Sadolin | ALBÆK

NEWSLETTER

Commercial property in Denmark and abroad.

February 2000

Contents

	Page
The property investment market	**1**
Rising interest rates and declining yield targets	1
The rate curve of the Danish market	2
Low letting activity not caused by a lack of demand	3
Price index reveals steep increases in commercial property in 1999	3
Stronger international focus on the Greater Copenhagen property investment market	4
The market for hotel property investment	**4**
Solid interest from foreign hotel operators	4
Strong investor demand for hotel property with fixed-term leases	5
Warehousing and distribution investment property	**5**
Greater institutional interest in warehousing and distribution property	5
Growing tenant demand for prime distribution property	6
The office letting market and new office developments	**8**
Very few tenants willing to pay prime rental levels	8
Occupiers now demanding train-station proximity in new developments	9
Planning-based distinction between office and industrial premises is out of date	9
The international property markets	**10**
Volatile letting market in Stockholm	11
Norwegian property investment market driven by interest rates	12

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ONCOR INTERNATIONAL

Page

Stockholm 12

A strong, sturdy market for office space with no particular weakness 12

Oslo 13

Supply of new office space expected to exceed tenancy demand 13

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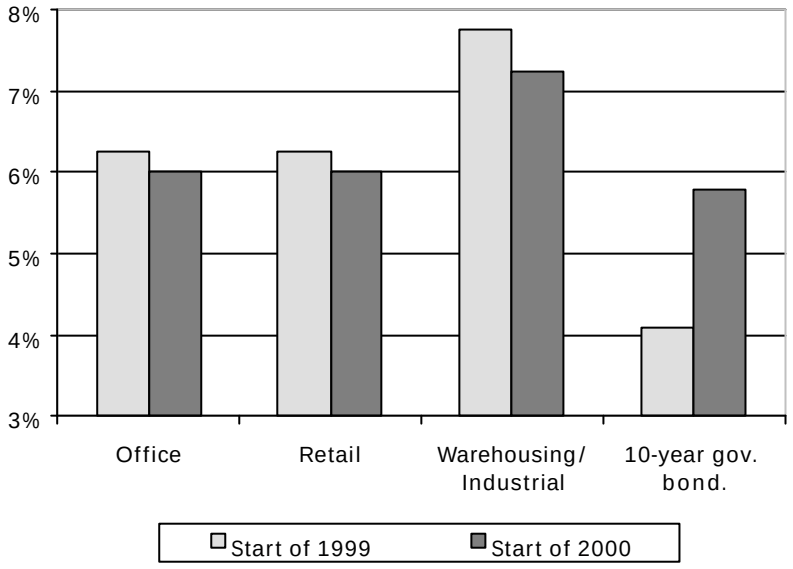
The property investment market

Rising interest rates and declining yield targets

Long-term interest rates, measured as the yield on 10-year government bonds, rose sharply in 1999.

Nevertheless, the net return on prime, fully-let investment property showed a slightly downward trend.

Net initial yield on prime property relative to long-term interest rates



Source: Sadolin & Albæk·ONCOR International

Basically, such developments are very logical and easy to explain. Interest rates rise during a boom cycle, partly because of rising inflation, partly because monetary authorities raise interest rates in order to curb growth. At the same time, occupiers strongly demand commercial space due to the strong economic activity which in turn drives up market rental levels.

Accordingly, investors expect rental income to rise over time. In addition to demand-driven growth in rent levels, existing leases are generally also subject to rent reviews based on developments in the net price index.

On the other hand, this trend will not last forever. Higher interest rates act to curb economic growth and employment growth. The

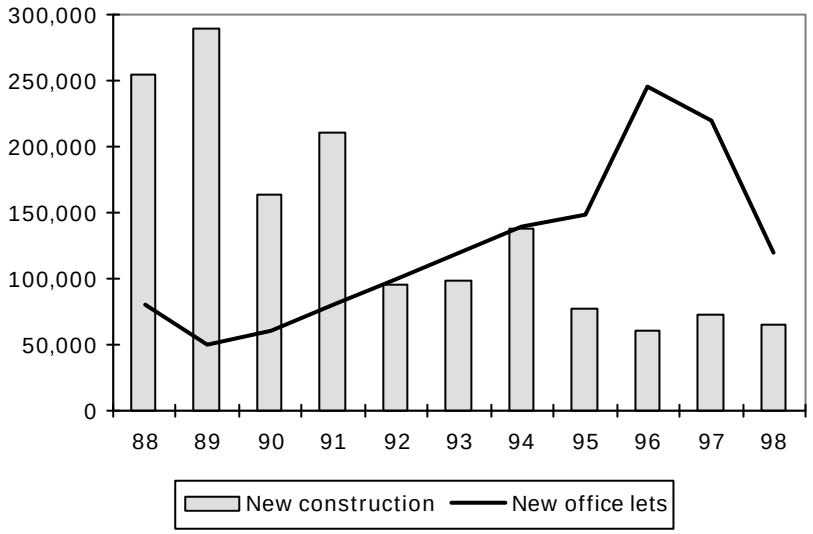
volume of new construction has risen during the economic upswing due to strong demand for leased space. This combination is, *ceteris paribus*, a trigger for rising vacancy rates and declining rental levels.

The rate curve of the Danish market

The following graph reflects completed building projects and net new office lets in the Greater Copenhagen area during the period from 1988 to 1998.

The figure shows that by 1998 new lets had been almost halved relative to previous years. During the same period, new building activity began to rise, gaining further momentum in 1998, when new building projects comprised some 100,000 sq m of gross floor space.

New construction and net new office lets (sq m)



Source: National Planning Department, Ministry of the Environment and Energy

Viewed separately, the figure could be an indication that the market is approaching a more difficult phase of declining letting activity. Add to this the increase in new construction, as pointed out above.

However, there are also factors that disprove this interpre-tation. In spite of weak growth in 1999, the Danish economy is expected to recover in 2000, driven especially by increasing exports to Sweden and continental Europe, ie to markets enjoying stronger economic growth.

Low letting activity not caused by a lack of demand

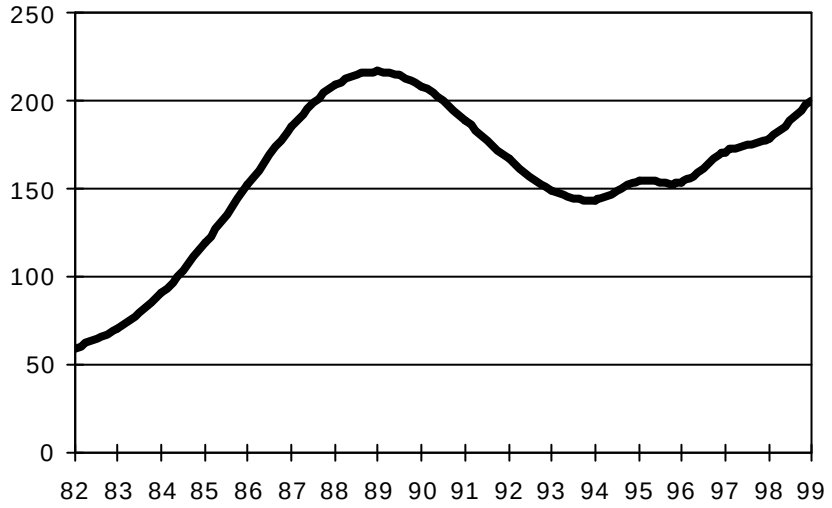
In addition, the low level of new letting activity is not, we believe, caused by weaker demand, but rather by a shortage of space to let. According to the National Planning Department, for example, there was only one vacant tenancy of more than 5,000 sq m as at 1 July 1999.

Consequently, businesses seeking new premises of a certain size have no option but to commit to new construction. This means that current new developments are generally not of a speculative nature, as a vast majority of the new space consists of pre-lets.

Price index reveals steep increases in commercial property in 1999

Our property price index for 1999 reveals a much steeper increase in commercial property in the Greater Copenhagen area than was expected at the start of the year: Prices on commercial property rose by no less than 12% on average during the year.

Sadolin & Albæk property price index (index 100 = Q3 1984)



Source: Sadolin & Albæk·ONCOR International

In other words, we had underestimated the growing trend in our previous price forecast for 1999 which predicted much weaker growth.

We believe that the main explanation is to be found in the much stronger growth in employment, not least in the Greater Copenhagen area, than previously expected. The price forecast was based on economic estimates that proved to be overly pessimistic.

The Danish economy has seen stronger growth in recent months than expected, in part because the Whitsun package had a slightly weaker impact than anticipated, in part because Danish exports recovered during the period to show quite decent growth rates once again.

Stronger international focus on the Greater Copen-hagen property investment market

Twelve months ago, we predicted that 1999 would be the year in which foreign investors would truly begin to focus on the Copenhagen property market, and to some extent we were right.

The *Fisketorvet* retail development project was won by *Piren AB*, a Swedish company which was recently acquired by the giant Dutch property company *Rodamco*. *Diligentia* of Sweden, which has now merged with *Castellum*, also invested very substantial amounts, mainly in office property. *Olav Thon* of Norway has launched hotel projects and UK players have continued making acquisitions in high street property.

Overall, these transactions exceeded DKK 2 billion, and had *Danbyg* been taken over by foreign interests, international investment would have amounted to about DKK 4 billion.

There are no signs of diminishing interest from foreign investors. We have recorded many enquiries from important German, Dutch, UK and Norwegian investors.

The market for hotel property investment

Solid interest from foreign hotel operators

After being stagnant for many years, the Copenhagen hotel market is undergoing strong expansion. International players are showing a solid interest in entering the market which for years has been dominated by Danish and to some extent Scan-dinavian operators.

The hotel capacity of Greater Copenhagen has been relatively stable at about 11,000 rooms for the past several years. In 1999, the 400-room *First Hospitality* hotel opened on Vester-brogade in the city centre. Other new projects already launched or committed will add about 1,500 rooms to the current capacity.

In our view, a capacity increase taking place during the period from 2000 to 2002 does not in the least give any cause for alarm. For one thing, the capacity utilisation is very high at the moment and, secondly, a number of new, very powerful international operators are entering the market. Our past

experience shows that through their existing international customer bases, such operators often generate whole new classes of hotel guests.

On the other hand, there is no doubt that the greater capacity will trigger industry consolidation in the long term. Small hotels in peripheral locations that are not operated by a large chain will be struggling to survive.

Strong investor demand for hotel property with fixed-term leases

The strong developments in the hotel market have been a catalyst for a surge in investor interest, especially from private investors. In Q4 1999 alone, our records show five transactions comprising about 700 rooms and involving total investment of some DKK 600 million.

Private investors mainly demand hotels with indexed leases that are not linked to profits and with at least a 15-year term. Currently, the net initial yield for such hotel property with 100-200 rooms and a three or four-star category, according to Danish standards, is from 7.25% to 7.50%.

During the last couple of years, there have been no investment transactions in which global operators took long-term leases on new, large-scale hotel property. We are confident, however, that such property would attract the interest of both Danish and international institutionals at lower yield levels, most likely at about 6.25-6.50%.

Warehousing and distribution investment property

Greater institutional interest in warehousing and distribution property

The market for warehousing and distribution investment property has traditionally been less liquid than the office property market. Its dominant players have been specialist developers, property companies and private investors.

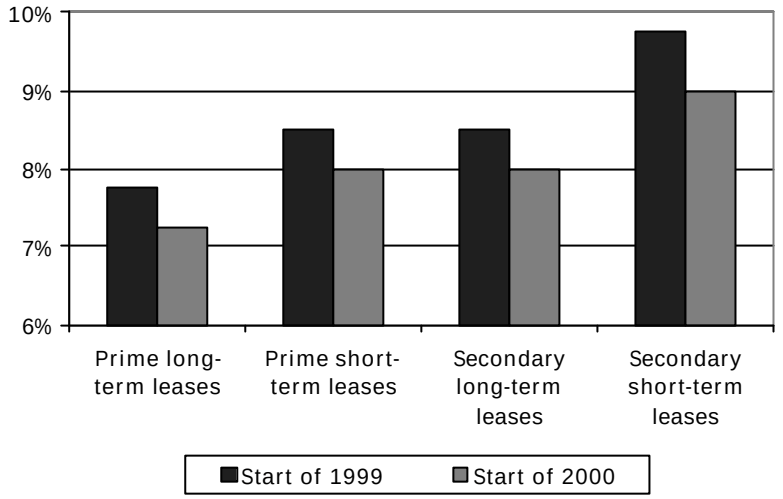
In several international markets, however, institutional investors have shown a great deal of interest in this segment, and this trend has now reached the Danish market.

Basically, this is very logical. Modern standard, high-ceilinged property built for warehousing and distribution purposes without interior columns have no greater re-letting risk than does office space.

Furthermore, there is seldom any imposing need for conversion on re-letting to a new tenant, unlike the situation in the office segment where re-letting often involves substantial costs in order to fit the premises to the new tenant's requirements.

Moreover, the net initial yields available from warehousing and distribution property are a good deal higher than those of office property, even though this segment returns have shown steeper declines during the last 12 months than the office segment.

Typical net initial yields for warehousing and distribution property



Source: Sadolin & Albæk·ONCOR International

Growing tenant demand for prime distribution property

The Greater Copenhagen area is becoming a key distribution hub for northern Europe.

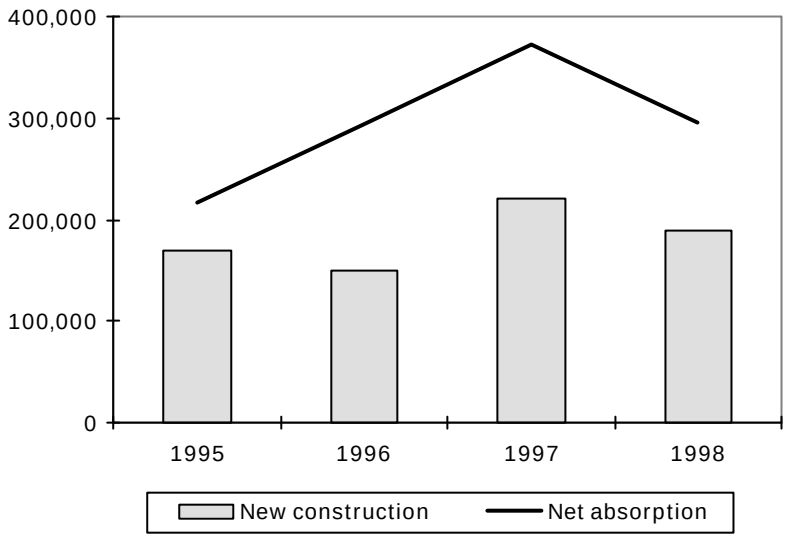
At the same time, a potential surge in e-commerce will trigger an increased demand for modern distribution facilities. There is already strong growth in the construction of new, modern standard warehousing and distribution facilities for e-commerce businesses in the south-eastern part of the UK.

A vast majority of the existing stock of warehousing and distribution facilities in Greater Copenhagen is more than 10-15 years old and does not meet current international standards for distribution facilities.

Nevertheless, the current vacancy rate for warehousing and production space is only about 1.5%, and the volume of new construction projects has fallen well short of the net space absorbed.

Added occupier demand for new developments will serve to enhance the investor focus on this sector. On the other hand, there is by no means an endless supply of major sites for warehousing and distribution facilities at preferred locations in the Copenhagen area or in the vicinity of Copenhagen Airport with direct access to the motorway network and the fixed link to Sweden.

New construction and net absorption, warehousing and production facilities (sq m)



Source: National Planning Department, Ministry of the Environment and Energy

Therefore, we expect to see a further drop in the net initial yield demanded for modern standard warehousing and distribution property with ceiling heights of, say, 11 metres and the most attractive locations in terms of infrastructure.

On the other hand, we would not rule out that older warehousing property designed with columns and ceiling heights of between 4.5 and 6 metres could be hit by weaker tenant demand and a greater vacancy risk.

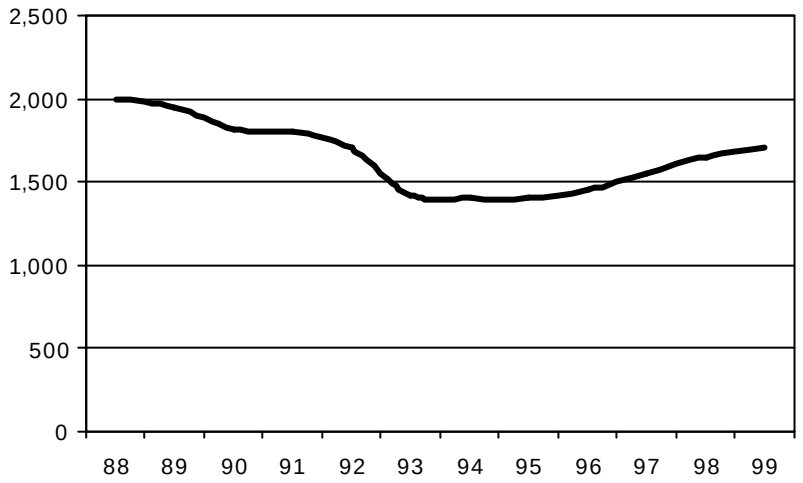
Accordingly, this type of property could be affected by demands for higher net initial yields.

The office letting market and new office developments

Vacant office space is very scarce in the Greater Copenhagen region. The overall vacancy rate is only 2% of the building stock, which has prompted heavy activity within pre-letting of new office developments.

In addition, rental levels for prime office space at the best locations continue to rise.

Prime rents for office space in Copenhagen (DKK per sq m per year)



Source: Sadolin & Albæk·ONCOR International

On the other hand, the opportunities available for new construction, especially in the Ørestad, lead us to believe that within the foreseeable future prime rents will not match the peak levels reached during the boom cycle in the late 1980s.

Very few tenants willing to pay prime rental levels

At the same time, we also note that very few tenants are prepared to pay the current prime rental levels.

Even among tenants demanding modern standard space in central locations, we see considerable reluctance to pay a rent of more than DKK 1,500-1,550 per sq m annually.

In decentralised areas, only the most attractive business locations in Tuborg Nord and in the vicinity of *Lyngby* Station are able to attract tenants at city centre rental levels.

In other decentralised locations, such as the district of *Ballerup* and the vicinity of *Glostrup* Station, annual rental levels for new developments still hover around DKK 1,000-1,100 per sq m annually.

Even in *Sydhavnen*, the district south of the city centre, where the best locations are let at rental levels of DKK 1,200-1,300 per sq m annually, there are still sites available for modern stan-dard office space at rental levels of about DKK 1,000 per sq m.

Occupiers not demanding train-station proximity in new developments

Since 1989, the overall political objective has been for all new office developments to be built in the proximity of train stations. Basically, this means that efforts are made to ensure that all new office developments are located within a 500-metre radius of stations on either the S-train or the regional train network.

According to the National Planning Department, however, only 22% of new office space built in 1998 complied with the station-proximity principle.

The reason is not the very abundant building opportunities in older development plans, as suggested by the National Planning Department. Unexploited development opportunities in such older plans have certainly provided the basis for new con-struction in areas distant from railway stations, but new projects do not materialise just because they are made possible through council planning or by local plans. They are built for companies having signed a lease for a project simply because such companies want to be located at a particular site.

Our past experience shows that many private businesses consider train-station proximity a secondary factor in their considerations for space.

Planning-based distinction between office and industrial premises is out-of-date

The principle of train-station proximity applies only to office space and not to industrial projects. However, the traditional distinction between office and industrial developments could well be described as an anachronism. It is the product of a time when industrial construction meant building factories for varying degrees of heavy industry.

In most of today's production companies, not least those in the IT industry, employees involved in development and production use individual PC workstations in office-like environments. In reality, the premises used by such production companies are no different than office accommodation used for, say, administrative purposes or sales operations.

This means that some businesses, including players within the IT industry, end up finding locations at sites distant from the rail networks in areas otherwise classified for industrial purposes, whereas other businesses with the same type of employees and with identical requirements as to premises are prevented from doing so.

We sincerely hope that the policy on the locations of commer-cial developments can be revised and made more evenly balanced. One of the principal objectives of planning policy must be the continuing efforts to create the physical framework demanded by businesses.

Accordingly, a much more flexible set of rules is required in place of the dogmatic and outdated approach expressed both through the distinction between office developments and developments for light manufacturing purposes and through the planning authorities' very rigid and inflexible enforcement of the train-station proximity principle.

The international property markets

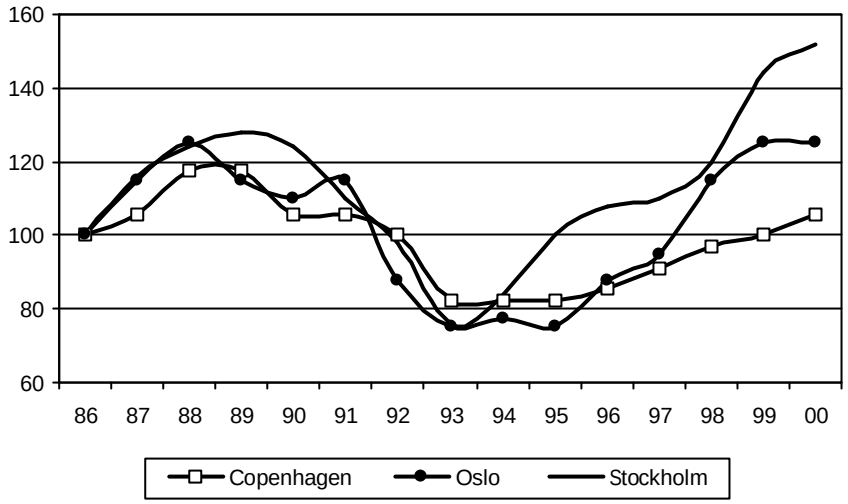
Our report on international property markets in this issue of our newsletter focuses on the two other Scandinavian markets, Sweden and Norway.

Although many international investors increasingly consider Scandinavia to be a single market, there is only limited correlation between the general developments in the three major markets of the region, Copenhagen, Oslo and Stockholm. Economic developments in the three countries are simply too diverse.

The cities also differ in terms of urban structure. Copenhagen still offers many opportunities for new developments in attractive, central locations.

This is not the case in Stockholm and that means that rental levels for prime office space in that city rise more steeply during times of expansion.

Indexed movements in rental levels for prime office space (1986 = index 100)



Sources: Sadolin & Albæk/NewSec/DnB Næringsmegling

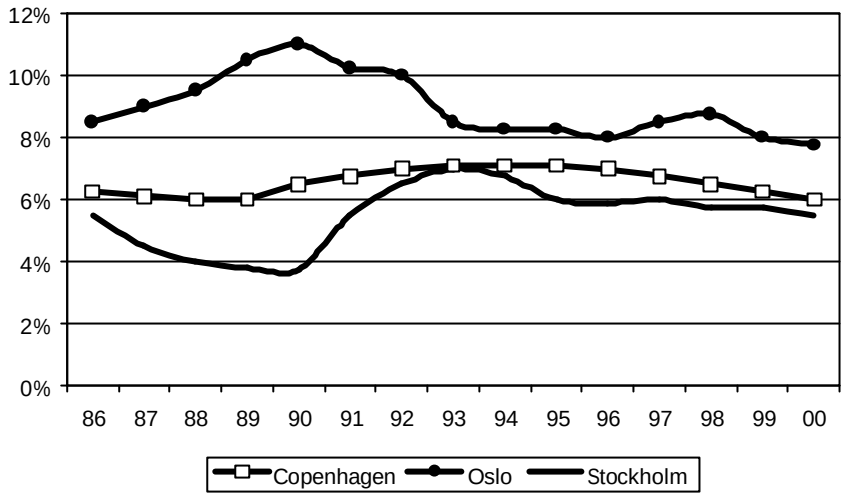
Volatile letting market in Stockholm

As the figure indicates, prime rental levels for office space in the three Scandinavian capitals have to some extent correlated during the past ten years. However, the figure also shows that Stockholm is clearly the most volatile market of the three and that Copenhagen has experienced the least volatility.

Movements in the three investment property markets, especially in terms of net initial yield on prime, fully-let office space, show similar developments for both Copenhagen and Stockholm. The two markets move largely in step with each other, although Stockholm is clearly the more volatile of the two.

In Copenhagen, prime yields have ranged from 6% to 7% during the past 10 years, while Stockholm has seen much greater fluctuations.

Prime yields on office space in the Scandinavian capitals



Sources: Sadolin & Albæk/NewSec/DnB Næringsmegling

Norwegian property investment market driven by interest rates

From 1987 to 1992, in particular, Oslo property investments moved in a very different cycle than did the other two cities. Our analysis indicates that to a much greater extent than in the other Scandinavian markets, the yield targets for investment property in Norway are driven by long-term interest rates.

During periods of recession, investors in Copenhagen and Stockholm demand a risk premium to compensate for potential vacancy. This is considered a high risk during weak economic conditions. Investors in Norway see things differently, however. There may be a greater vacancy risk during a recession, but as interest rates are held low in order to boost the economy, investors also accept a lower direct yield on their property investments.

Stockholm

A strong, sturdy market for office space with no particular weakness

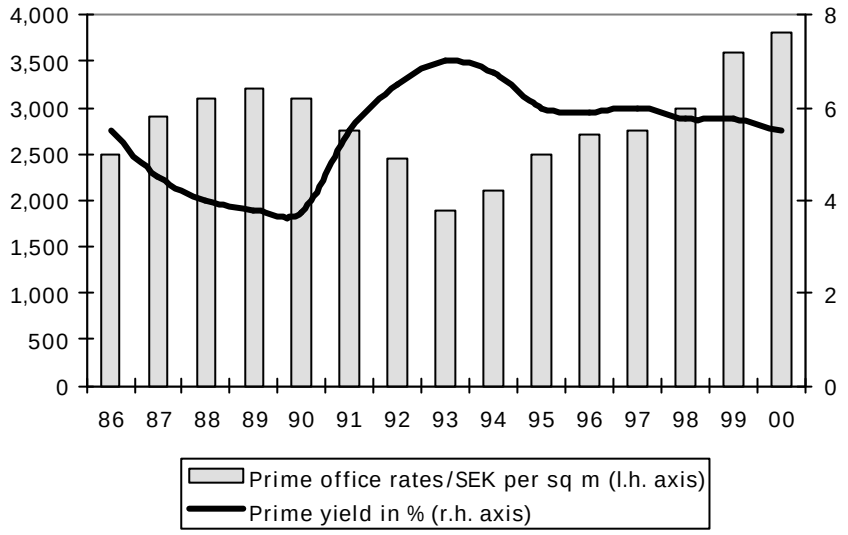
Stockholm's commercial property market has recovered strongly since the severe recession in the early 1990s. Rental levels have nearly doubled for modern standard office space at prime locations in Stockholm's 'Golden Triangle', and vacancy rates are very low, at about 2%.

The Swedish economy is still in a strong recovery cycle. Relative to most European countries, Sweden is enjoying very strong economic growth of more than 3%. Nevertheless, inflation was at the very moderate level of 0.4% in 1999.

Unemployment has been forecast to drop to just 4.5% in 2001. This is expected to cause inflation to pick up, but only to 1% in 2000 and to 1.6% in 2001.

The solid growth also acts to support the investment property market with current net initial yields on prime location office space at around 5.5%.

Rental levels and initial yields – Stockholm office space



Sources: Sadolin & Albæk/NewSec

The rather significant rate increases in central Stockholm have caused more and more companies to opt against leasing the most prestigious locations. Therefore, we would expect growth in Stockholm's rental levels to slow down somewhat even with the continuing prospects of favourable economic developments.

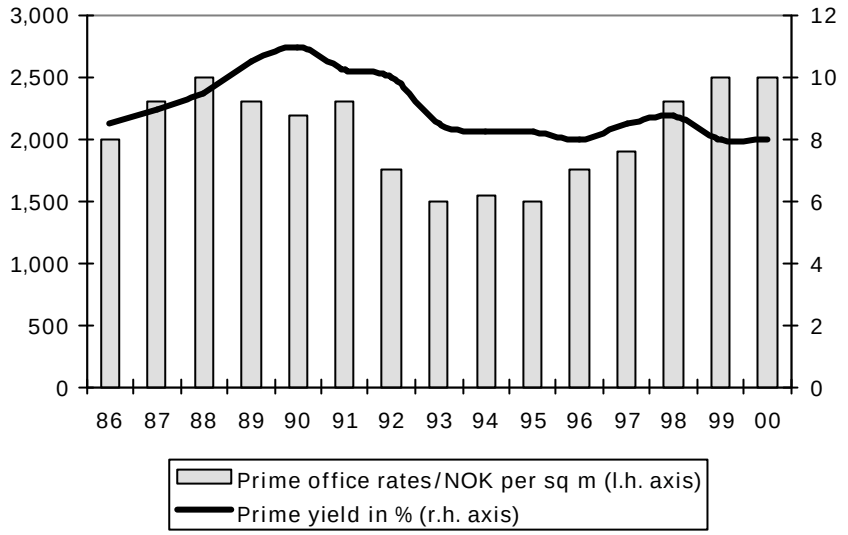
Oslo

Supply of new office space expected to exceed tenancy demand

Oslo's property market has also seen favourable developments during the last five years. Prime rental levels are now at about NOK 2,500 per sq m. In nominal terms, this is very close to the peak level recorded during the 1988 boom cycle.

Although tenancy demand has retained a fair momentum, building activity has also accelerated and several estimates now suggest that construction activity is a good deal higher than what tenancy demand is able to absorb. This makes us expect an increase in the office vacancy rate from the current level of about 4%.

Rental levels and initial yields – Oslo office space



Sources: Sadolin & Albæk/DnB Næringsmegling

As already mentioned, the Norwegian investment property market is very much driven by interest rates.

There is a general feeling in the market that, even in terms of initial yield, ie with no considerations for future rent or price increases, property investments should carry a risk premium to the safe measure of long-term bond yields.

The general view is that Norwegian interest rates will not fall in the foreseeable future even though the current level is quite high by European standards.

This combination of some uncertainty in the letting market caused by a potential oversupply of new office space to let and an upward trend in interest rates does not indicate any signi-ficant improvements in the Norwegian market for investment property within the near future. This may be one of the reasons why major, financially strong Norwegian property investors have begun to take a greater interest in other markets, including Denmark.

On the other hand, no other mature investment property market in Europe is able to match the Norwegian market in terms of direct yield. This may be a good reason for investors focusing strongly on cash flows to take a look at the Oslo property market.

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