Research on Real Estate Development Opportunities and Identification of the Most Appropriate Segments for Investment in Latvia

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Keywords: Real estate, Business environment, Segments, Investment.

Abstract. The present research provides the assessment of the Latvian real estate business environment by considering social, economic, ecological and technological aspects in order to identify the overall real estate development opportunities in different sectors. The authors of the research examine the sectors of office, retail space and residential areas, and put forward proposals for the most successful real estate development strategies in Latvia.

Introduction

One of the most important aspects that distinguishes a successful company is a strategy that is consistent with ever-changing circumstances of the market. The real estate development sector is not an exception: when the company starts its business activity or evaluates the possibilities to change it, the company first defines its strategy—an area to which it is necessary to concentrate resources. In order for the company to operate successfully, it is necessary to choose an appropriate strategy and to take into account a wide range of influential factors as possible.

The research analyses the current market situation, identifies and analyses the real estate development strategies appropriate for the Latvian market and their influencing factors, as well as draws conclusions and makes recommendations for choosing an optimal strategy for the development of the real estate sector in the Latvian market.

The goal of the research is to put forward a number of optimal strategies from a wide range of strategies, which, under the current market conditions, as well as under the conditions expected in the near future, could be optimal for the successful operation in the real estate development sector in Latvia. To achieve the set goal of the research, the following tasks are formulated: to analyse the external environment of the real estate market in Latvia, to propose and analyse a number of possible strategies, and after the analysis of the relevant strategies, to put forward more promising strategies and substantiate their choice.

The Analysis of the Existing Environment

The research examines and analyses the external environment that affects the development of real estate sector, the impact of the external environment on the choice and operation of a real estate development strategy. The research also analyses regulatory, economic, social, technological and environmental aspects.

Economic Aspects

One of the most significant indicators of the economic situation is gross domestic product (GDP). The economic growth rate has recently fallen. In 2016, only 2.3 % of GDP was recorded in Latvia, being the lowest level since 2010. GDP per capita has had a steady upward trend in recent years. In 2010, GDP per capita was 8 553 EUR, while in 2016 it was already 12 722 EUR [1].

A significant indicator of the economic situation is also the increase in retail sales. The data of the Latvian domestic consumption allow evaluating the purchasing power of Latvian residents, which is an essential indicator when considering different strategies, especially in the segment of residential...
buildings. Purchasing power and retail data show slow growth since the end of 2015, with this trend remaining throughout 2017.

The inflation rate remains low in Latvia, reaching 2.9% in September 2017 and fluctuating around 0% in previous years [2]. Another important indicator of economic activity in the country is the unemployment rate. In the second quarter of 2017, the unemployment rate reached 8.9% in Latvia (86.6 thousand of the working-age population), being the lowest level since the third quarter of 2008. One year ago, the unemployment rate was 9.5%, i.e., it decreased by 0.6% or 4.8 thousand compared to 2017. In the current unemployment situation, there is a significant improvement over the first quarter of 2010, when 21.30% of the working-age population was unemployed, accounting for 225 thousand people [3].

Social Aspects

Population change, change in the average age of the population, change in income and wealth, as well as urbanization can be considered the main demographic trends. As the mortality rate exceeds birth rates, the negative migration balance not only reduces the population but also changes the age structure of the population. It should be noted that since 2010 there has been a slight increase in the proportion of the age group 0–14 years, which is explained by a slight increase in the birth rate. Nevertheless, the proportion of working-age population aged 15–61 years decreases year by year, just as the proportion of the age group over 62 years is constantly increasing. The number of working-age population has decreased by 141 000 since 2010, the number of people over the working age has increased by 9 000 [4]. The typical profile of a real estate buyer in 2016 and 2017 is the family, mostly in the age group of 28 and above, with at least one of the family members working in the IT sector or at an international company [5].

Technological Aspects

One of the drivers of globalisation is technological development. Technology is a catalyst for change not only in the real estate sector but also in all segments of the economy. Technological innovations make it possible to design and build more sustainable structures. Globalisation has the greatest impact on the global real estate market, creating conditions where the international metropolises play a significant role, where international business centres are located, which, to a large extent, dictate the development of the global economy. The society is increasingly buying on the Internet, which significantly reduces market barriers to new retail networks compared to traditional outlets located in supermarkets. Online marketing brings many benefits, for example, Internet users can order goods 24 hours a day and are not affected by the working hours of the store, as well as the target audience is significantly more global in online shops. Products in an online shop that is registered and based in one country can be purchased by almost any Internet user anywhere in the world.

Although online shops reduce the turnover of traditional stores, gradually eradicating certain sectors of the business from the goods and services market, they generate a significant turnover in the logistics sector, which in turn leads to the need for ever-increasing warehouse and logistics areas, as well as the development of innovative infrastructure in order to ensure the operative and high quality delivery of the purchased items to the customer.

In the residential sector, the most significant technology-related changes are the emergence of smart home technologies on the market. These technologies have become increasingly popular and widely used in recent years. In the United States, almost half (47%) of all residential areas are equipped with a smart home functionality product [6].

Smart home technologies are mainly focused on increasing energy efficiency and comfort, but it should be taken into account that these types of technologies achieve much higher efficiency when embedded in a building project and already integrated into building systems during its construction.

In the office space segment, technologies have a two-fold effect: on the one hand, cities with relatively cheaper workforce, for example, Riga, attract international companies interested in deploying an office and creating a service that could be exported. This tendency can be particularly
noticeable in the IT sector, as it makes no difference for international companies where to produce their software; what matters is the production cost that can be optimised by choosing to deploy offices in countries with lower costs and cheaper labour. On the other hand, remote work from home is increasingly gaining popularity worldwide, where employees can carry out the same workload, but without going to the office—working from home and connecting to a company’s computer system via the Internet. This way, companies significantly reduce the area of leased office required for the work process and the associated costs. For example, the US costs are about $11 000 per employee a year. In 2014, compared to a year earlier, the number of online home workers increased by 26 % [7].

**Environmental Aspects**

In the real estate segment, the environmental aspects are the aspects that can be easy identified, provided that no development project of a particular real estate takes place. An ideal location with good visibility and access to the main traffic roads with the largest flow of people brings benefits to the construction of retail and business premises and vice versa is undesirable in the case of residential projects. As each of the plots where it is possible to develop real estate is unique, in the course of designing the project it is necessary to consider the way of its use and environmental aspects.

An important factor is the natural resources located in the vicinity of a particular area and the location of the intended project, such as an offshore property versus a similar property, the development costs of which may be equivalent, but the location does not add value to the property, significantly influences the choice and decision of project developers. Thus, conclusions can be drawn about other natural resources, and the landscape is an important factor to consider when developing projects, especially if they are residential projects.

**The Analysis of the Existing Market**

To understand and analyse the real estate industry, the areas of real estate that are most often invested in Latvia are analysed.

**Retail Space Segment**

In line with development trends of the real estate market, the gradual improvement of the retail environment in Latvia is expected, mainly due to the slow, but stable economic growth, the improvement of living standards, which increase the purchasing power of the population and change their shopping habits. The above-mentioned considerations are also reflected in the activity of shopping centre owners in various expansion projects and the development of new retail space projects, which will continue to evolve in the coming years, as well as the arrival of new participants, is expected in the Latvian market. Brands that have strong positions in the Latvian market will maintain a constant growth rate and high demand from consumers.

**Residential Space Segment**

The residential space segment is directly dependent on the welfare and purchasing power of the population, where one of the most important parameters is credit availability, which has now reached the most stimulating indicators, owing to the low interest rates reported by state credit institutions in recent years. In addition, state credit institutions report that the population’s debt is rapidly decreasing at the moment, and it can be concluded that the purchasing power of the population is increasing and this increase is expected in the coming years.

Compared to previous years, the number of residential buildings in Latvia has increased compared to previous years. It can be observed that the growth rate has slowed down considerably. However, in 2017, an increase in the growth rate of residential buildings was observed, which could be explained by favourable conditions in the segment.
Office Space Segment

In spite of office buildings put into operation in 2016 and 2017, the shortage of high quality office space is still unresolved, which has resulted in a very small A-class office space. Considering projects that are under development now, on which public information is available, the office segment will experience significant changes in 2018, but the volume of office space currently under development is not enough to cover the current deficit and additional demand that will arise as economy continues to show strong growth, not to mention the entry of international companies in the Latvian market, as the current volume of A-class offices remains insufficient according to publicly expressed statements of industry representatives.

The authors of the research forecast that the rent will remain at the current level in the coming years and there will be a moderate increase in the rent of office space with a higher level of quality (easy access and advanced infrastructure). Prelease agreements and office space reservation will gain in popularity, where the company signs a lease agreement for areas that are not yet under construction at the time of signing the contract. In comparison with other European countries, Riga does not take advantage of an opportunity to attract branches of large international corporations as large office space of appropriate quality is not available.

Strategies

Each investor needs a multi-level (term) strategy to ensure stable and appropriate performance and competitiveness in a changing environment. The strategy is a set of actions that executives follow in order to improve the company’s performance compared to its competitors in the market. The strategy is a common plan for allocating resources, which results in a company gaining market benefits [8]. According to the company’s business model, it is necessary to determine its mission, vision, values, and goals, so that all actors in the company can coordinate their efforts towards achieving these goals. The next step is the analysis of the external environment, based on which, it is possible to develop strategies.

Corporate level strategies determine, for example, whether to develop projects by financing them with bank funds, through taking loans, or using equity as well as define the proportion of equity to be used for real estate development purposes. An enterprise level strategy determines the industry segment to which concentrate resources, and which type of projects to give preference. As the present research does not focus on a specific company but on the industry as a whole, it is not possible to perform an internal analysis of an enterprise that is often one of the most important aspects determining the choice of the appropriate strategy. Therefore, it is assumed in the research that the strategies discussed below are not affected by the company’s internal environment, which is neutral in all manifestations.

At the first level in the choice of strategy, it is necessary to analyse a segment of real estate development analysed during the previous analysis of the external environment. Next, at the second level of strategy, the authors evaluate the payback period of the project. Within the framework of the research, only the medium and long-term payback periods are evaluated, as short-term speculation in the national economy does not generate any added value but acts only as a means of capital transfer (relocation) among various market participants. In general, the authors propose six different strategies (see Figure. 1).

Recommendations for Choosing a Strategy

In general, out of the analysed real estate segments, there is an office space segment with the favourable opportunities in the future and the lowest risks to profitability. In this segment, it is also possible to implement diversification of capital using different strategies of the second and third levels, according to the strategy levels adopted within the framework of the research.
The optimal strategy for at least five years is the development of real estate in the residential segment by developing medium-term projects. Due to the oversaturated market, the retail space segment will not be optimal in the coming years in order to organise project development.

In general, the proposed strategies and their levels, as well as the authors’ recommendations are demonstrated in Figure 2, where the optimal and perspective directions of strategies are shown in green, the directions, which are recommended in cases when a retail segment is chosen, are marked in orange. In turn, the directions of strategies marked in red are not recommended to be chosen as a company’s strategy.

### Table 1. A circle of identified strategies.

<table>
<thead>
<tr>
<th>Residential space segment</th>
<th>Office space segment</th>
<th>Retail space segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium-term (to sell)</td>
<td>Long-term (to rent)</td>
<td>Medium-term (to sell)</td>
</tr>
<tr>
<td>Long-term (to rent)</td>
<td></td>
<td>Long-term (to rent)</td>
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### Table 2. A circle of recommended strategies.

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Considering **the residential space segment**, it can be concluded that the market is currently growing, the purchasing power of the population increases owing to low interest rates, economic growth and the state aid programmes. In spite of depopulation at the national level, in the capital of Latvia, Riga, and in regions around Riga, an increase in the number of inhabitants is observed as a result of urbanization processes, which create the demand for new residential areas. The living space per capita in Latvia is lower than the average indicators in Europe and, as a result of the increase in living standards, it can be forecast that these indicators will smooth out. Based on the results of the research, the authors consider that the demand for 2- to 3-bedroom apartments can be forecast in Riga.

**The office space segment** is considered to be the most promising one of the reviewed segments as a result of the external environment analysis. The current shortage of A-class buildings and other office buildings in Latvia and low free space indicators demonstrate a deficit of office space. Analysing the absorption of the area of the developed projects up to now, it can be concluded that the Latvian internal market is capable of absorbing a large volume of newly built office space. There are also high potential and many positive factors that would allow attracting international companies for the establishment of their branches in Riga, which is currently significantly hampered by the lack of office space offers. By creating an appropriate offer, it is possible to increase the demand by attracting new market participants.

The above-mentioned considerations indicate a relatively low risk of developing the real estate in the office space segment, and deficit prevailing in the market maintains inappropriately high capitalisation indicators that are not characteristic of low risk. This segment also provides a wide range of second- and third-level strategies that make the segment more attractive as a result of its diversification potential. The developer can choose the office space segment as the main strategic direction and implement several sub-strategies, for example, developing both medium and long-term projects.

### Conclusion

In compliance with the set goal, within the framework of the research the authors have analysed six real estate development strategies appropriate for investors in the Latvian market, as well as considered their influencing factors. As a result of the analysis, the most optimal strategies have been proposed and well-grounded recommendations have been formulated for choosing an optimal strategy in the real estate development market. The most rational strategies are as follows:

a) an office segment strategy with a long-term repayment period;
b) an office segment strategy with a medium-term repayment period;
c) a residential segment strategy with a medium-term repayment period.

The retail space segment is considered to be oversaturated in the near future and an irrational choice for the development of real estate.

References


