi, Gldani and Krtsanisi.

Considering all these factors, increased construction costs and retailers' expectations, we project rents to fully recover towards the end of 2022, while vacancy rates will temporarily increase in 2022 and return to pre-pandemic level in 2023.

Major Indicators

Rents

In contrast with a street retail, mixed rents model (a combination of minimum fixed rent and turnover rent) is a commonly adopted practice in malls. Some (usually the largest) tenants pay only turnover-based rents (without minimum fixed rent), while only retail (mall) kiosks are paying fixed rents. Minimum fixed rents in Tbilisi shopping malls are fully dollarized and no changes in this regard are expected in the near future. At the same time, the minimum fixed rent depends on the size of area occupied by tenant: bigger the area - lower the rent per SQM. On top of the rents, tenants pay mall's services fees, which vary from 2 to 7 USD. The fee rate differs by malls and depends on the size of area occupied by tenant.

Weighted average rents in Tbilisi's modern shopping malls fell by 16% YoY in Q1 2020, as the shopping malls were forced to stop their operation in late March (see Figure 20). In Q2 2020, rents collapsed by 53% YoY reaching the minimum at 12.3 USD per SQM. In the following quarters, as COVID-19 regulations were still affecting the operation of malls, weighted average rents were 27-34% down compared to the same periods of 2019.

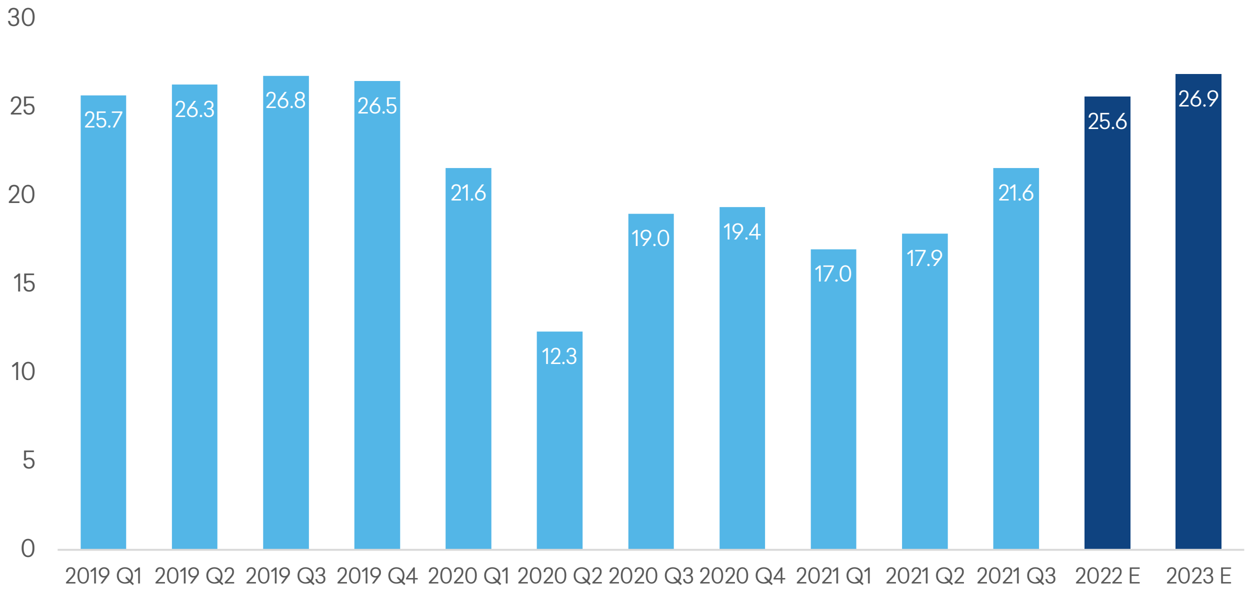
Despite the fact that malls were fully operating since April 2021, the recovery in rents was slow. In Q3 2021, rents stood at 21.6 USD per SQM, which was 19% lower compared to 2019's level. This could be explained by the following factors:

a. In new lease agreements (contracted during COVID-19 outbreaks) rents decreased by about 10-20%. This factor. might continue to affect weighted average rents in upcoming 3-7 years – a typical length of lease agreements in malls.

b. Temporary discounts on rents are still in place in some cases. Its impact on weighted average rents will end in 2021

FIGURE 22

WEIGHTED AVERAGE ACTUAL RENT IN MODERN SHOPPING MALLS, TBILISI (USD PER SQM)



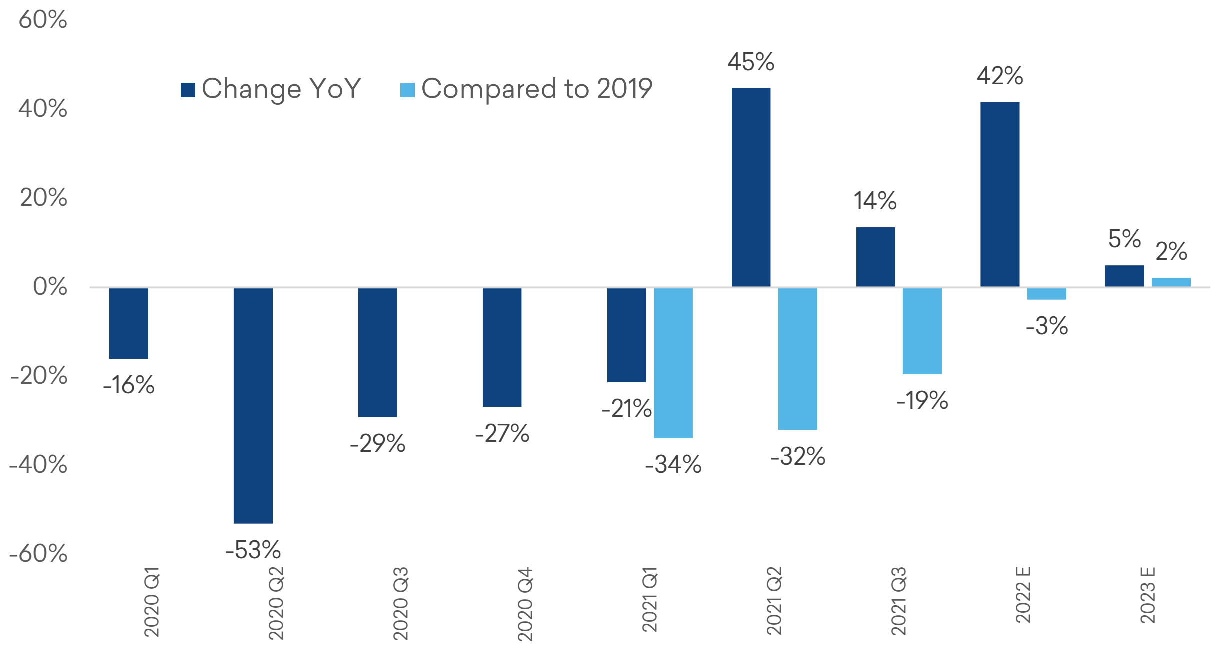
Source: TBC Capital

Similar to street retail, malls do not expect that e-commerce will have the negative impact on rents in the upcoming years, as “e-commerce is still underdeveloped in Georgia.”

Based on qualitative information received from interviews with retailers and shopping malls and considering the future supply of GLA in Tbilisi (see the section below), we expect the weighted average rents to fully recover towards the end of 2022, averaging 25.6 USD per SQM.

FIGURE 23

GROWTH RATE OF WEIGHTED AVERAGE RENT IN MODERN SHOPPING MALL, TBILISI



Source: TBC Capital

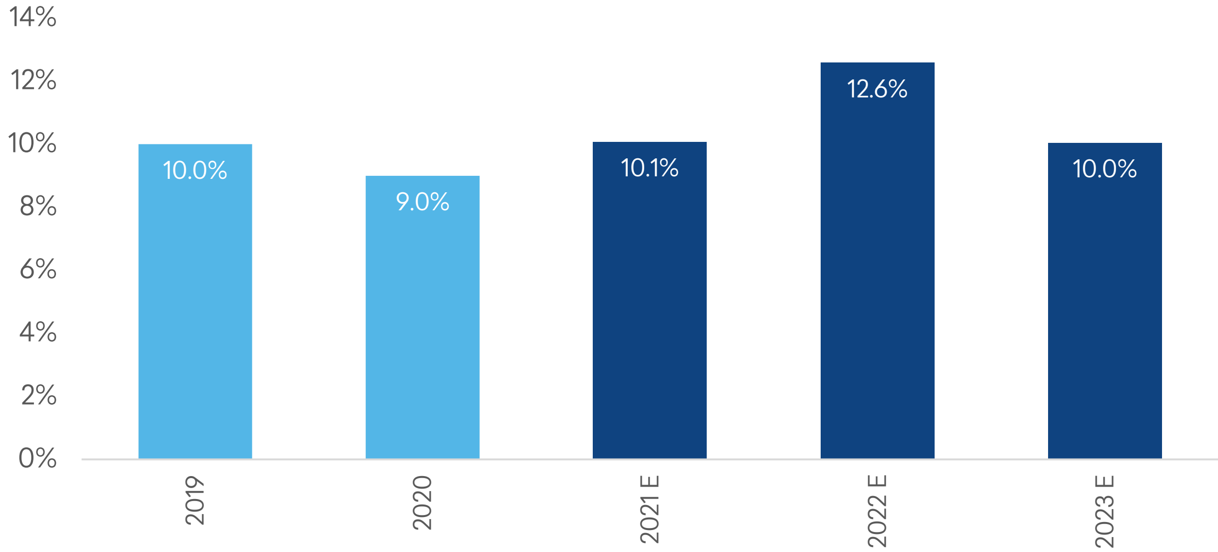
Vacancy rates

In contrast with rents' dynamic, vacancy rates in modern shopping malls was stable during COVID-19, which can be partially explained by retailers' expectations of quick recovery. In addition, mall operators tried to maintain their spaces occupied and provided sufficient rental discounts to their tenants.

GLA in Tbilisi (see the section below), we expect the weighted average rents to fully recover towards the end of 2022, averaging 25.6 USD per SQM.

FIGURE 24

VACANCY RATES IN MODERN SHOPPING MALLS, TBILISI



Source: TBC Capital; Colliers International

Supply

In 2020, total area of issued permits for construction of shopping malls in Tbilisi was 3.4 times above five-year average. Such increase is driven by:

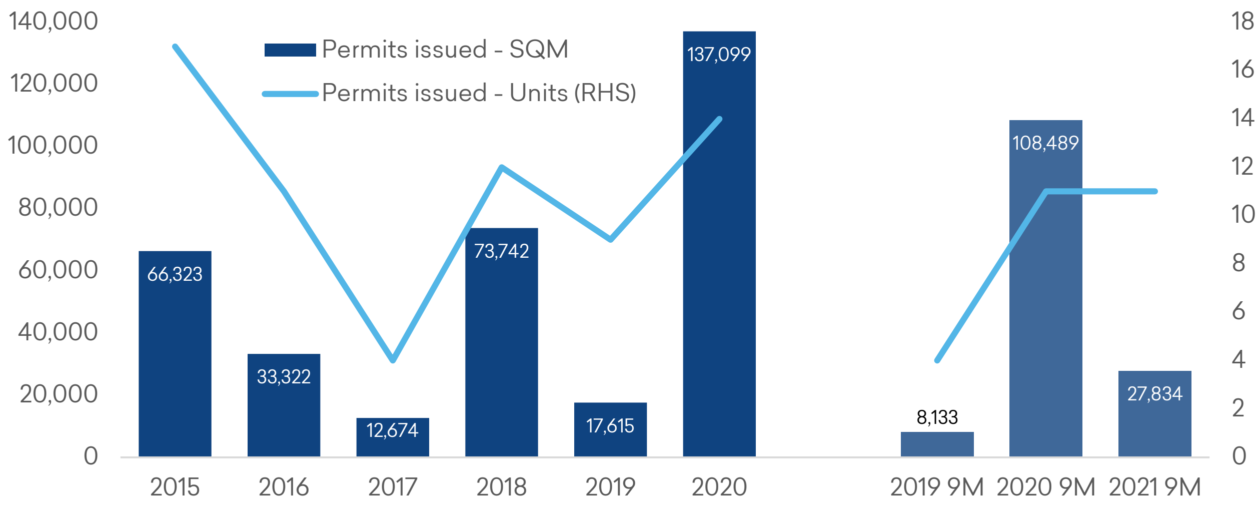
• One construction with GLA of around 50,000 SQM in Samgori. The project will be completed in 2024.

• Two constructions in Didi Dighomi with GLA of 25,000 SQM each. Both shopping centers will be operating in 2022.

In 9M 2021 total area of issued permits for construction of shopping malls was 32% lower compared to the five-year average. Nevertheless, supply of shopping centers in Tbilisi will increase in 2022-2023.

FIGURE 25

PERMITS ISSUED FOR CONSTRUCTION OF SHOPPING MALLS IN TBILISI (AREA, UNITS)

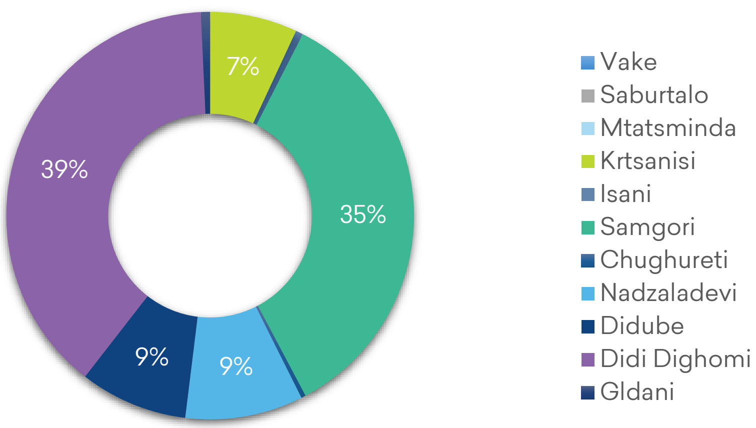


Source: Tbilisi City Hall, TBC Capital

On district level, Didi Dighomi (39% of total) and Samgori (35% of total) accounted for the biggest part of total area for construction of shopping malls in 2020-9M 2021 period, followed by Nadzaladevi (9% of total), Gldani (9% of total) and Krtsanisi (7% of total).

FIGURE 26

DISTRIBUTION OF TOTAL AREA ISSUED FOR CONSTRUCTION OF SHOPPING MALLS IN 2020-9M 2021

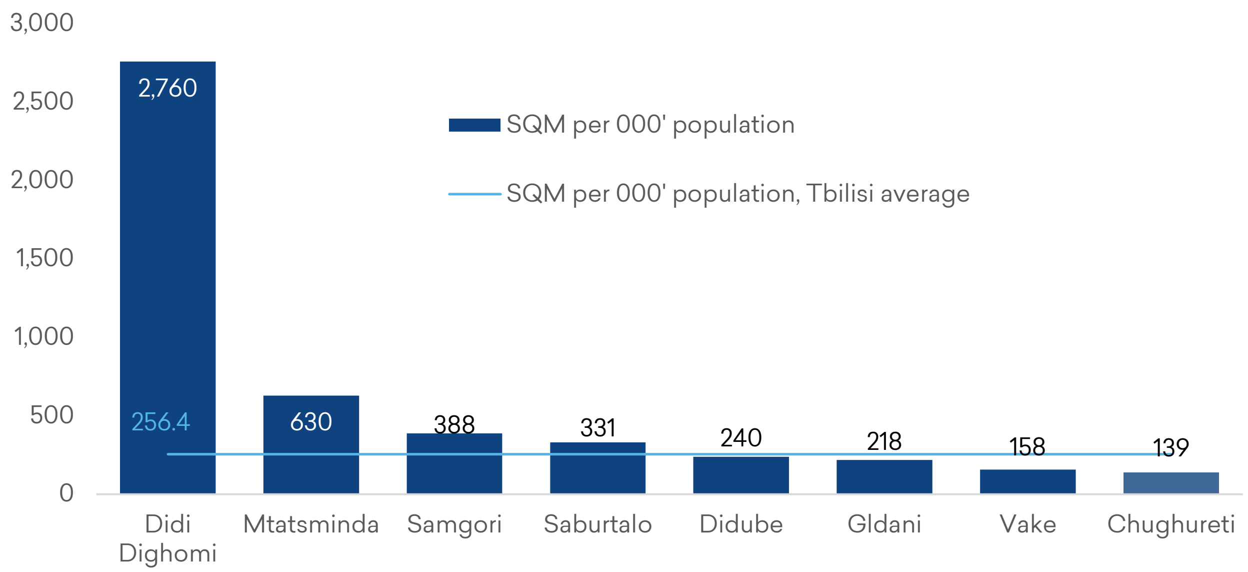


Source: Tbilisi City Hall, TBC Capital

In 2021, GLA in modern shopping malls per 1,000 population constituted 256 SQM in Tbilisi. The “density” of modern shopping malls varies significantly by districts (see Figure 25). Didi Dighomi, the district with lowest number of population, has the highest density with 2,760 SQM per 1,000 population. At the same time, this indicator is zero in Nadzaladevi, Krtsanisi and Isani (as the list of modern shopping malls consists of 12 malls and neither of them is located in these districts).

Considering the existing density of shopping malls and construction pipeline, rents and vacancies in upcoming years will be affected the most in Didi Dighomi and Samgori (at some degree).

FIGURE 27
DISTRIBUTION OF EXISTING GLA IN MODERN SHOPPING MALLS BY DISTRICT



Source: TBC Capital

Offices and business centers

Global Trends and future perspectives

European offices during the pandemic

The European office market was on the rise before the pandemic: investment in offices and rents were on the rise, while the vacancy rate reached the historically low level of 5.2% in 2019.[21] The pandemic reversed these trends. In 2020, office take-up dropped by 35% YoY, as people have been forced to work from home (WFH) due to strict lockdown measures imposed to contain the spread of the virus. In times of emerging uncertainties about the future of work, businesses focused mainly on lease renewals rather than expansion and relocation. The amount of grey space (tenant-controlled space available for sublet) in the market increased and vacancy rates rose to an average of 6.7% by the end of 2020.

The roll-out of the vaccination program has allowed the gradual return to the office. However, the uncertainties about the future of work and the future of the office remain. The average vacancy rate is expected to increase further in 2021 by about 80 bps to 7.5%, which is driven by excess supply (of secondary space returning to the market) rather than weakened demand. At the same time, rents remained largely stable, recording on average a 1% YoY decrease in rents. Despite the rising vacancy, inflation of construction materials and increased capital expenditures required to upgrade prime office space to meet ESG principles, asking rent prices are projected to rise again. The office market is expected to recover in 2022.

At the same time, European office investment contracted by 26% in H1 2021 compared to the five-year average. This change reflects a more cautious approach of investors to offices. If this trend remains, the supply of office space will be limited in the next years, driving vacancy down and fueling rents.

Emerging global trends

The future of remote work

The debate as to how demand for offices might be affected by work from home (WFH) practices has become polarized. Although many multinational companies are open to embracing working from home as a long-term permanent option for employees, analysts have strong views that the impact on occupancy rates will differ by region, with European and US offices affected more compared to Asian markets.[16,18,23] The reasons for Asia's resistance to attrition from WFH policies are well known - cultural influences, office hierarchies, small homes, and the desire to collaborate all play their parts.

Nevertheless, there still seems to be an acceptance that, even a hybrid office/home approach is by now well established and probably here to stay, with a majority of experts expecting a lasting increase in remote working. The exact impact of all these drivers of office demand is hard to game and it will vary by location and type of job. However, analysts agree that space demand will be lower than before.[16] Still, the decline will not match the reduction in the average daily worker occupancy in the workplace, as companies will need to provide enough space for remote workers to collaborate directly, at least part-time.

Decentralization and flex workspace

Widespread uptake of hybrid working practices may bring with it long-term implications for a more decentralized approach to workplaces. Not only do secondary business hubs offer cheaper rents, but also with many employees now working from their homes, employers are responding by providing workplaces nearer to where they live. This theme will apply in particular to super-metropolises (for example, London or Paris, where this process is already happening) where workers have to endure long daily commutes.

Co-working spaces and flex offices are becoming increasingly popular ways for occupiers to hedge uncertainty about future staffing requirements, as well as to minimize exposure to long-term leases of conventional office space. Flex workspace means providing access to serviced workspaces of various kinds, ranging from traditional co-working facilities, to overflow office space within a single building, to networks of workspaces across portfolios of buildings, or near-to-home drop-in locations scattered around a city. This distributed working concept also plays to the idea of decentralization, because as a company's allocation to flex goes up, its use of traditional central business district (CBD) headquarters space tends to stagnate or decline.

Quality matters

High-quality offices, those with modern amenities, strong ESG credentials, good air quality, and the right location, retain rents and capital values per square meter at record highs in some markets. Companies want access to good space in cities that have strong economies because they believe it helps attract and retain talent. Employers are working to modernize and restructure the workplace in a way it is less dense, offers additional wellness amenities, collaboration facilities and experiential spaces.[18]

Among wellness amenities, employers are focusing on introducing new touchless technologies such as touchless facilities for building access, lifts, and bathrooms. Air treatment equipment is another important wellness theme, such as high-quality air filters and UV treatment of air conditioning units.

The new widespread trends which create in-office experiences are providing workers with:

- Leisure-oriented common lounge spaces;
- Biophilic design - an approach in architecture that seeks to connect building occupants more closely to nature
- End-of-trip facilities - dedicated places that support people using non-motorized ways to commute rather than driving or taking public transport. They include secure bicycle racks, lockers and change rooms where cyclists, joggers and walkers can shower, change and secure their belongings.

It also includes recreational amenities such as games rooms, rock climbing walls, etc. All these amenities require a lot of space, which according to some analysts will require to increase office space from traditional 10 SQM to 20-30 SQM per employee.

Flex leases

Another emerged trend today is greater contractual flexibility. In practice, this involves an option to decrease or increase space leased by a company on, six-twelve months' notice. Such flex leasing is growing fast, and as landlords see the tide turning, they have begun to evolve their product offerings, either by deploying prebuilt spaces fitted out for one- to three-year periods or by creating purpose-built spaces they either lease out themselves or via a contract with an operator.

While the upfront operating costs of flex leasing may be higher, optionality brings with it several advantages apart from just bypassing risk. For one, companies can move faster by using flex-space operators to roll out multiple offices in numerous locations. Fit-out costs are effectively eliminated, and flex leases are more digestible to corporate managers in control of finances as higher operational costs are more preferable to high capital of millions of dollars on an office that the company may not need.

Rising construction costs

Construction cost inflation became an important concern for commercial landlords and developers. Lack of labor, materials and transportation delays has increased cost pressure. Developers also argue that bureaucracy and delays in approval had a significant impact on the implementation of construction projects.
Rising constructions costs and the increased importance of the ESG agenda may push upward pressure on office investment and rents in the medium term.

Offices and business centers in Georgia

COVID-19 had a negative impact on office demand in Georgia due to deteriorated general economic conditions, closure of businesses, lockdowns and mobility restrictions. In 2021, these factors faded as the economy recovered and restrictions were lifted. However, it seems that pandemic will have a lasting impact on office demand in Georgia, as increasing share of employees work from home and will continue doing so in the future.

In addition, the pandemic triggered some other changes on office market. Flexibility of leases and workspaces became an important factor for tenants when choosing the offices. In order to cut costs, businesses started to think about optimization of office space. All these stimulated the demand on co-working spaces, which now attracts not only individual remote workers or startups, but increasing number of medium and large companies.

In 2020, weighted average rent in Tbilisi business centers increased by 4.8% YoY. This is explained by increasing share of high-class (and more expensive) offices in the total stock of existing offices. Combined with high inflation of construction materials, it will drive weighted average rent up in 2023 (+9.2% vs 2019).

In Q3 2021 rental yield on offices constituted 8.4%, which was 0.2 pp lower than in the same period of 2019. However, rental yield on offices was by 1.3 pp higher than residential yield.

On district level, offices in Saburtalo provide the highest yield (9.3%), while the lowest yields were observed in Vake (6.7%) and Mtatsminda (6.8%).

Vacancy rates in Tbilisi business centers increased by notable 11.3 pp in 2020 and constituted 24%. The increasing stock of office space in combination with the lasting impact of COVID-19 on office demand will drive vacancy rates beyond 25% in 2022 and 2023.

In 2022-2023, the existing stock of modern offices in Tbilisi is expected to increase further by 60,000 SQM. 32% of this area is concentrated in Saburtalo.

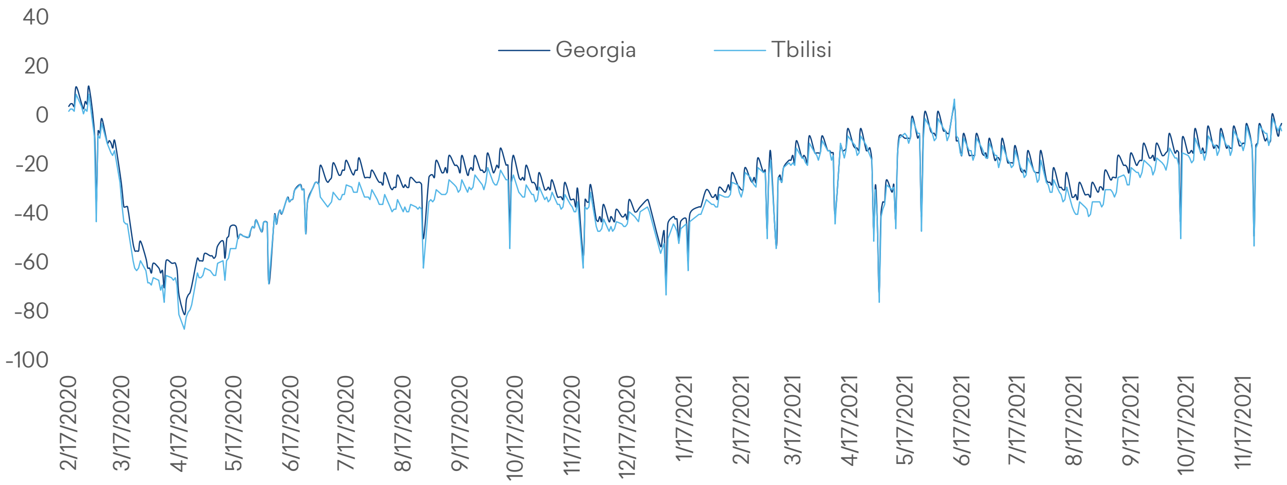
Demand

Demand on office spaces in Georgia was affected by the same factors as on the Global market. These factors were downturn in general economic conditions, closure of businesses and increased unemployment, mobility restrictions and broad adoption of WFH practices.

Because of these factors, Tbilisi (and Georgia in general) offices saw a drastic decrease in people's mobility in Q2 2020 compared to the baseline. Similar but less severe reduction in mobility was observed in Q4 2020 and Q1 2021 when second wave of COVID-19 hit the country. Afterwards mobility in working places started to recover. As of November 2021, mobility in working spaces in Tbilisi was 13% lower compared to the baseline.

FIGURE 28

MOBILITY IN WORKING PLACES (% CHANGE VS BASELINE)



Note: The median value from the 5-week period Jan 3 – Feb 6, 2020. See community mobility reports help for more detailed information.

Source: Google's Community Mobility Report

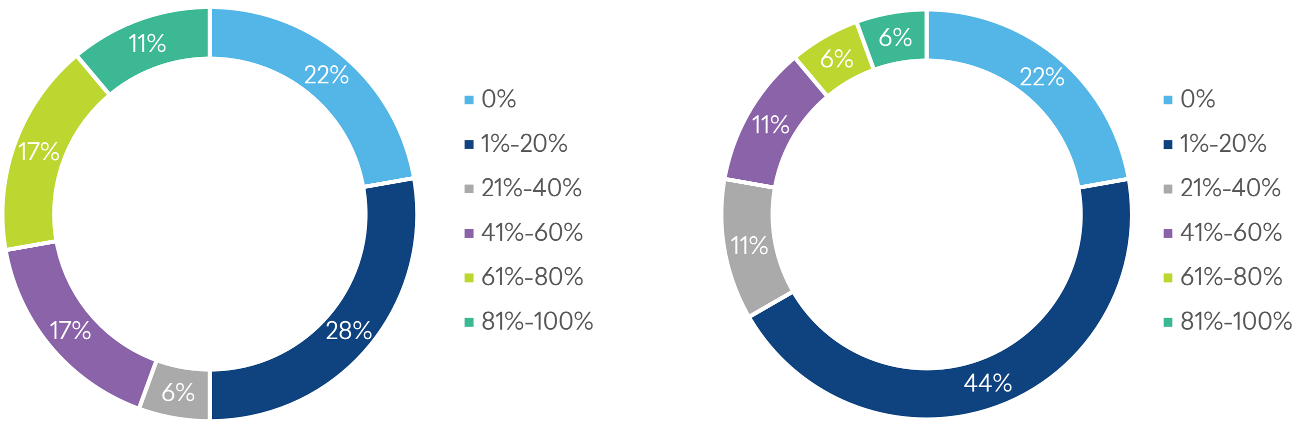
As shown in Figure 28, mobility trends in working places in Georgia and Tbilisi were similar. However, Tbilisi showed bigger reduction in mobility because of more stricter and frequent COVID-19 related restrictions. In addition, this difference might indicate the wider adoption of WFH practices in Tbilisi compared to the rest of Georgia.

The share of hired workers who reported usually working from home in Georgia increased from 1% in 2019 to 6.9% in 2020.[24] Furthermore, 78% of members of business association of Georgia (BAG) reported that at least some part of their staff was working remotely in Q3 2021. From this 78%, 11% of companies mentioned that more than 80% of their employees were working from home, while 34% reported that 40%-80% of their employees were working remotely (see Figure 29).

In 2022, companies project that the share of their staff working from home will decrease, however they share of companies that use WFH practices will stay the same. Consequently, such trends might affect office space requirements in the future.

FIGURE 29

(1) CURRENTLY, WHAT PERCENTAGE OF YOUR EMPLOYEES WORK REMOTELY?
(2) WILL WORK REMOTELY OVER THE NEXT TWO YEARS?



Source: TBC Capital

Interviews conducted with sector representatives indicate that the impact on office demand varied by classes of business centers. High-class offices showed a greater resilience compared to lower class offices. “No single tenant exited our Class A business centers in last two years. At this point, some tenants do not use office at all (they work remotely), however they do not consider to exit from our business center.” (Business Centers' representative).

Based on analysis of Global trends, projections of businesses and operators of office centers, we expect that more employees will come back to offices in 2022. However, it seems that remote work is here to stay and COVID-19 might decrease the demand on offices in upcoming years.

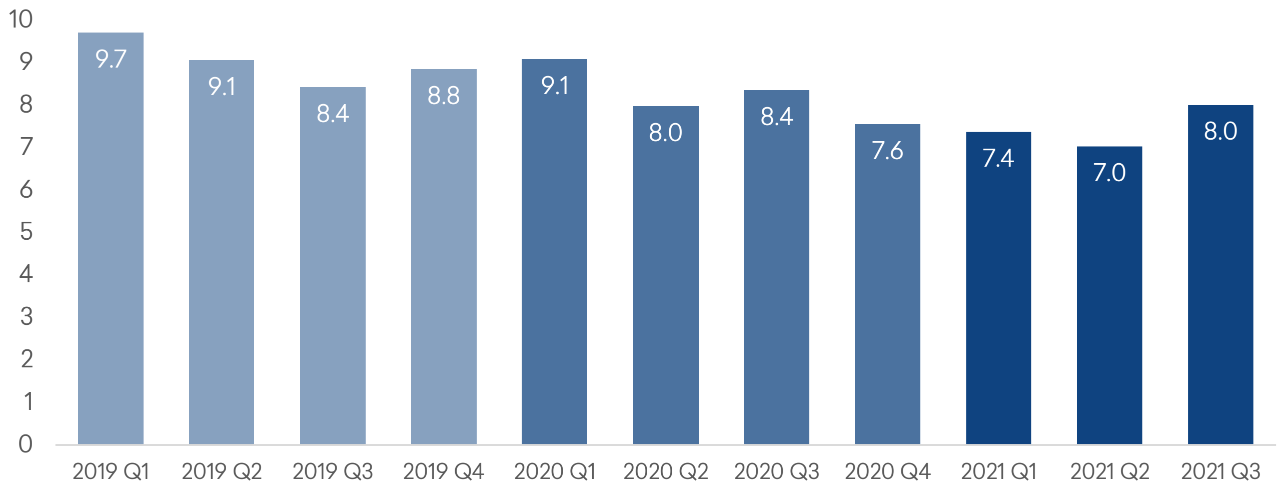
Major indicators

Rents

Weighted average rents of listed offices in Tbilisi were decreasing even before the pandemic. However, COVID-19 has accelerated this trend. Listed rents on offices reached their minimum at 7 USD per SQM in Q2 2021 (-22.4% vs Q2 2019). Rents rebounded to 8 USD per SQM in Q3 2021, which was only 5.0% below the same period of 2019.

FIGURE 30

WEIGHTED AVERAGE LISTED RENT; TBILISI (USD PER SQM)

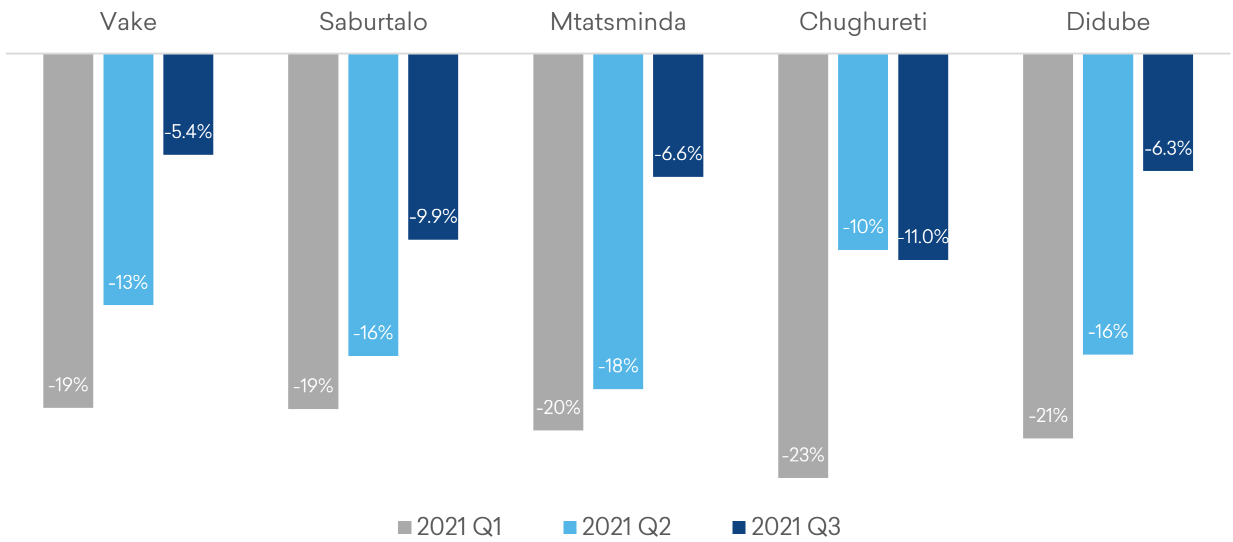


Source: myhome.ge, TBC Capital

Weighted average rents of listed offices in Tbilisi districts followed the average pattern with some districts showing more resilience in rent prices. In Q3 2021, office rents in Vake were the closest to 2019's level - only 5.4% below. At the same time, Chugureti was the slowest recovering district in terms of listed office rents (see Figure 31). The number of listed properties in other districts was not sufficient to conduct the analysis on rents' dynamics.

FIGURE 31

WEIGHTED AVERAGE LISTED RENT; TBILISI (USD PER SQM)



Source: myhome.ge, TBC Capital

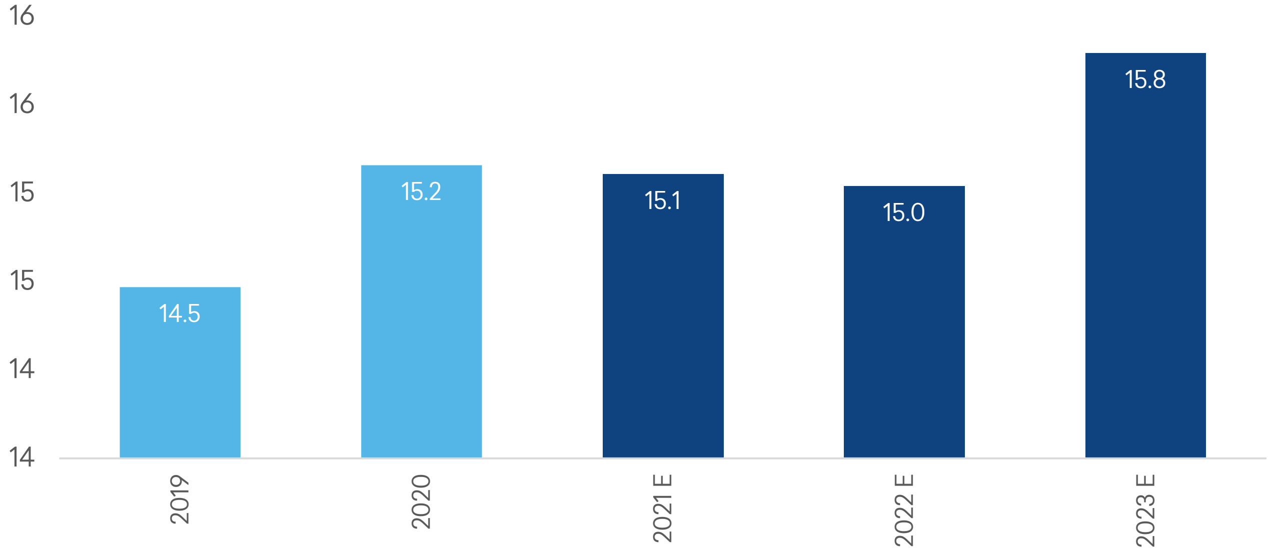
Actual weighted average rent in Tbilisi business centers did not reflect the impact COVID-19 had on the sector. In 2020, actual weighted average rent increased by 4.8% YoY and reached 15.2 USD per SQM (see Figure 30). This surprising dynamic is explained by rapidly increasing share of high-class offices (in which rents are high) in the total stock of existing modern offices in Tbilisi.

In 2022 and 2023, the weighted average rent in business centers will be formed by combination of the following factors:

- Accelerated supply of office space (see the section below);
- Increasing share of high-quality offices in the existing stock;
- Higher construction costs (due to inflation of construction materials);
- Weakened demand on office space, especially on Class B offices;

FIGURE 32

WEIGHTED AVERAGE ACTUAL RENT IN BUSINESS CENTERS, TBILISI (USD PER SQM)

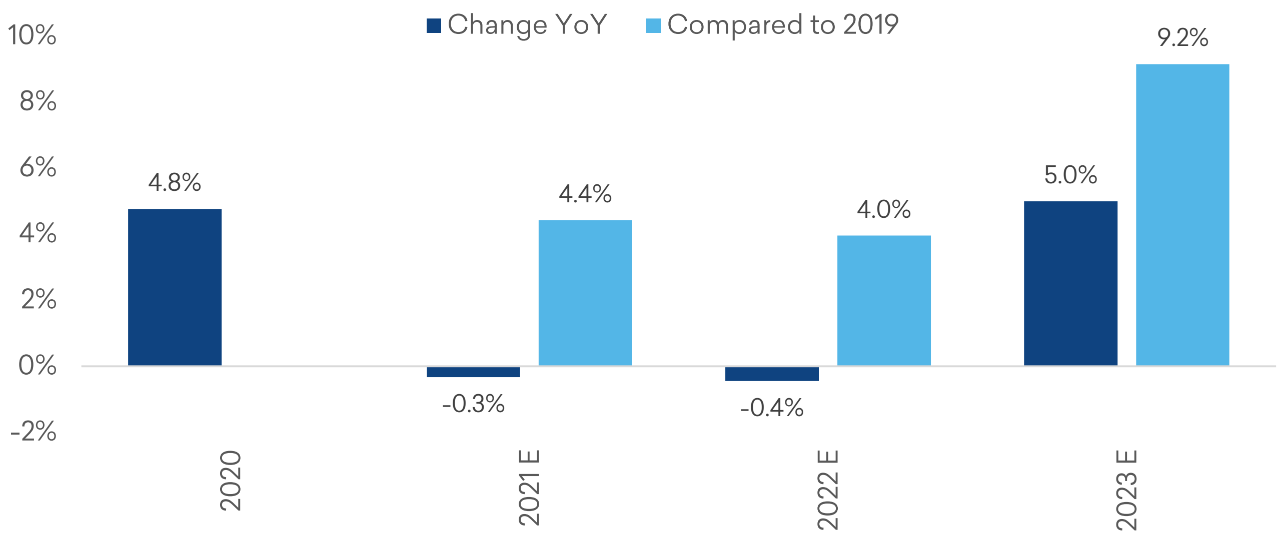


Source: TBC Capital, Colliers International

Considering all these factors and qualitative information received from interviews with business centers' representatives, we expect the weighted average rents to reach 15.8 USD per SQM in 2023 (+9.2% vs 2019).

FIGURE 33

GROWTH RATE OF WEIGHTED AVERAGE ACTUAL RATE IN BUSINESS CENTERS, TBILISI



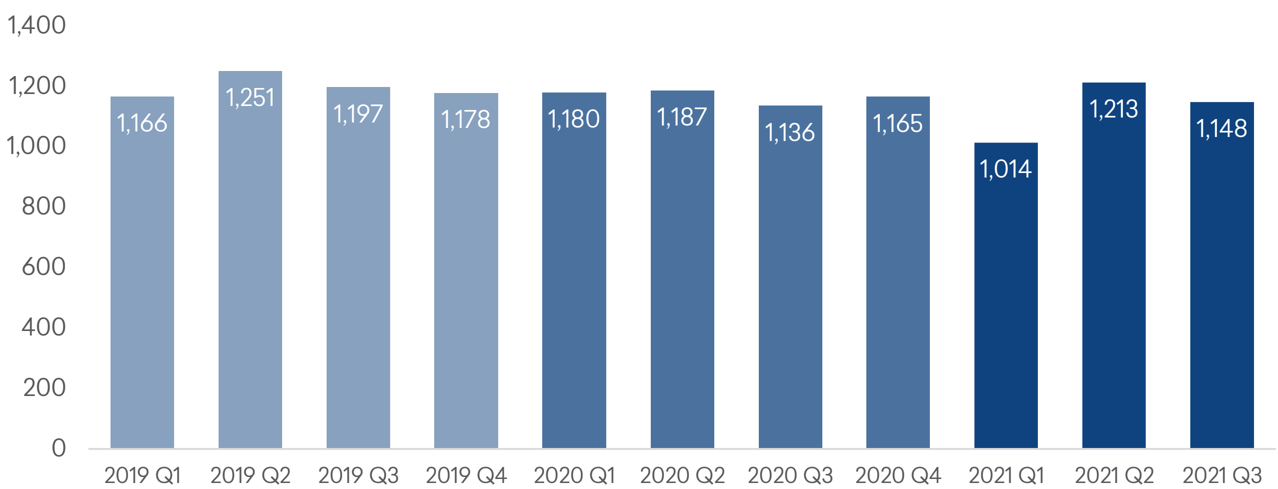
Source: TBC Capital, Colliers International

Sale prices

During the pandemic weighted average listed sale prices of offices have been more stable than rents. In Q2 and Q3 2020, sale prices were down by only 5.1% YoY. In Q1 2021 listed sale prices reached their minimum at 1,014 USD per SQM, which was 13.1% lower compared to the same period of 2019. However, prices rebounded in the following quarters and stood at 1,148 USD per SQM - a 4% decline vs Q3 2019

FIGURE 34

WEIGHTED AVERAGE LISTED SALE PRICE , TBILISI (USD PER SQM)

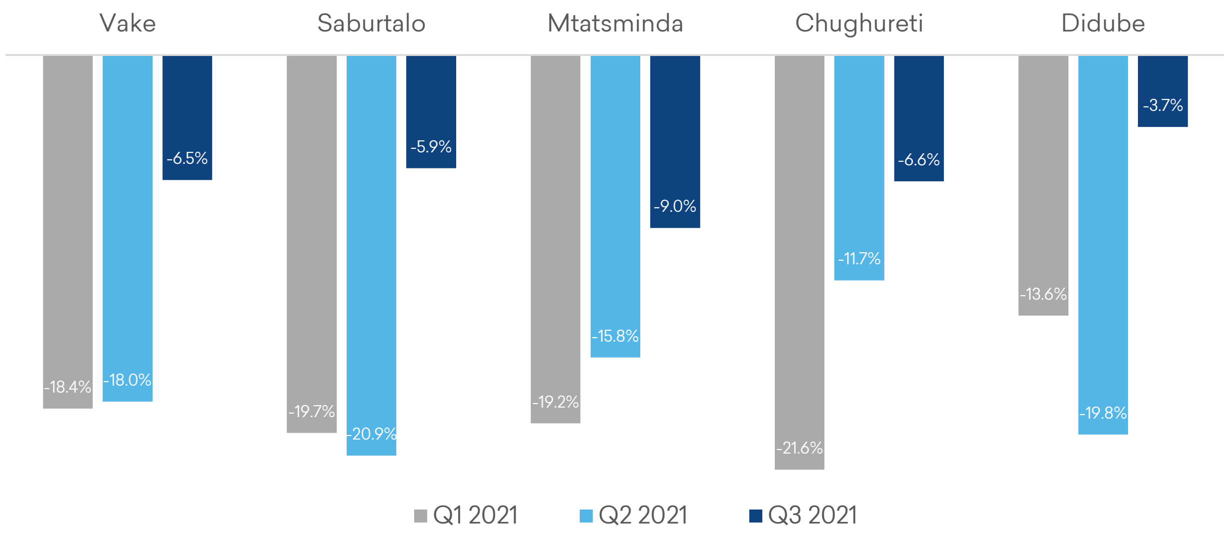


Source: myhome.ge, TBC Capital

Weighted average listed sale price of offices listed for sale recovered the most in Didube - only 3.7% below in Q3 2021 vs Q3 2019. At the same time, Mtatsminda (-9.0% vs Q3 2019) was the slowest recovering district in terms of listed office rents (see Figure 33).

FIGURE 35

GROWTH RATE OF WEIGHTED AVERAGE SALE PRICE BY DISTRICT (VS THE SAME QUARTER IN 2019. %)



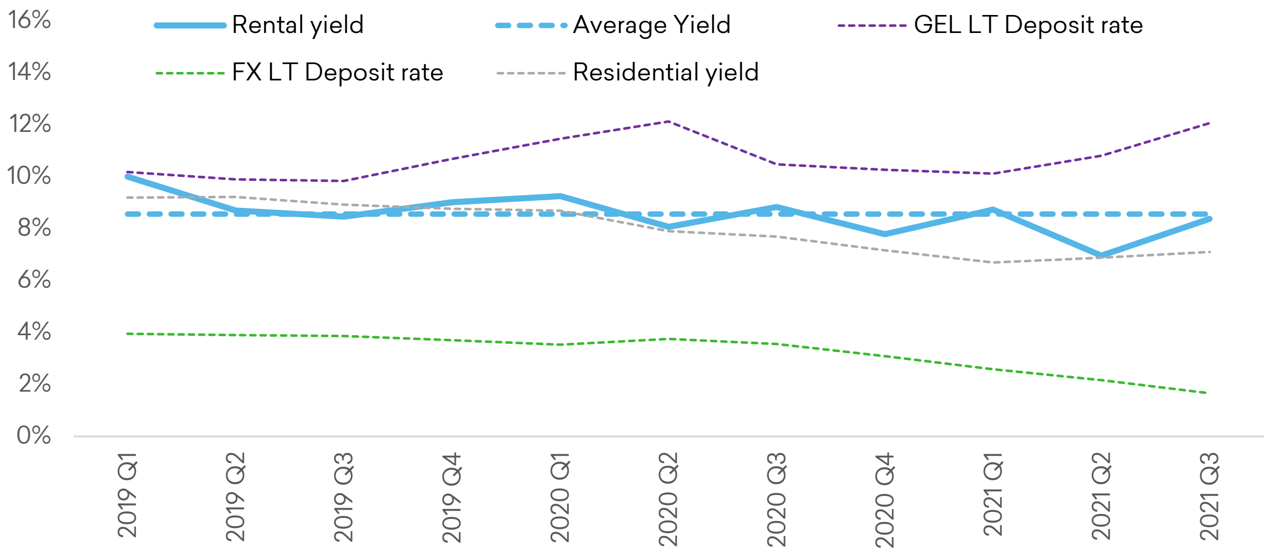
Source: myhome.ge, TBC Capital

Yields

Average rental yield on offices in 2019 - Q3 2021 constituted 8.6%. The pandemic has negatively affected offices' yields, as rents showed a bigger adjustment compared to sale prices. The figures in 2020 and 2021 stood slightly below their pre-pandemic levels. As of Q3 2021, yield on offices constituted 8.4%, which was 0.2 pp lower than in the same period of 2019.

FIGURE 36

RENTAL YIELD, OFFICES

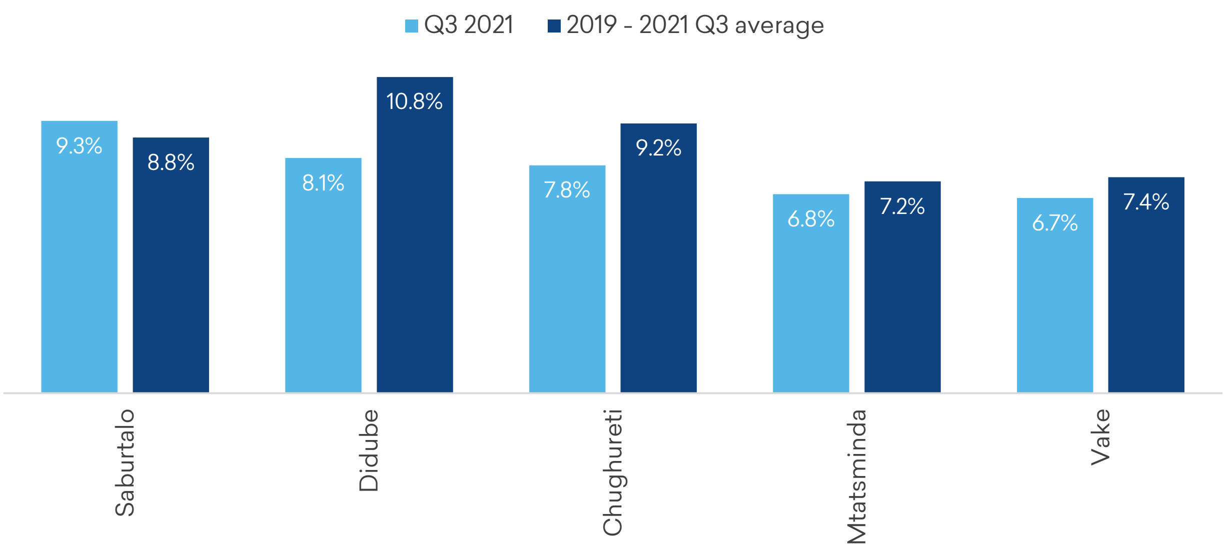


As it was a case in street retail, the gap between rental yields and FX LT deposit rate has been increasing. In Q3 2021, the gap was 6.7 pp, which was 2.1 pp higher compared to 2019's level. In Q3 2021, rental yields on offices was by 1.3 pp higher than residential yield.

Rental yields in Tbilisi offices varies by districts. In Q3 2021, yield in Saburtalo were the highest at 9.3%, while the lowest yield was observed in Vake (6.7%) and Mtatsminda (6.8%).

FIGURE 37

RENTAL YIELD, OFFICES



Source: myhome.ge, TBC Capital

Data on permits for construction of offices (see section below) indicates the high interest of investors in Tbilisi offices. Offices remained the largest real estate sector on global market as well. For example, the share of offices in all deals on European real estate market from the end of March 2020 through September 2021 was 38%. However, the sector was down from 49% in 2019 and Q1 of 2020.[16] In the ranking of real estate types with best investment and development prospects in 2022 all types of offices – flexible offices and co-working (17th out of 27), central city offices (19th out of 27) and suburban offices (24th out of 27) - were on the bottom of the list.

Vacancy rates

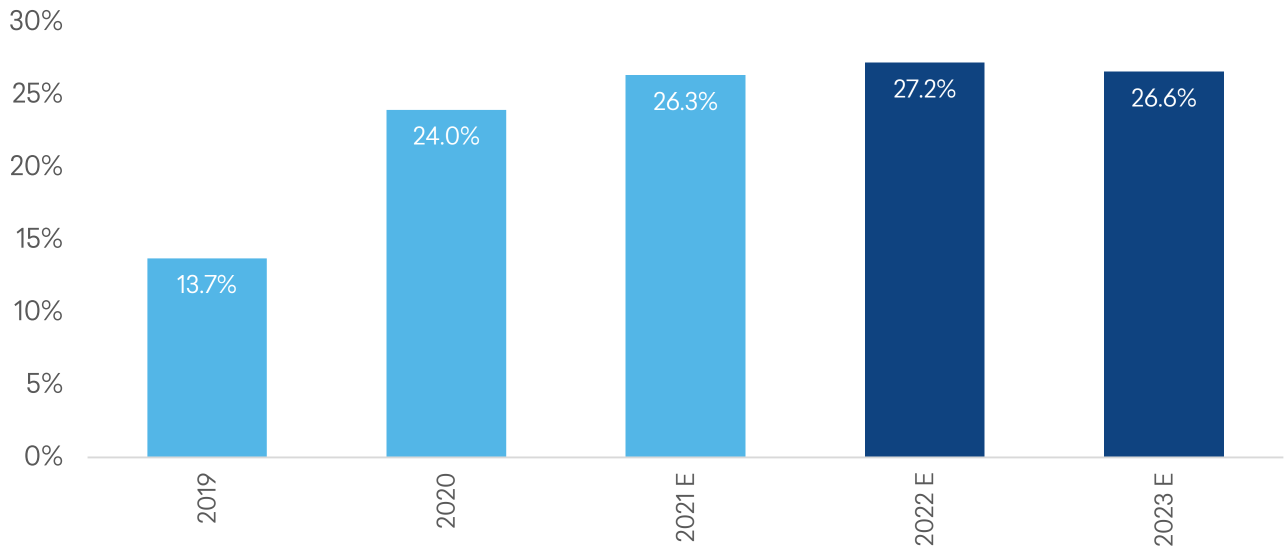
Vacancy rates in modern offices in Tbilisi business centers were increasing before the pandemic and are expected to continue growing in upcoming years. The main factor behind this dynamic is an accelerated supply of office space, especially Class A (see the section below). Business centers that started operation in 2020 and 2021 findfound it difficult to fill their spaces with tenants.

“Due to the pandemic our new business center was almost empty in 2020. Existing uncertainties prolonged the negotiation process with businesses” (Operator of Business Center).

The increasing stock of office space in combination with the lasting impact of COVID-19 on office demand will drive vacancy rates beyond 25% in 2022 and 2023.

FIGURE 38

VACANCY RATES IN MODERN OFFICES, TBILISI



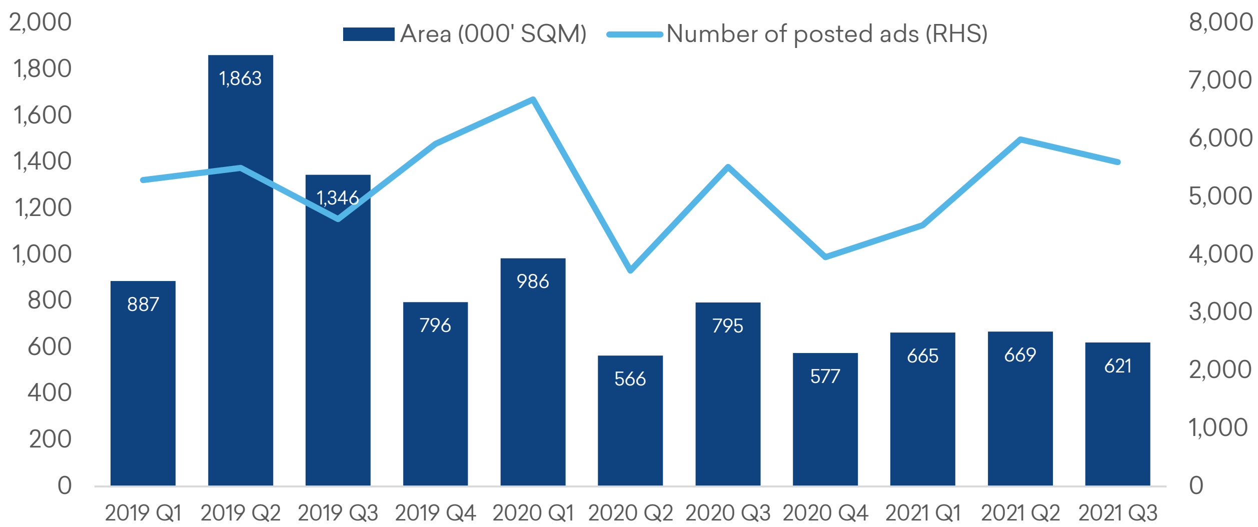
Source: TBC Capital, Colliers International

Supply

Total listed areas of offices for rent in Tbilisi has been stable during the pandemic. In Q3 2021, 5,604 office spaces with a total area of 621,000 SQM, was available for rent in Tbilisi. The majority of listed offices were allocated in five districts: Saburtalo (47%), Vake (21%), Mtatsminda (12%), Chughureti (7%) and Didube (5%).

FIGURE 39

VACANCY RATES IN MODERN OFFICES, TBILISI

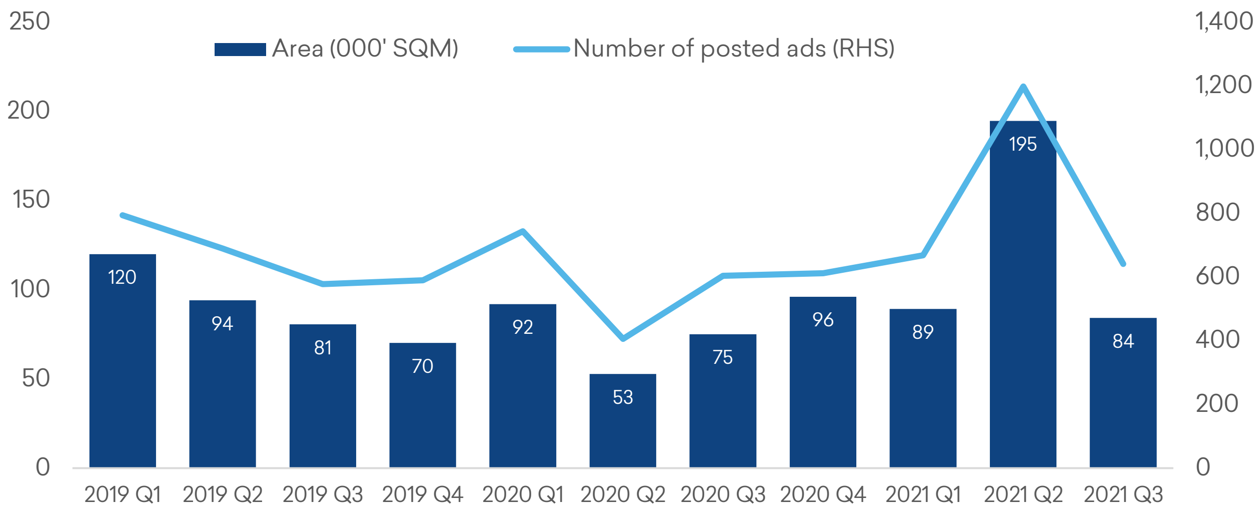


Source: myhome.ge, TBC Capital

No signs of COVID-19's possible impact was observed in data on offices listed for sale. 641 offices with a total area of 84,000 SQM were listed in Q3 2021 for sale in Tbilisi. Saburtalo (49%), followed by Vake (19%), Mtatsminda (8%), Didube (8%) and Chughureti (5%) were the leading districts in terms of total area listed for sale.

FIGURE 40

OFFICES LISTED FOR SALE, TBILISI

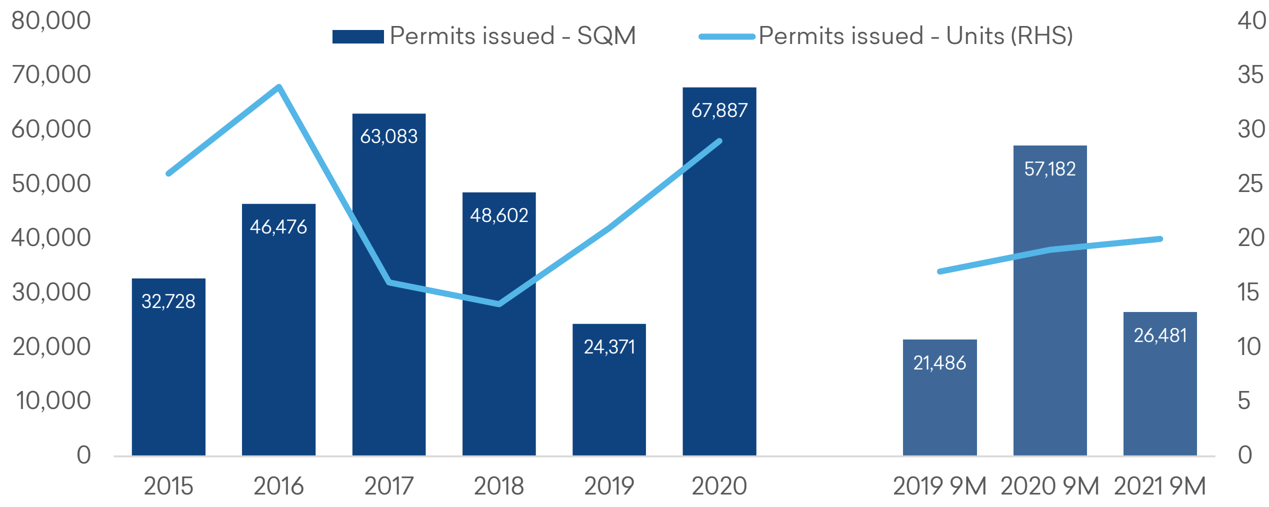


Source: myhome.ge, TBC Capital

While statistics on listings shows the current supply of offices, permits issued for construction of offices could be used to project the supply in upcoming 2 years – an average time of construction completion. In 2020, total area of issued permits for construction of offices in Tbilisi was 58% above five-year average, while in 9M 2021 investors were more cautious - permits were down by 38%. It should be mentioned that two business centers with total GLA of 17,000 SQM (which is included in data on construction permits issued in 2020) have already opened.

FIGURE 41

PERMITS ISSUED FOR CONSTRUCTION OF OFFICES IN TBILISI (AREA, UNITS)



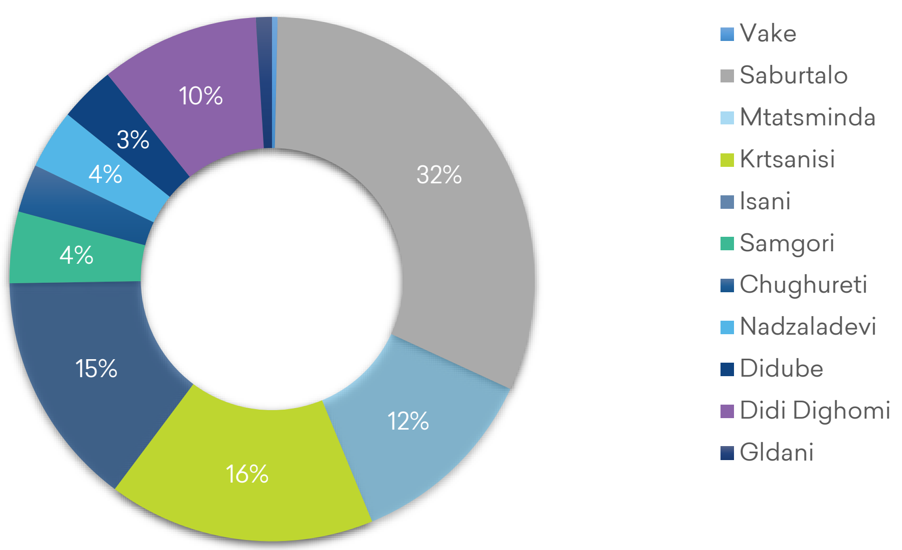
Source: Tbilisi City Hall, TBC Capital

On district level, Saburtalo (32% of total) accounted for the biggest part of total area for construction of offices according to construction permits issued in 2020 - 9M 2021 period, followed by Krtsanisi (16%), Isani (15%) and Mtatsminda (12%).

Interestingly, construction pipeline of offices is concentrated Saburtalo - the district with highest rental yield on offices (Figure 41).

FIGURE 42

DISTRIBUTION OF TOTAL AREA ISSUED FOR CONSTRUCTION OF OFFICES IN 2020-9M 2021



Source: Tbilisi City Hall, TBC Capital

Emerging trends in Georgian offices

The pandemic has accelerated the transformation process of office market and work culture in Georgia. Existing uncertainties about the general economic conditions and possible lockdowns pushed tenants to seek for increased flexibility of leases and workspaces. Although, the average duration of lease agreements was largely unaffected by the pandemic, the notice periods for ending a tenancy decreased from 6 to 3-4 months.

In addition, tenants (of Class B office) started to think about office space optimization. Companies reconsidered their demand on additional office space, which is dedicated for individual conference and meeting rooms. "Tenants reduced their offices by renting shared meeting and conference rooms in our business center by hour". (Operator of Business Center). Furthermore, adoption of remote work practices encourage some companies to replace dedicated workspaces by hot desks (flexible working arrangement that allows employees to choose any desk in the office). It means that their demand on office space will be lower than before.

The increased need of contractual flexibility and office space optimization stimulated the demand on co-working spaces in Georgia. The market was expanding even before the pandemic with total number of co-working spaces in Tbilisi increasing from 2 in 2016 to 16 in 2020.[25] The pandemic temporarily paused this development and hit co-working spaces in 2020 even more than traditional Offices. It is explained by the fact that a) co-working spaces were closed during several months in 2020, b) employees preferred to work from home and minimize contacts with people outside their social circle. However, despite the poor performance in 2020, co-working spaces not only rebounded in 2021, but also brought new tenants. "If previously freelancers and startups were our main clients, now the biggest part of GLA is occupied by medium and large companies and international business". (Operator of co-working spacer). The main factors attracting businesses to co-working spaces are:

- Short-term lease period, which typically is 1 month;
- Short notice period for ending a tenancy, which typically varies from 1 to 7 days;
- Zero fit-out costs;
- Possibility to have multiple offices in numerous locations.

Co-working space operators project that the demand on their services will increase even further. In response to the increasing demand, the number of co-working spaces and their operators are expected to increase as well in the upcoming years not only in Tbilisi, but also in other big cities of Georgia.

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Annex

FIGURE A1

RETAIL – WEIGHTED AVERAGE RENT OF LISTED PROPERTIES (USD PER SQM)

FIGURE A1

RETAIL – WEIGHTED AVERAGE RENT OF LISTED PROPERTIES (USD PER SQM)

FIGURE A1

UNIVERSAL – WEIGHTED AVERAGE RENT OF LISTED PROPERTIES (USD PER SQM)

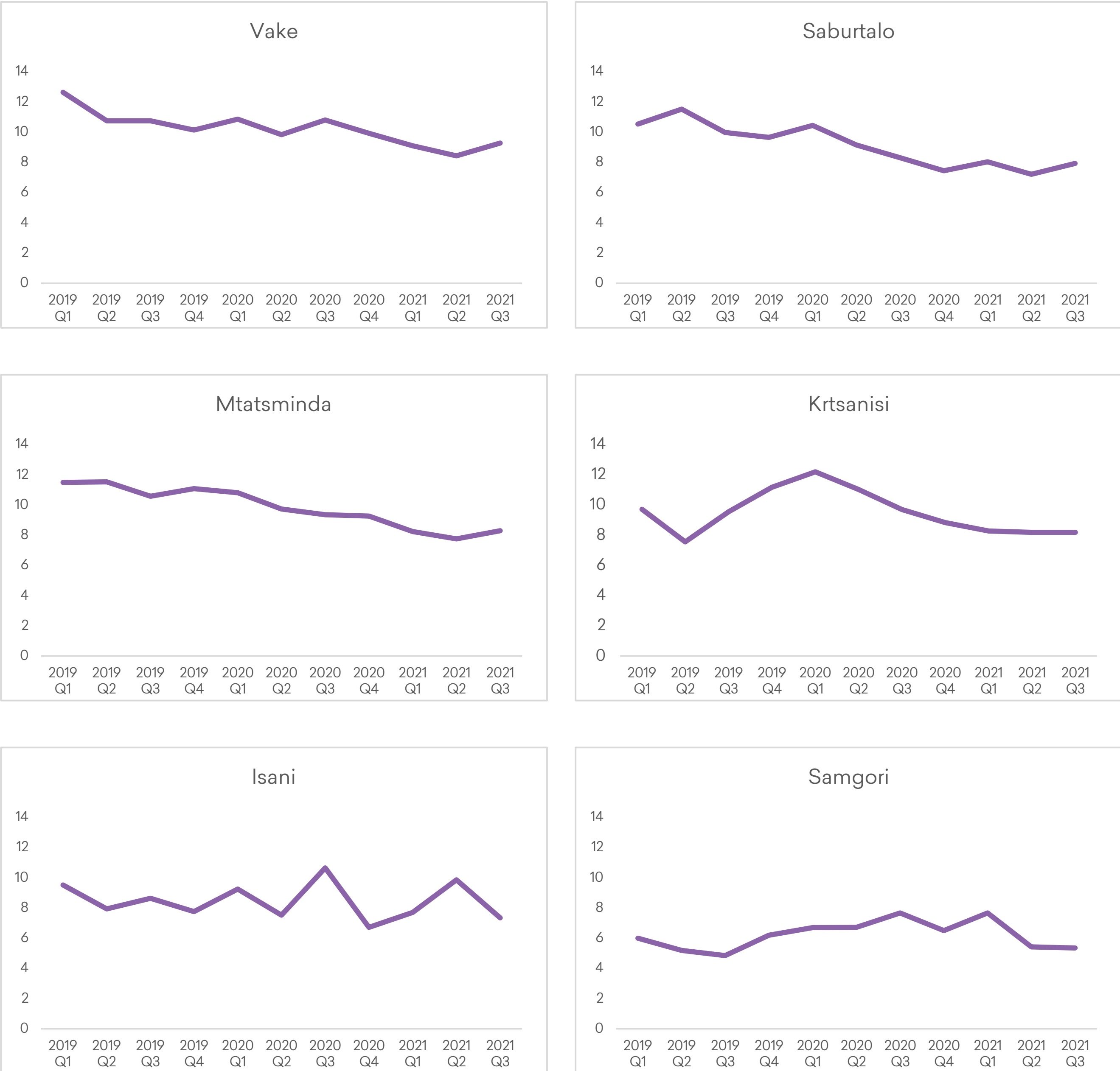
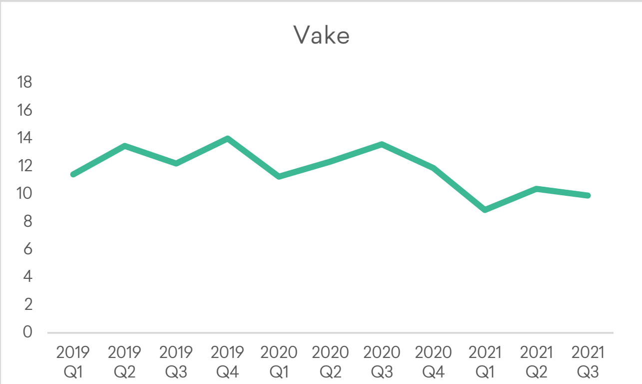


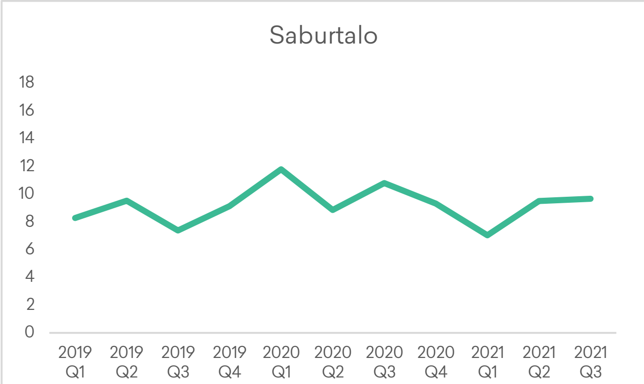
FIGURE A1

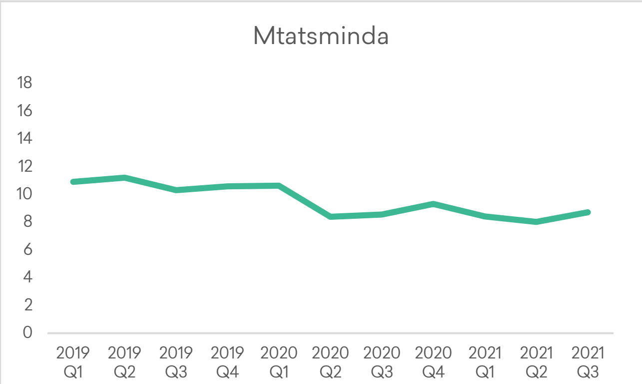
UNIVERSAL – WEIGHTED AVERAGE RENT OF LISTED PROPERTIES (USD PER SQM)

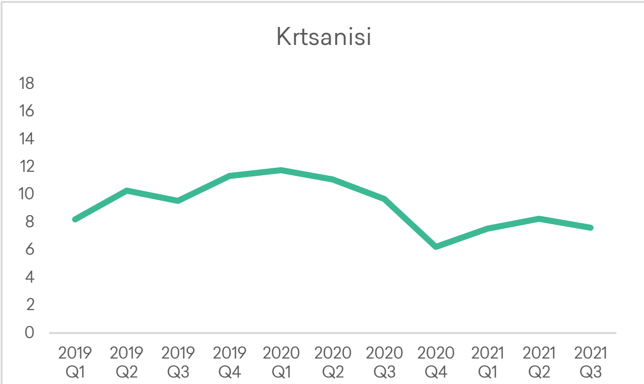
FIGURE A1

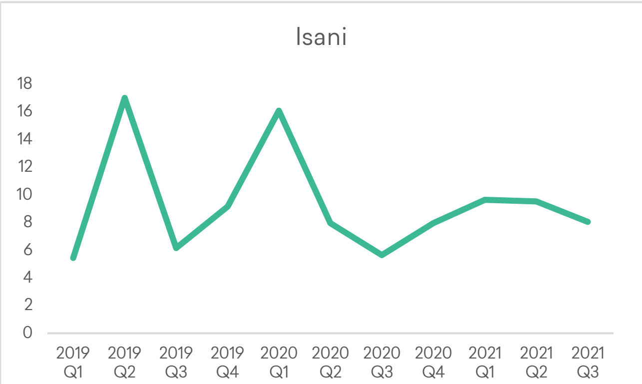
RESTAURANTS AND CAFES – WEIGHTED AVERAGE RENT OF LISTED PROPERTIES (USD PER SQM)











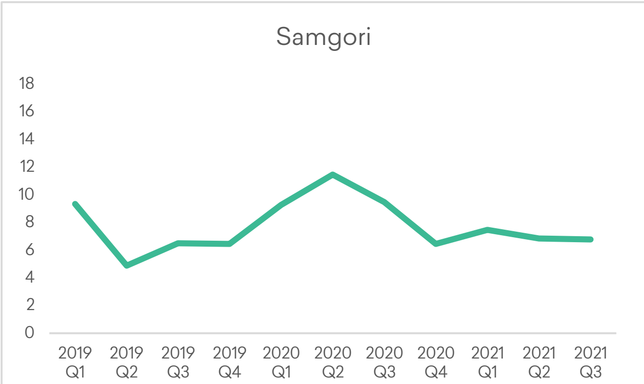
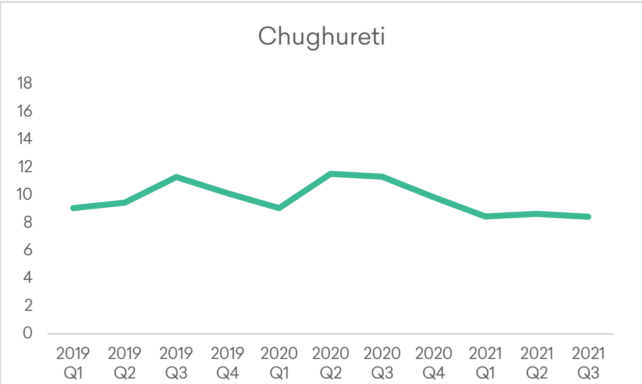
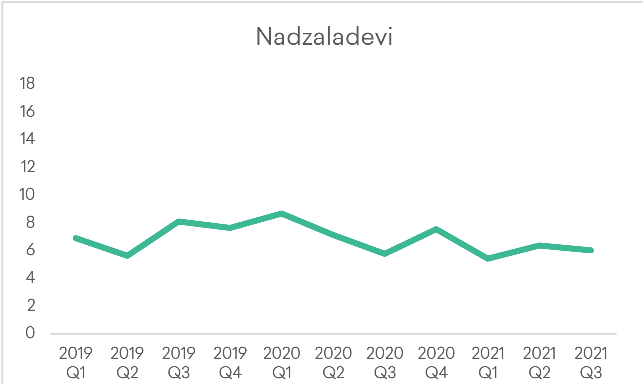
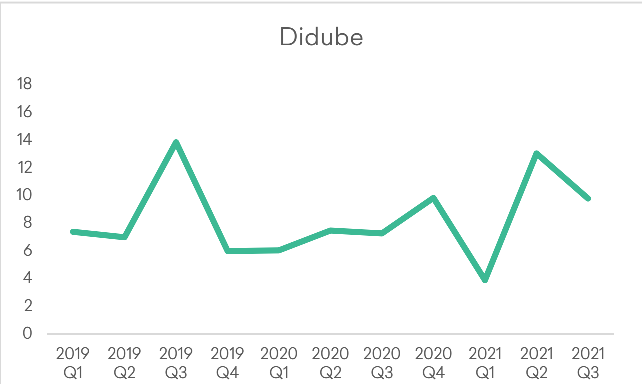


FIGURE A1

RESTAURANTS AND CAFES – WEIGHTED AVERAGE RENT OF LISTED PROPERTIES (USD PER SQM)







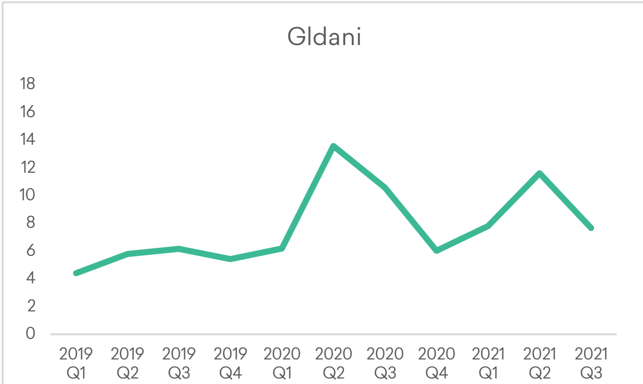


FIGURE A2

STREET RETAIL – WEIGHTED AVERAGE ACTUAL RENT (USD PER SQM)

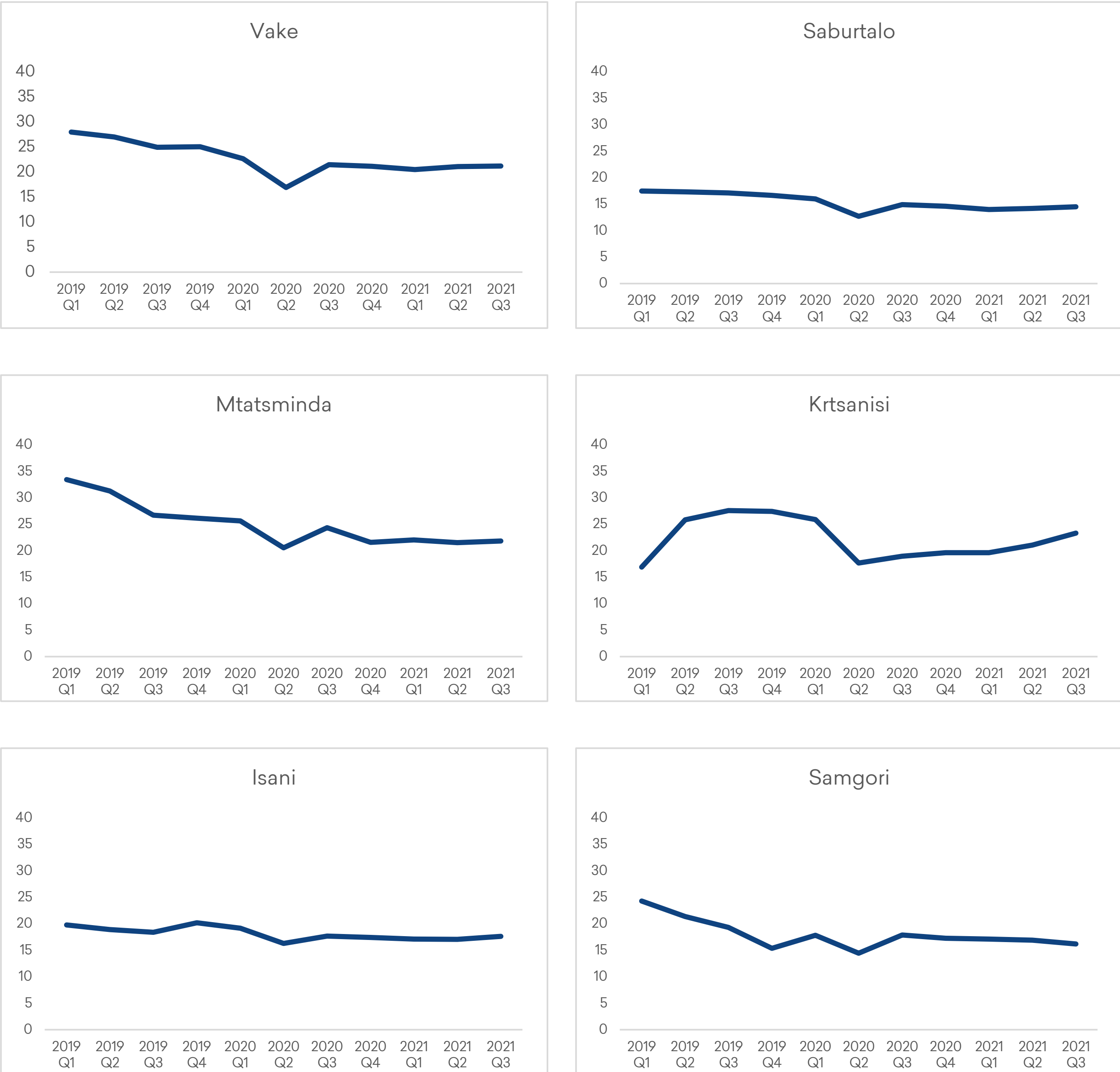
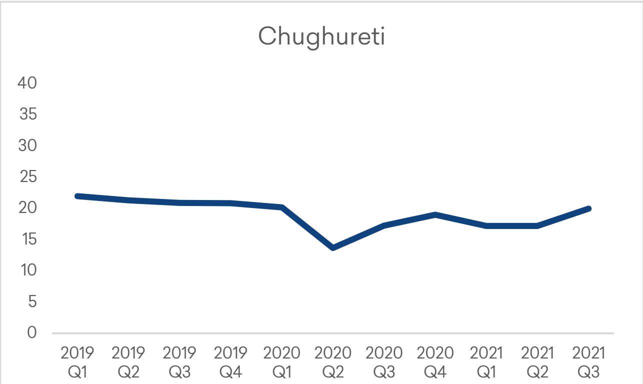
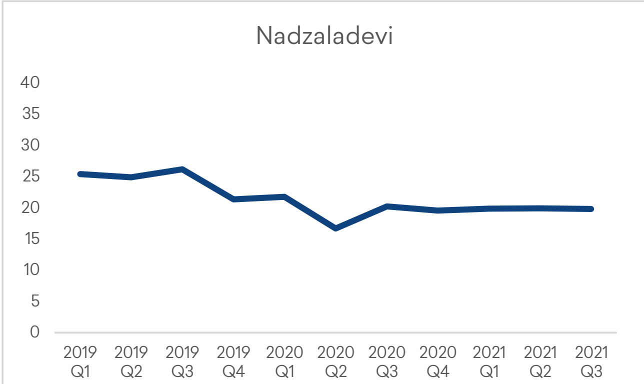
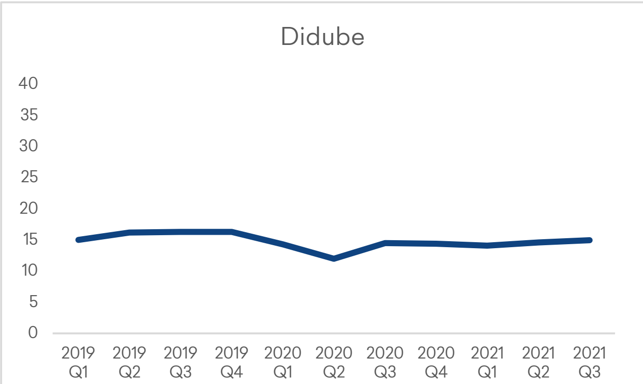


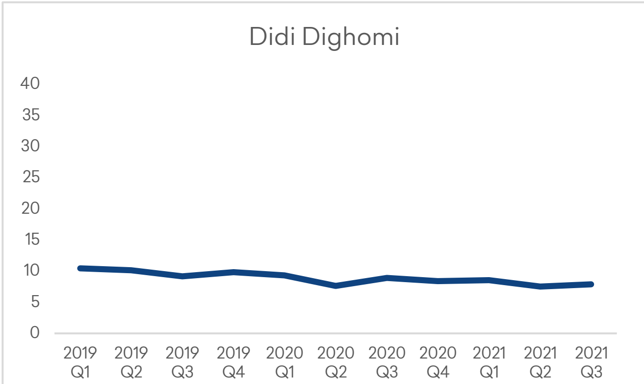
FIGURE A2

STREET RETAIL – WEIGHTED AVERAGE ACTUAL RENT (USD PER SQM)









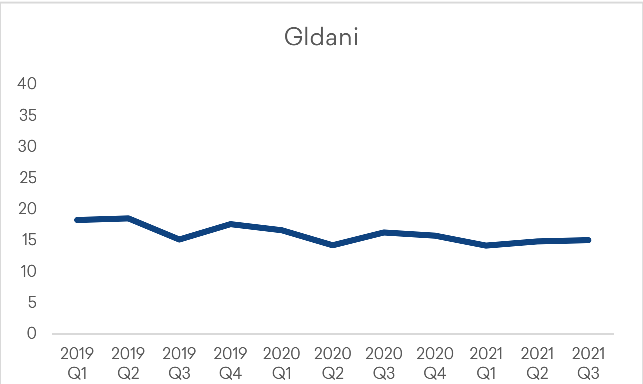
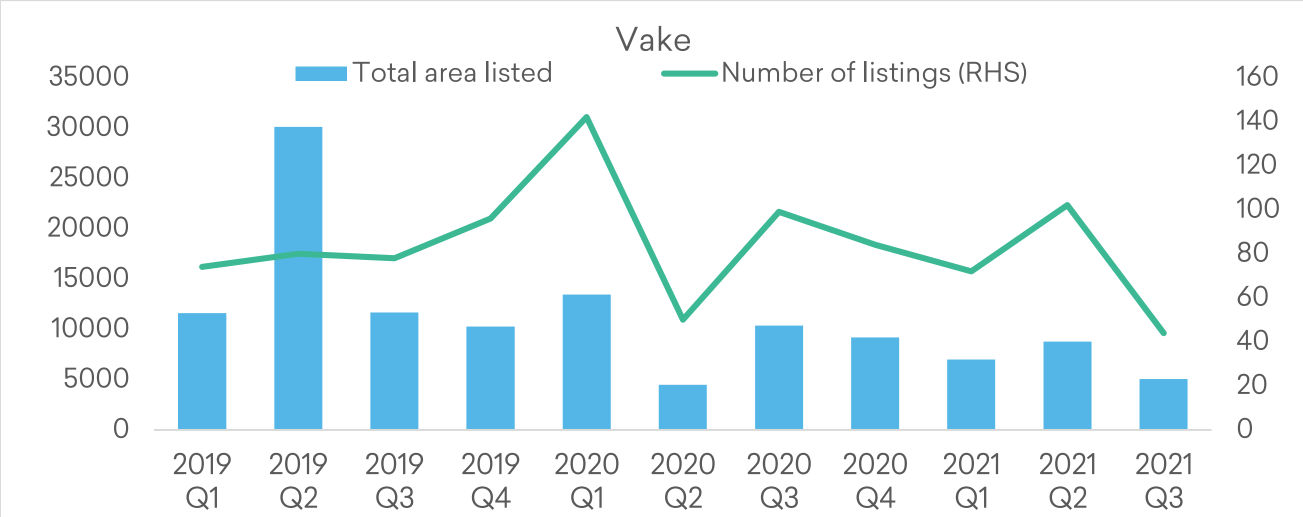
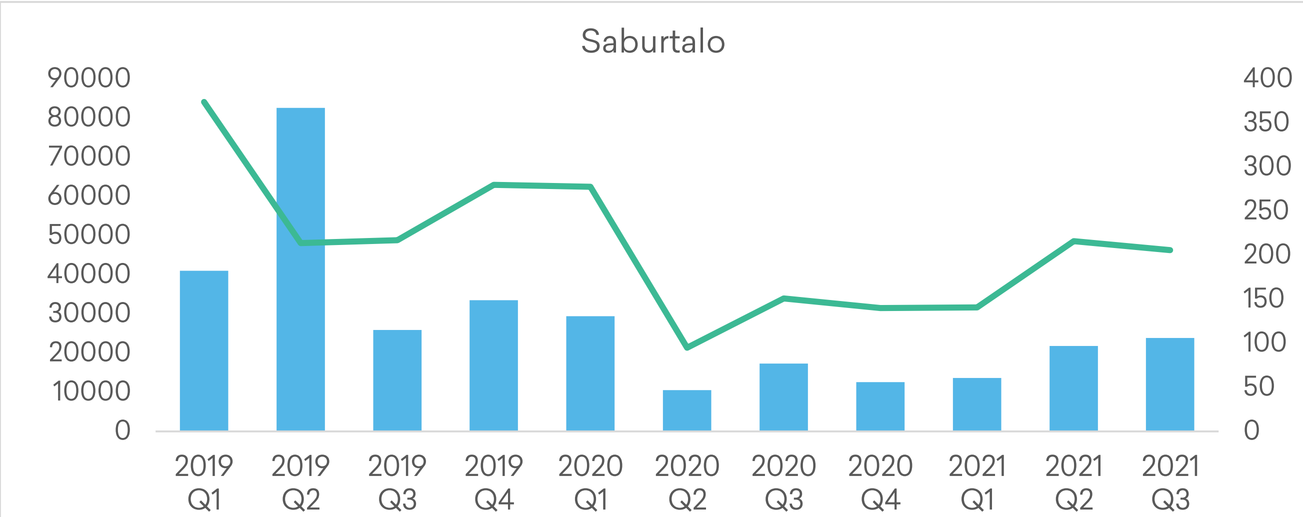
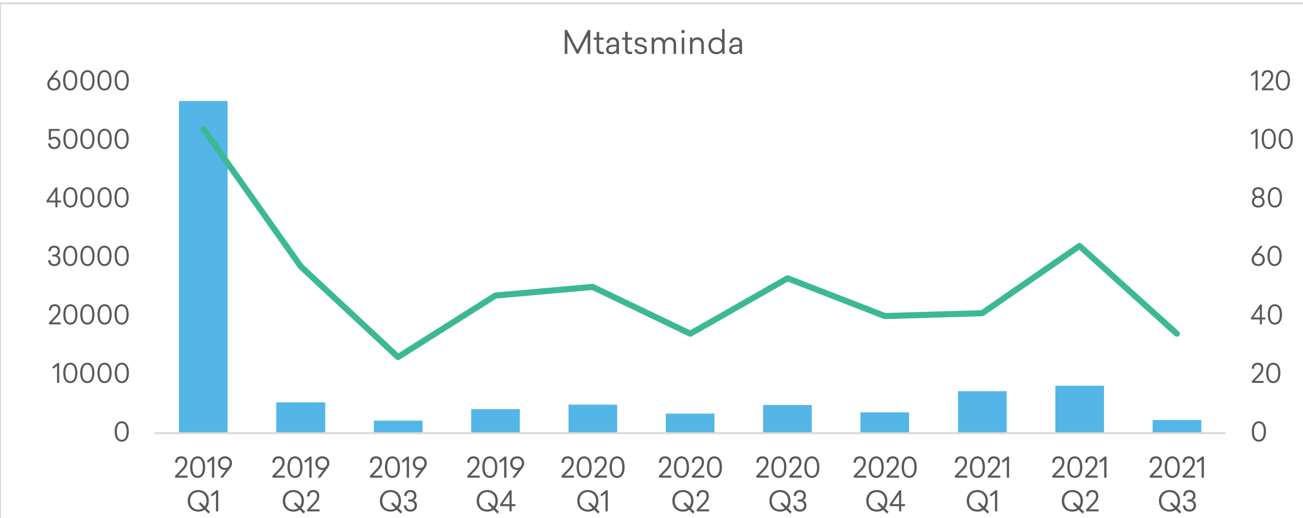


FIGURE A3

RETAIL – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES







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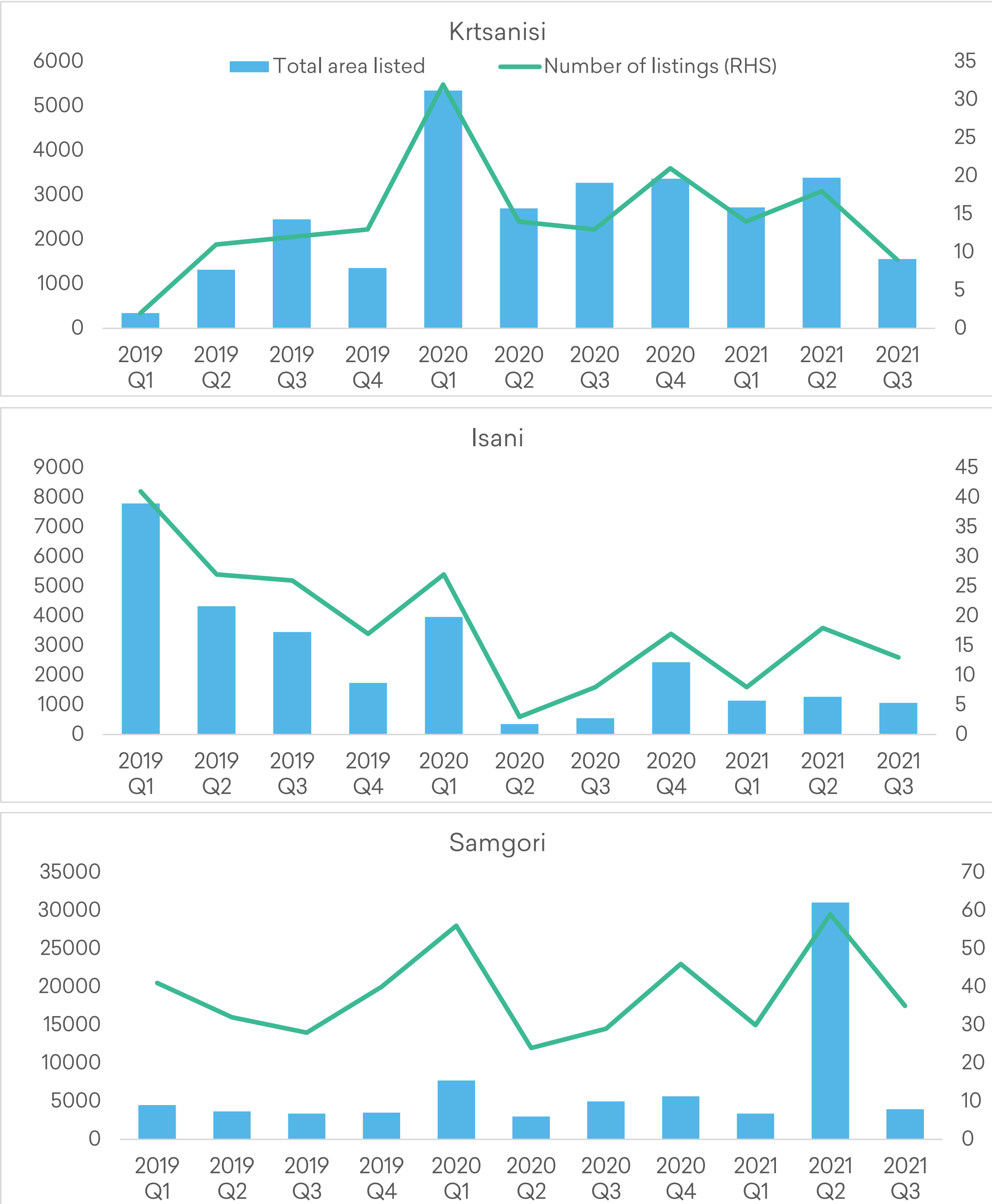

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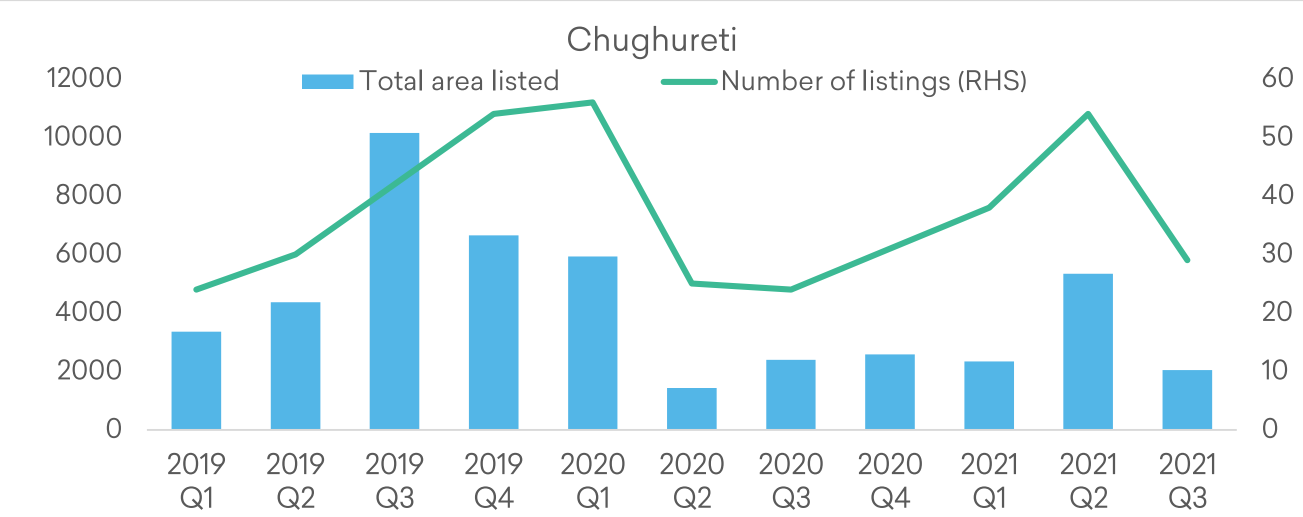
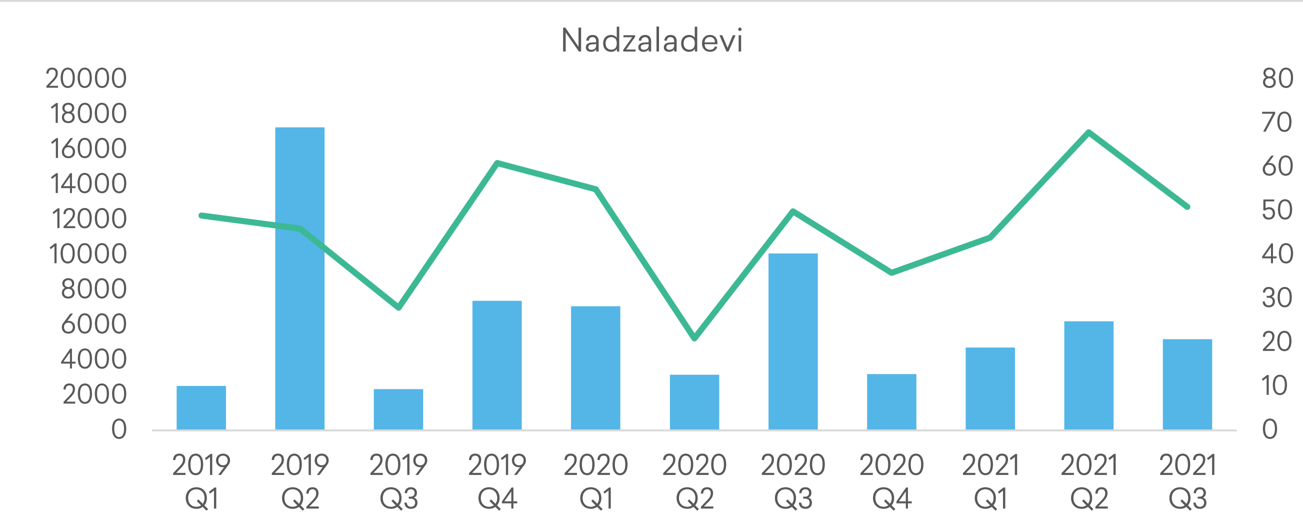
RETAIL – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES





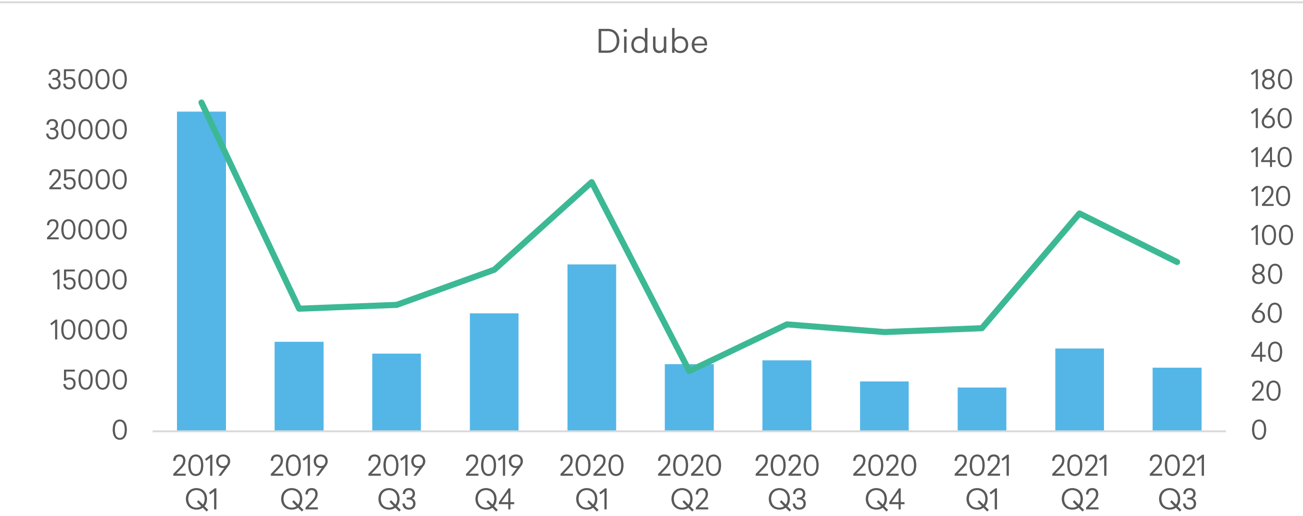
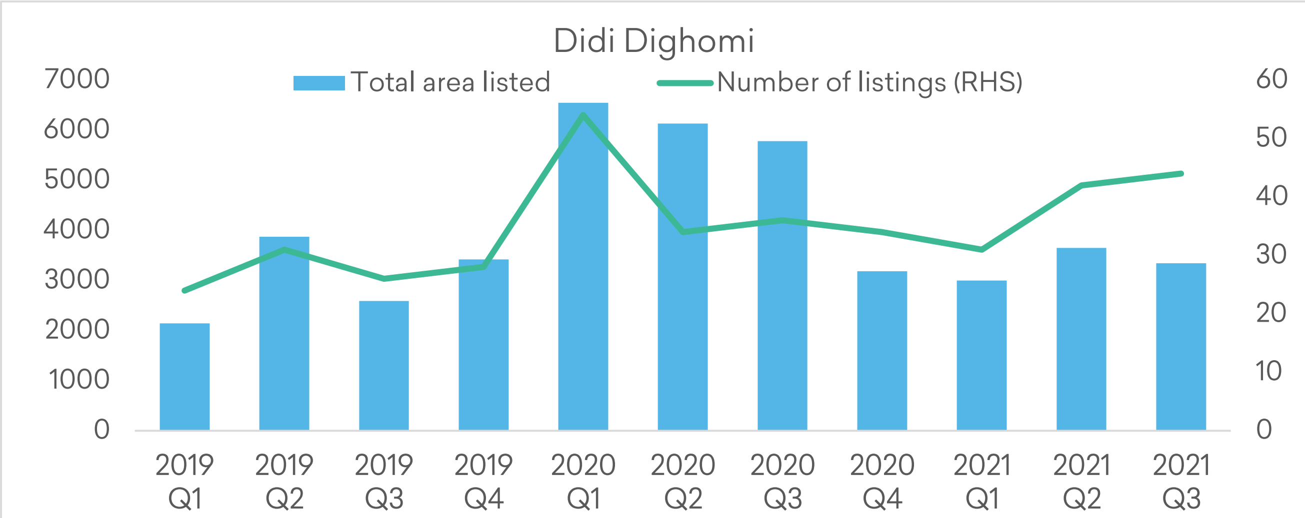


FIGURE A3

RETAIL – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES



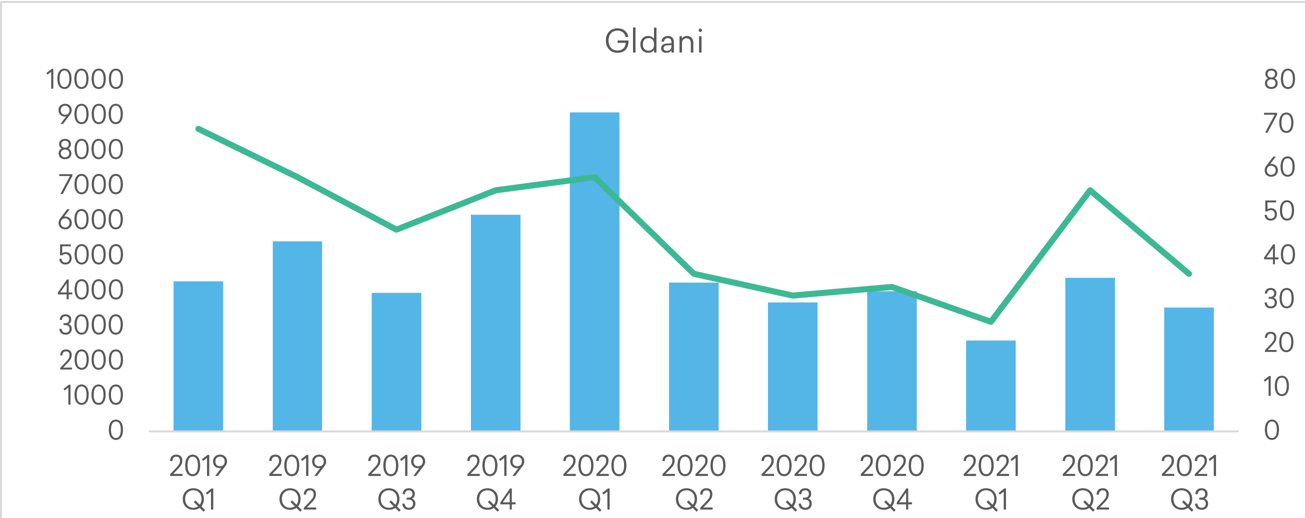
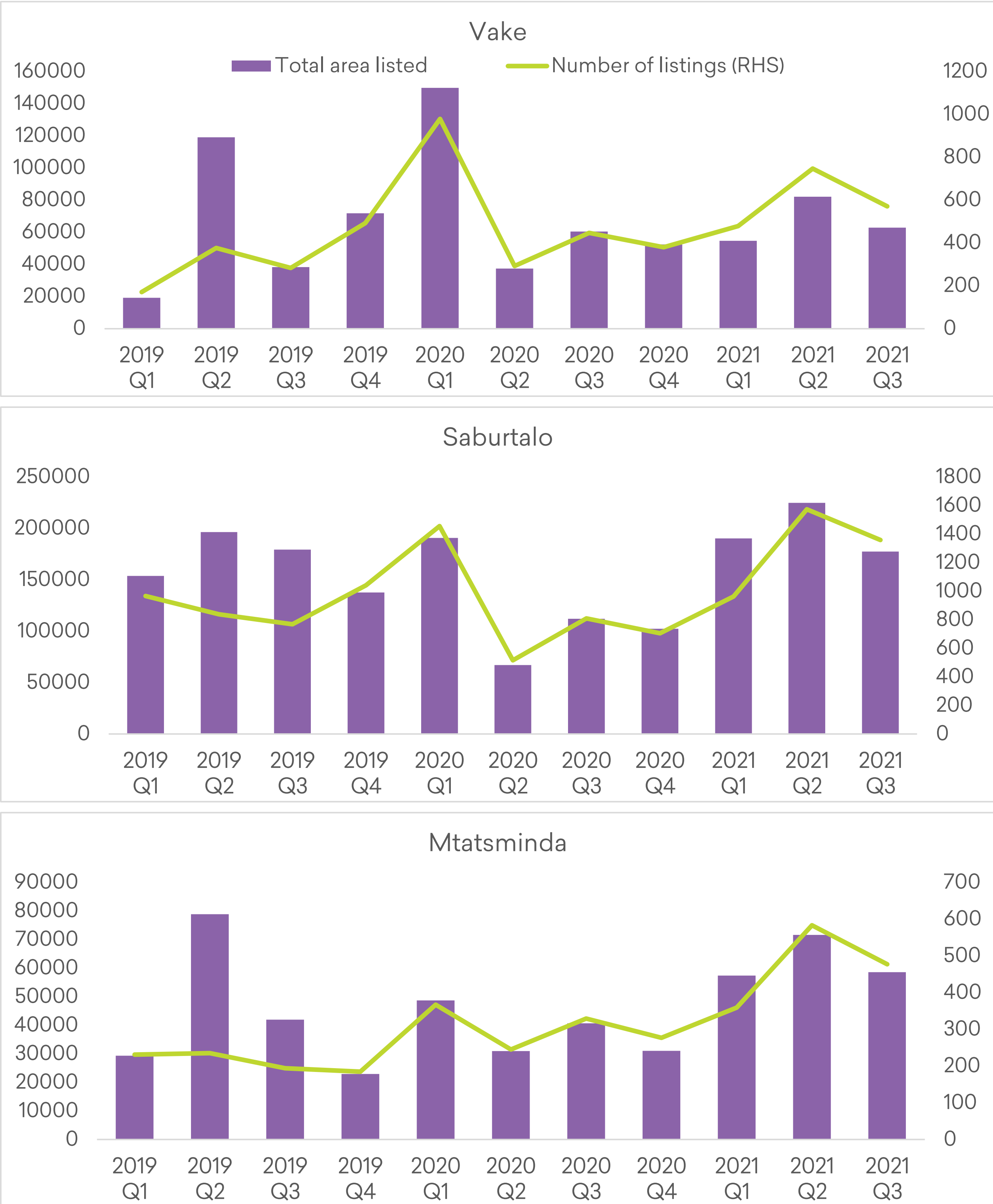


FIGURE A3

UNIVERSAL – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES



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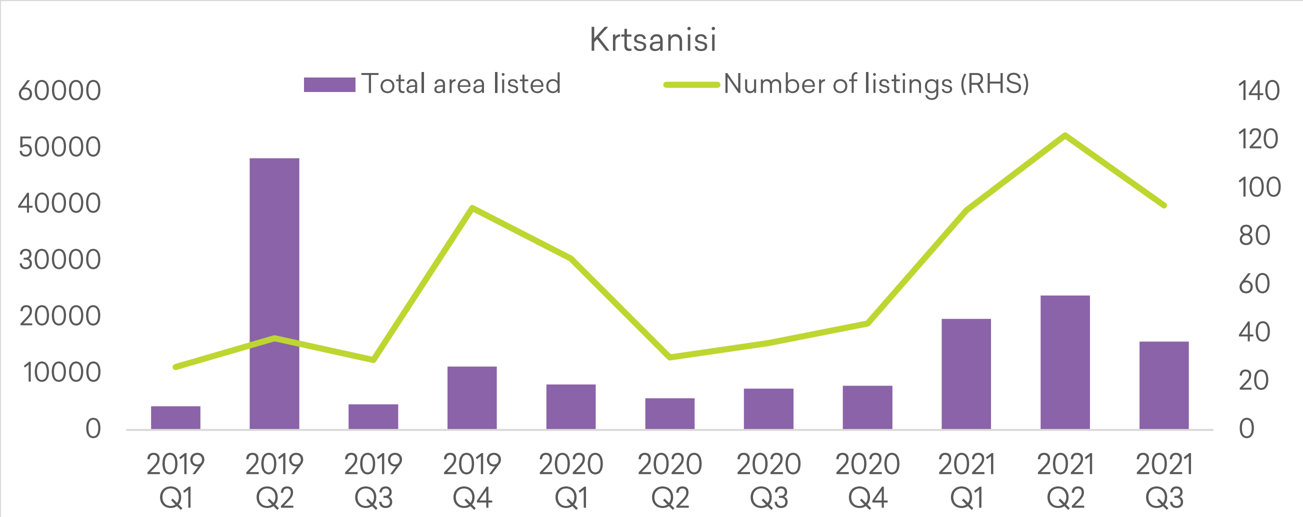
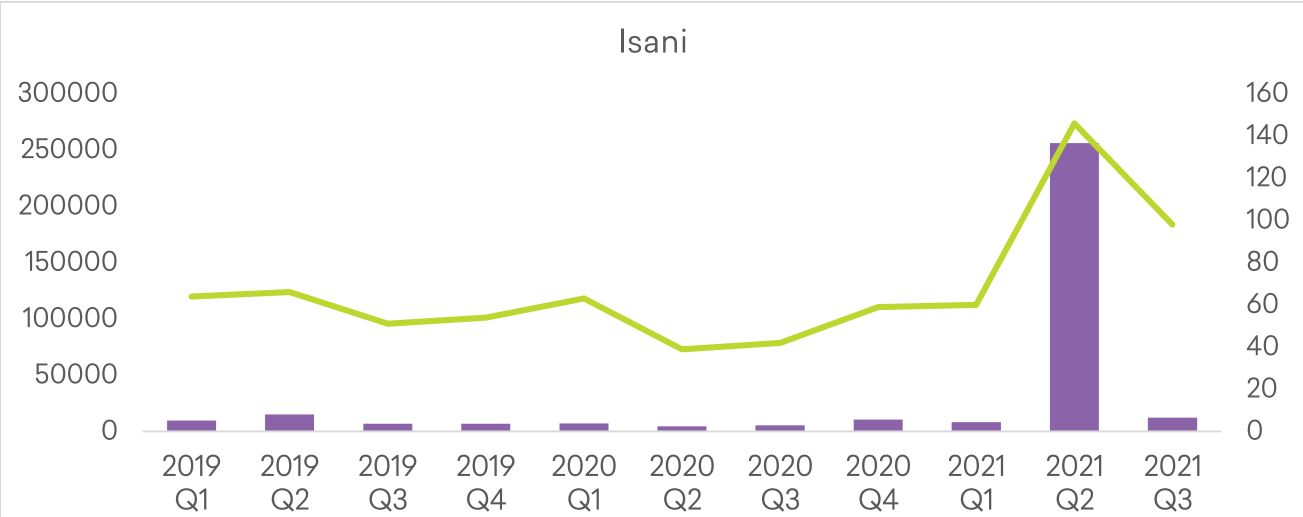
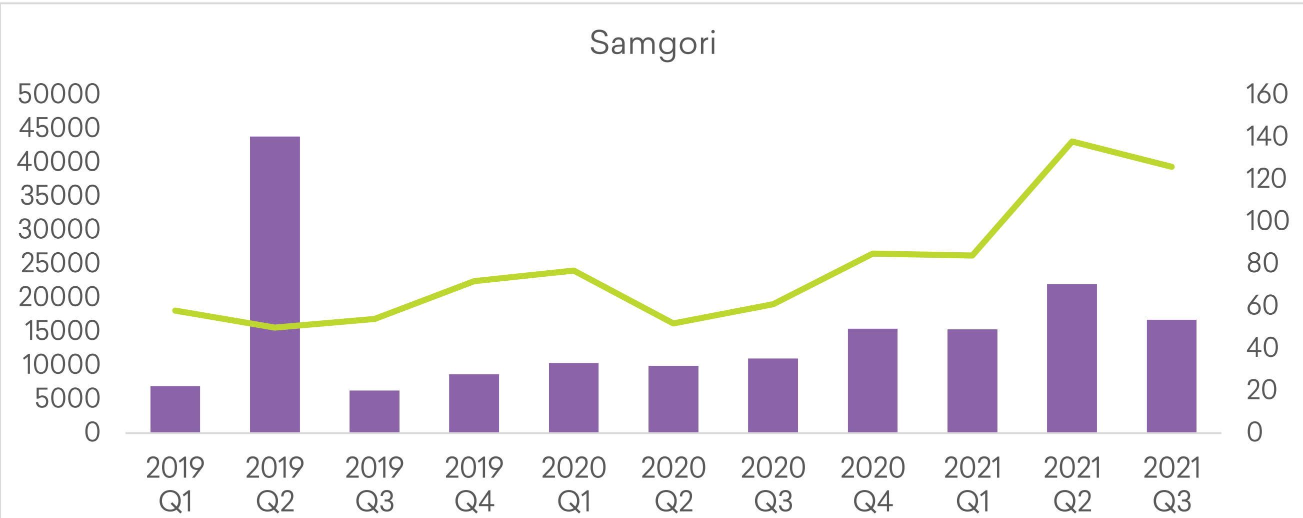
UNIVERSAL – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES







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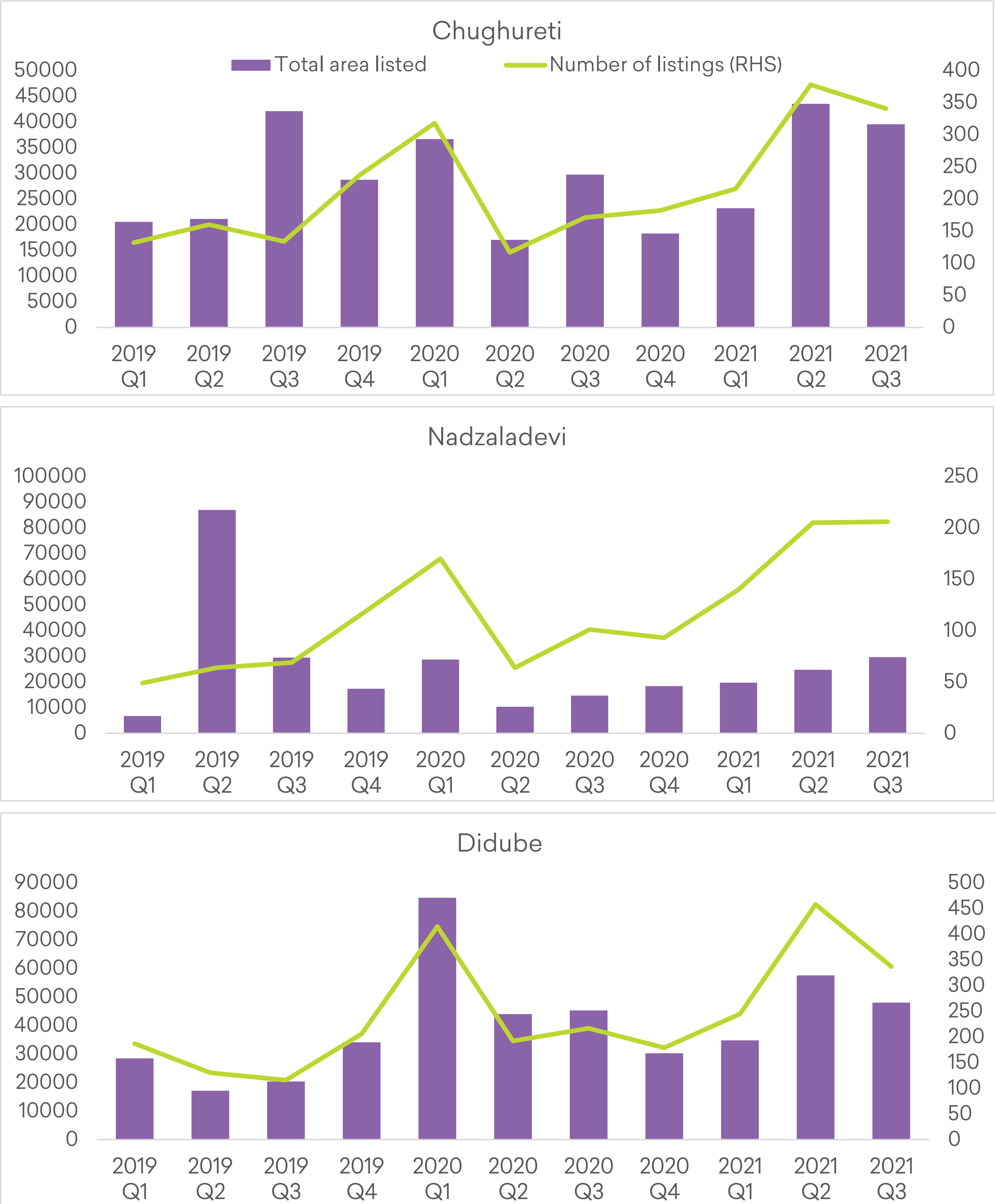
UNIVERSAL – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES



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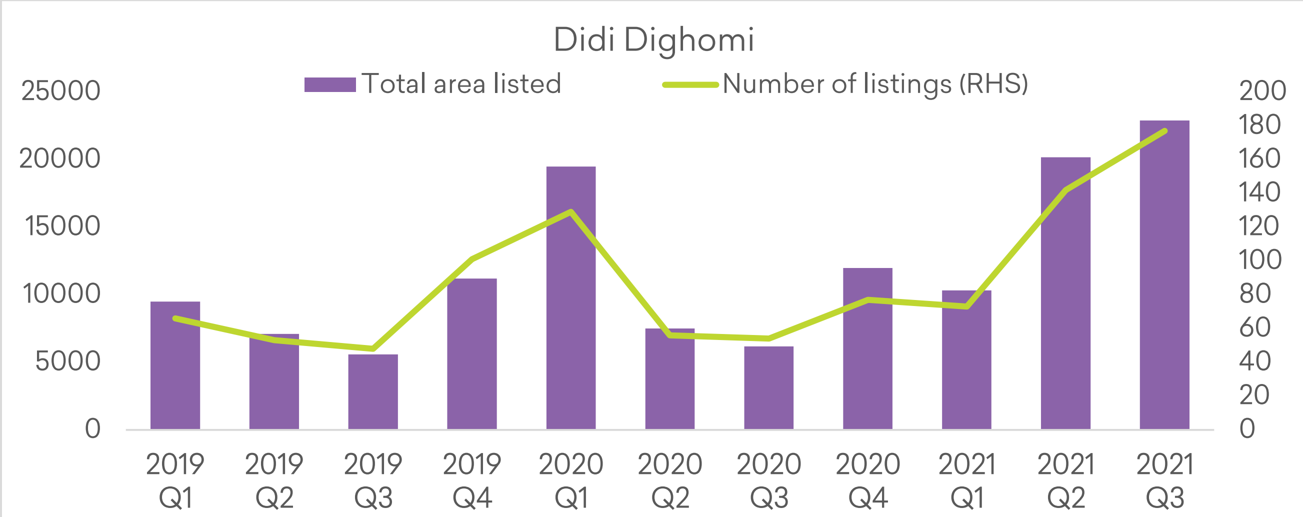


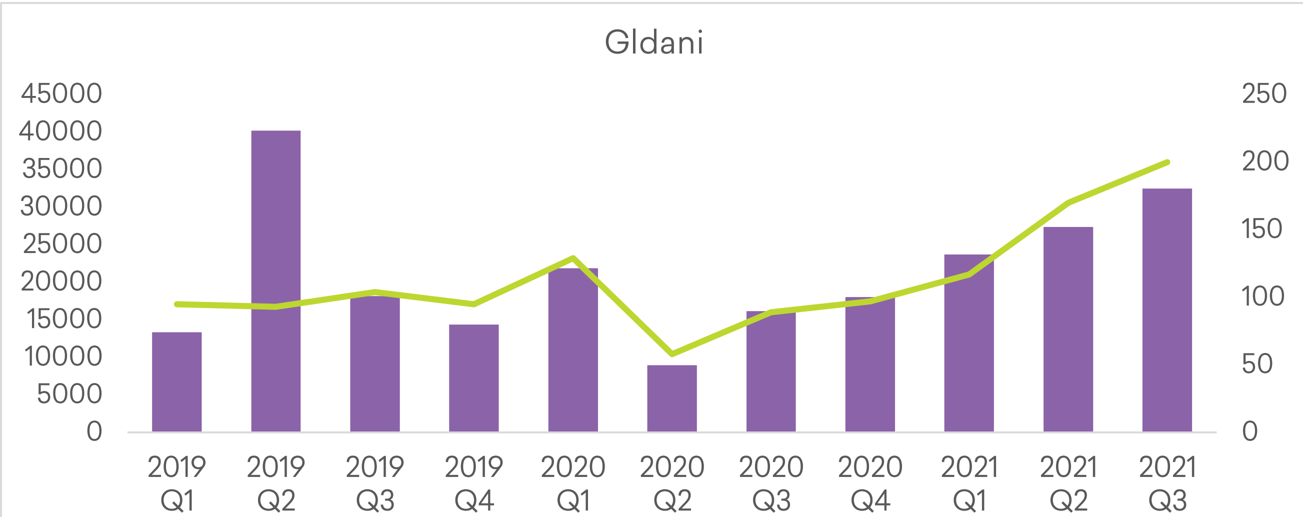


FIGURE A3

RESTAURANTS AND CAFES – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES

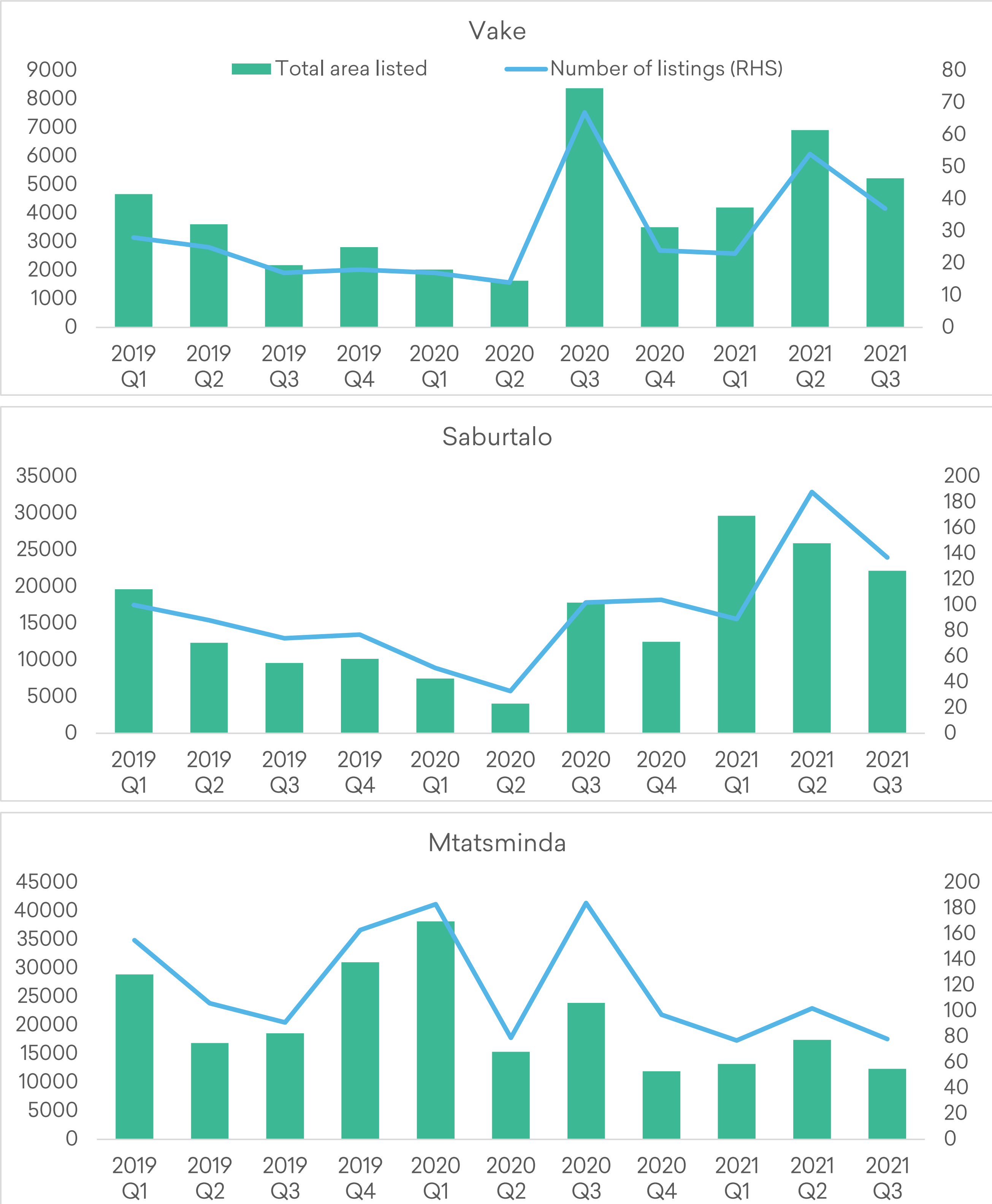
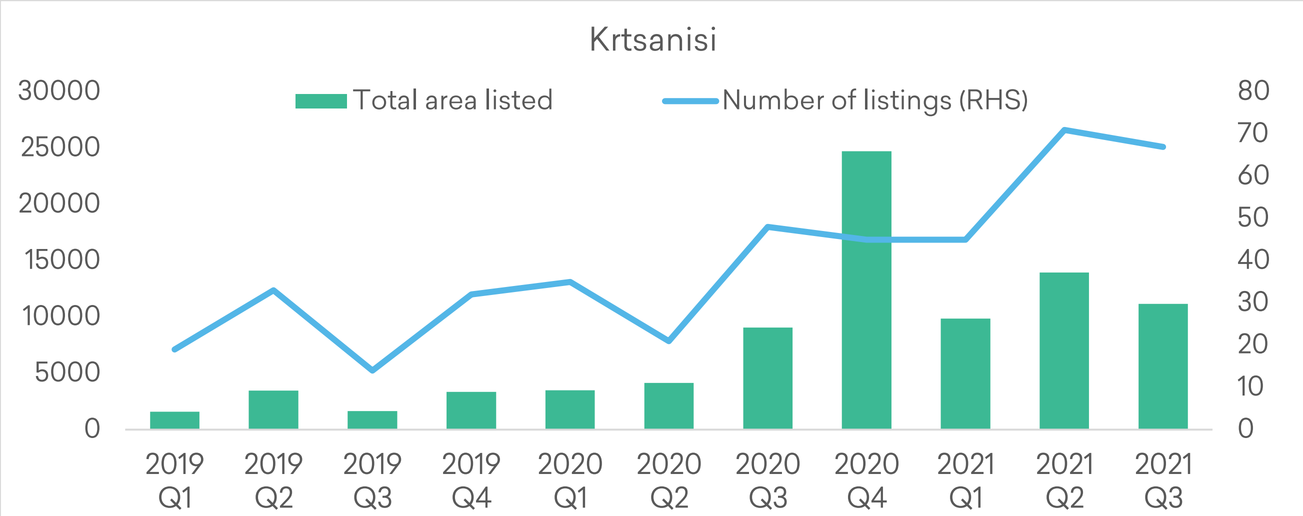
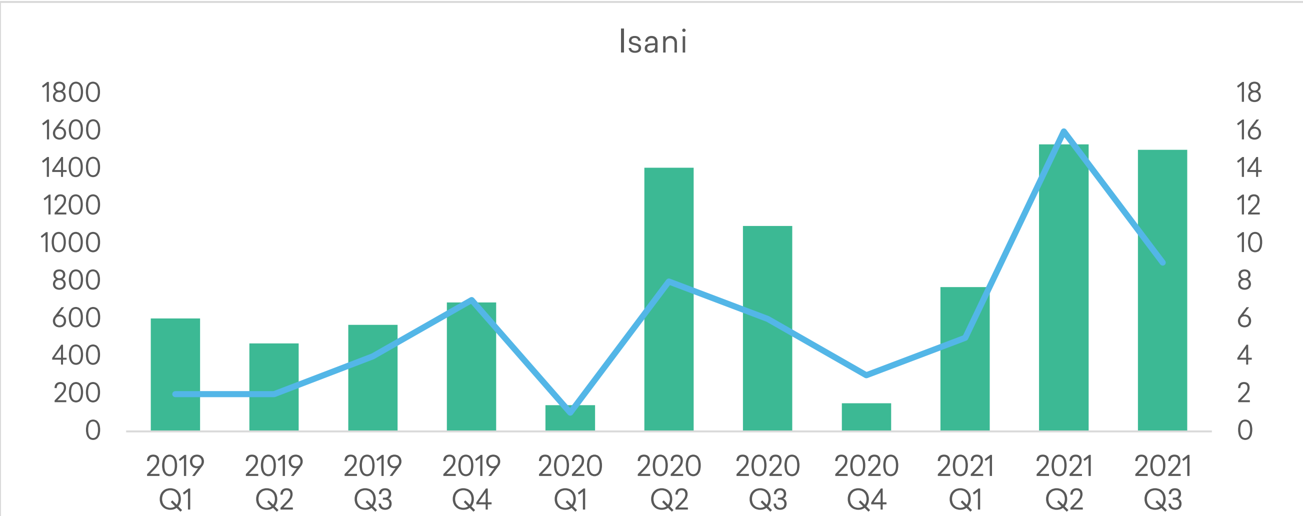


FIGURE A3

RESTAURANTS AND CAFES – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES





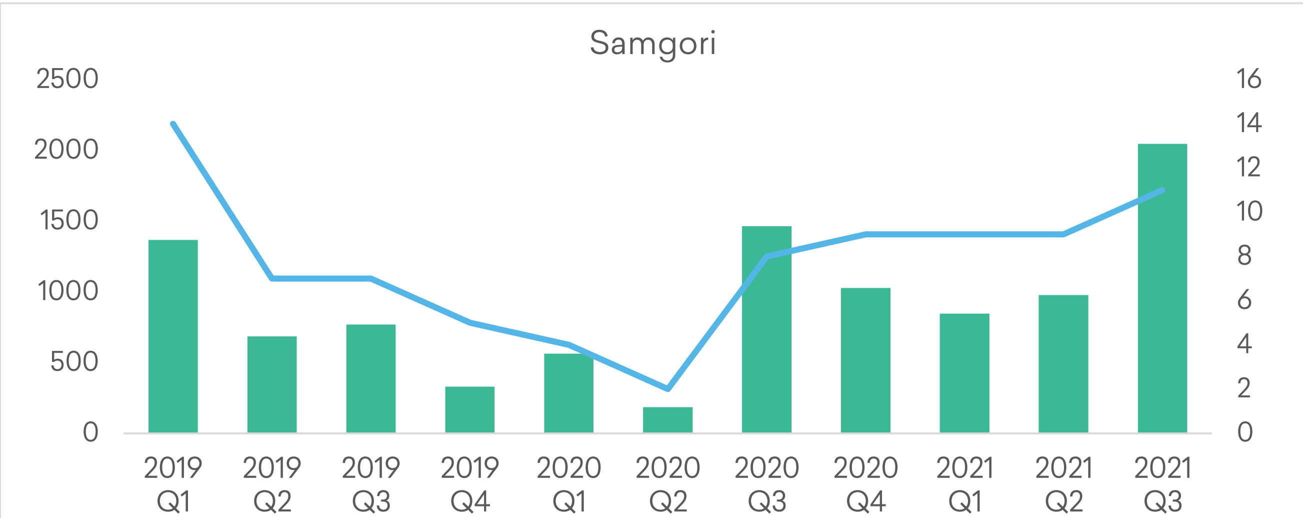
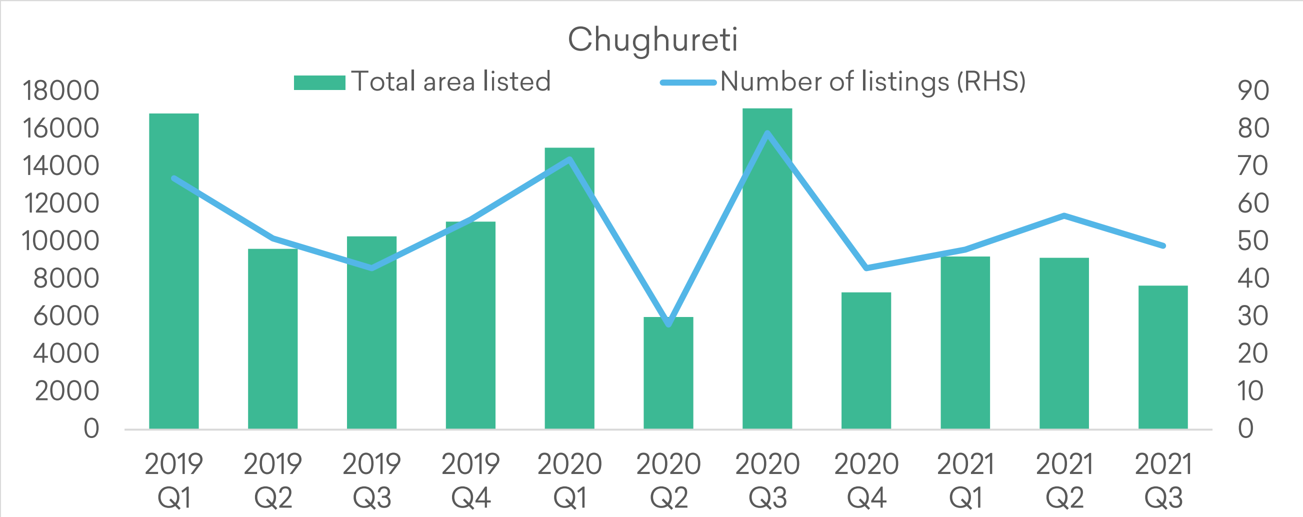
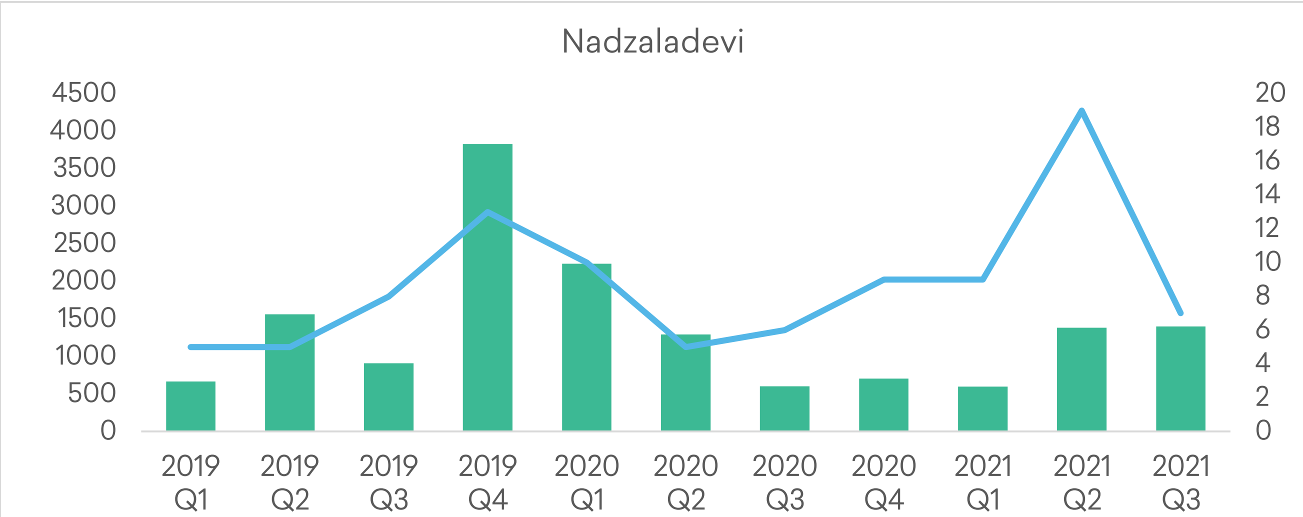


FIGURE A3

RESTAURANTS AND CAFES – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES





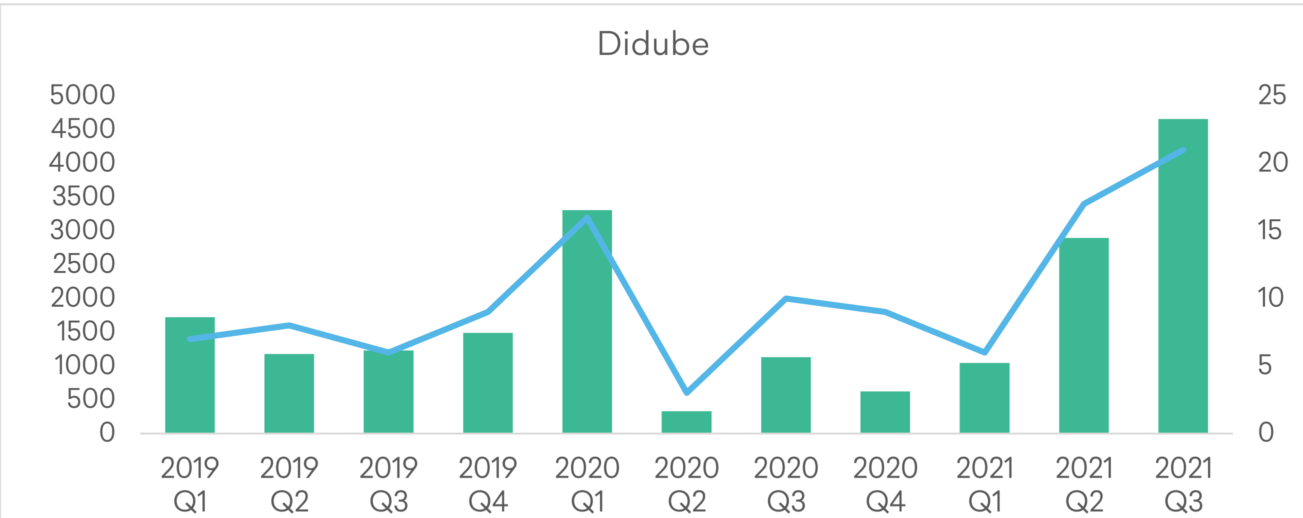
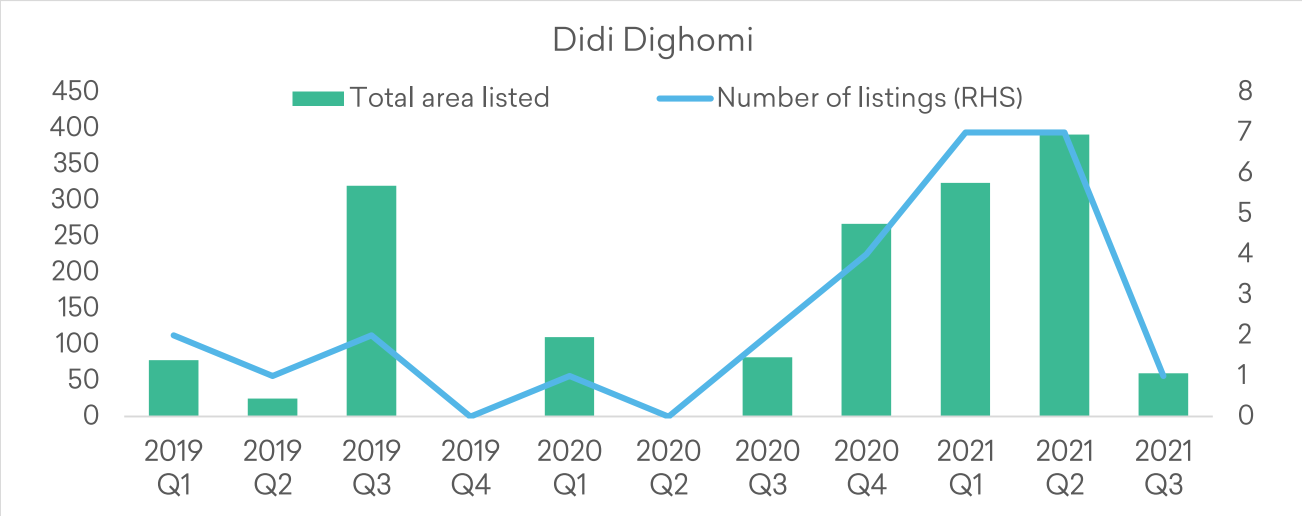
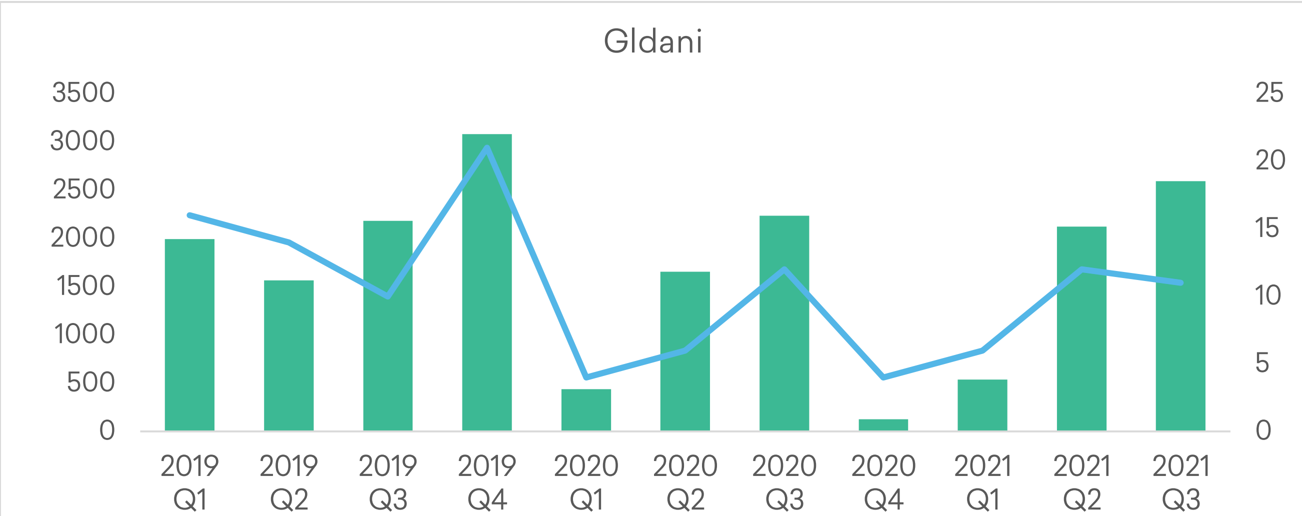


FIGURE A3

RESTAURANTS AND CAFES – TOTAL AREA (FOR RENT) AND NUMBER OF LISTED PROPERTIES





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