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**NEWSLETTER****Commercial property in Denmark and abroad.****Contents**

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## The commercial property investment market

### Investment property still in good demand

Institutional investors, property companies and private investors combined to generate relatively strong demand for investment property in Greater Copenhagen in 2000. Foreign investor demand also rose.

The healthy demand was fuelled by several factors: investors are confident that the stability of the rental market and the relatively strong demand for space will continue. Vacancy rates are low and the level of speculative office developments remains weak.

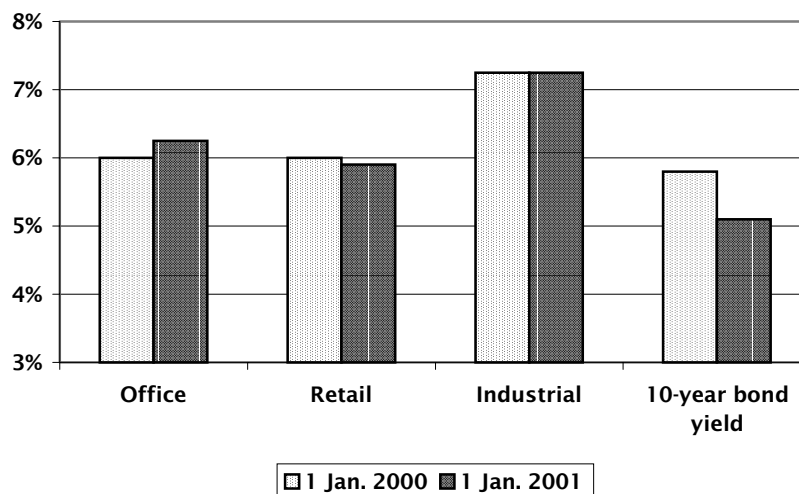
In addition, the equity markets experienced a good deal of turbulence during the final months of 2000, making institutional investors turn to real property for the, on balance, more stable return that this segment offers relative to equities.

At the same time, the falling level of interest rates not only makes the direct yield on a property investment an attractive alternative to bond investments, it also reduces the property investment funding costs.

### Net initial yields extremely stable

However, this strong demand does not mean that investors have lowered their net initial yield targets for property investments.

### Prime yields and 10-year bond yields, 2000-2001



Source: Sadolin & Albæk • ONCOR International

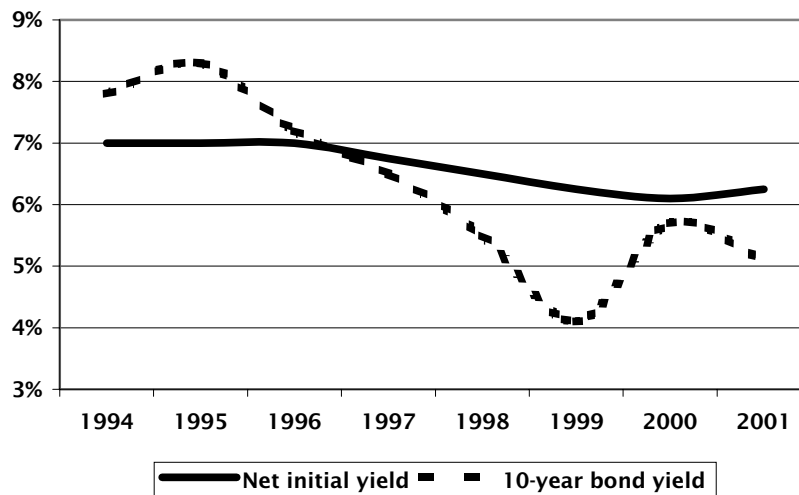
As shown in the figure above, prime yield targets are extremely stable in spite of the fall in bond yields (as indicated by the 10-year benchmark government bond yield).

In fact, target yields in the market for new, prime office developments, a segment dominated by institutional investors, have risen slightly, from about 6% to 6.25%.

**Yield gap widened to 100 bp**

Due to the fall in the level of interest rates, office property now provides a first-year direct yield of more than 100 bp above the 10-year bond yield.

**Net initial yields on office property vs. benchmark government bond yield**



Source: Sadolin & Albæk • ONCOR International

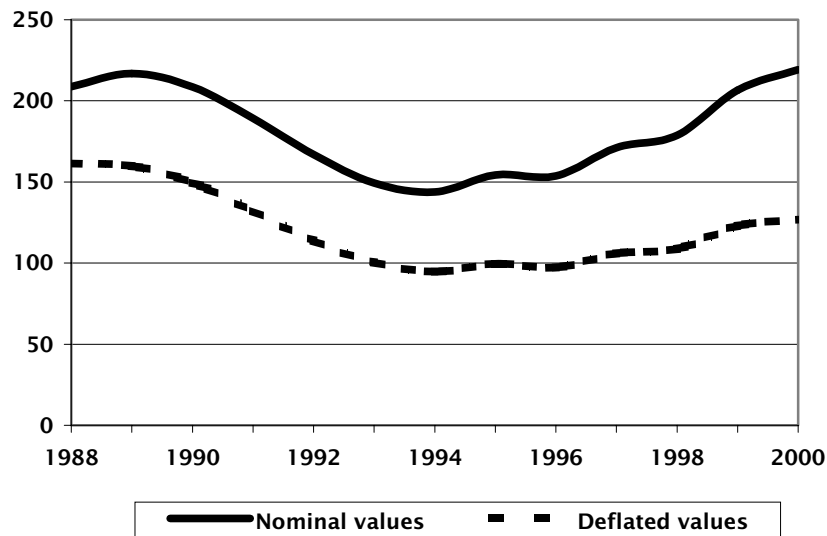
**6.1% increase in commercial property price index**

The Sadolin & Albæk property price index confirms the modest growth in commercial property prices in the Greater Copenhagen area in 2000, with average commercial property prices increasing by 6.1% during the year.

In other words, commercial property prices have finally, after 12 years, regained their record peak values of 1989. However, when adjusted for inflation during the period, real prices are still about 20% below the 1989-level.

Since the market bottomed out in 1994, commercial properties have experienced an average nominal value increase of more than 50%, and a real value increase of approximately 35%.

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



Source: Sadolin & Albæk • ONCOR International

**Is there a future for listed property companies?**

To small institutionals and private investors, becoming shareholders in listed property companies has been a means of gaining exposure to the property market while ensuring good risk diversification. Unfortunately, very few property companies of any importance are listed on the Copenhagen Stock Exchange.

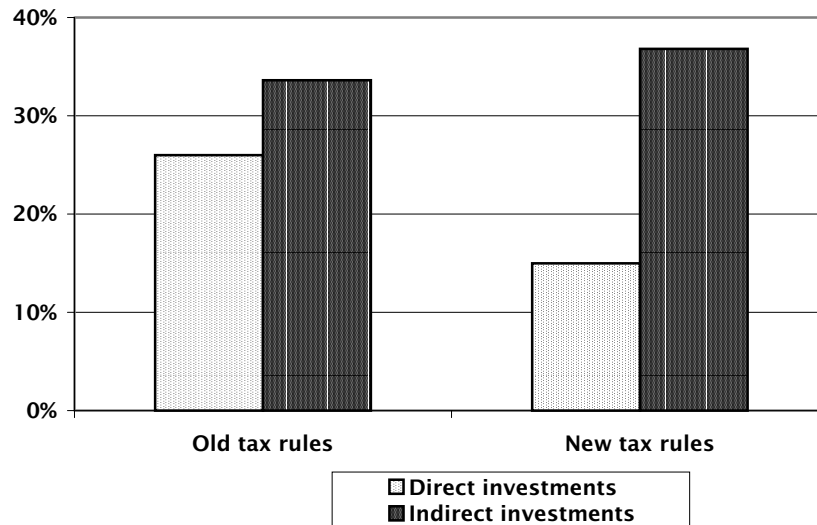
There have been several attempts to create a large, dominant player with a well-defined investment profile and a property portfolio large enough to attract international investor attention.

However, the December 2000 revision of the tax rules applying to pension funds and life insurers will most likely foil any new attempt to create a large, listed property company with liquid shares.

The new rules lowered the tax rate for direct property investments for institutional investors from 26% to 15%, but raised the rate of capital gains tax on equities from 5% to 15%.

Given the corporate tax rate of 32%, pension funds and insurers investing in property companies, which also have non-institutional investors, are now unable to generate a return matching a return on a direct investment.

**Effective tax rate on institutionals' property investments**



Source: Sadolin & Albæk • ONCOR International

**Legal corporation structures with tax transparency will most likely become popular**

As appears from the figure above, the effective extra tax rate applying to direct investments in limited companies has increased from 7.6 to 21.8 percentage points. These tax rules give us reason to believe that institutional investors will either invest directly in property or through other corporate bodies that offer tax transparency.

We are somewhat puzzled, however, by the lack of a political debate on the consequences of these new rules, when they were included in the bill between the second and the third hearing in the Folketing.

On the other hand, it would be fair to say that the changes will also have a favourable effect on the property market.

On balance, the lower tax rate will make it more attractive for pension funds and life insurers to invest in property.

**“Lock-up effect” becoming less important**

The rule making institutional investors' pre-1986 property investments tax-free still applies. Introduced as a transitional measure, this rule is now the cause of a “lock-up effect” that has all but eliminated any motivation among institutionals to sell their “old” property, even when doing so would seem reasonable on the basis of ordinary market considerations.

Even if an “old” property only generated a slight return, it would often be extremely difficult to reinvest the funds at the same net rate of return, because the return would be taxable.

By lowering the tax rate from 26% to 15%, the legislators have reduced this inexpedient “lock-up” effect, which has motivated irrational investor behaviour.

Consequently, pension funds and life insurers may now begin to consider whether the property they acquired several years ago is still appropriate for their current portfolio strategy.

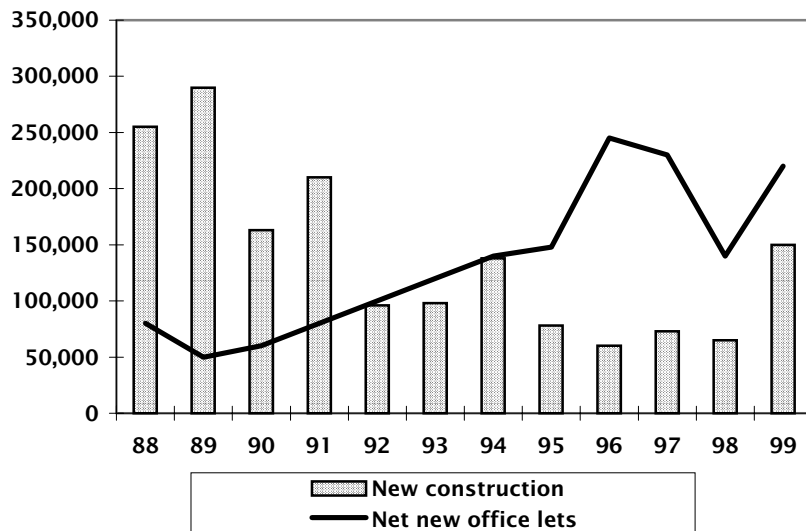
### Office property in Greater Copenhagen

#### Surge in new office developments

During the boom cycle of the late 1980s, the volume of new office developments amounted to between 250,000 and 300,000 sqm per year or substantially more than the annual net absorption of about 100,000 sqm.

In the following boom cycle, which began in 1995-96, the market had learnt its lesson. Even with the net absorption of offices rising to as much as 250,000 sqm in 1996, new developments were held at a modest level right until 1998, averaging only 75,000 sqm annually from 1995 to 1998.

#### New construction and net new office lets (sqm) in Greater Copenhagen



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

In 1999, new developments began to surge once again, reaching 150,000 sqm. On the other hand, new letting activity also recovered, exceeding 200,000 sqm in 1999 after having dropped

to about 140,000 sqm in 1998. This would indicate that up until 2000, the volume of new developments was less than the net absorption of office space. However, the volume of new developments was high in 2000 as well, and there are no indications of a decline in office construction activity in the Greater Copenhagen area in 2001; in fact, we expect the level of activity to remain strong going into 2002, whereas we anticipate a slight slowdown in 2003.

**Economic downturn need not imply a drop in new developments**

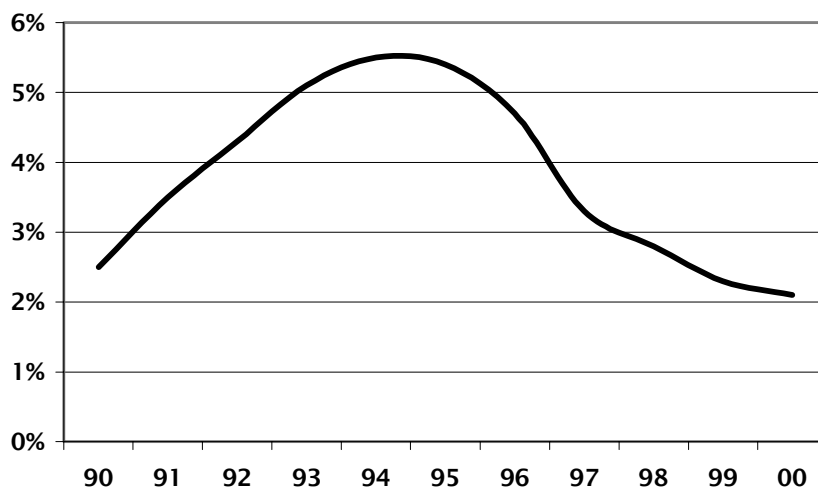
Expectations of a continued high level of new building activity are not based on anticipations of continued high economic growth. Although the Danish economy is stable and in good shape, the expected decline in US economic growth rates coupled with European currencies appreciating against the US dollar will almost certainly depress growth rates.

On the other hand, building activity will be driven by structural changes rather than the business cycle. Restructuring, mergers and new organisational structures often make it feasible to move to new, modern and flexible office premises. At the same time, the intensifying competition for highly skilled staff is making companies focus increasingly on factors such as comfort, quality and infrastructure.

**Rising vacancy rates in fringe areas and in unrefurbished property**

Office vacancy rates have been at about 2% during the past year. In the Copenhagen CBD and in new property developed over the last ten years, the rate has been as low as 1%.

**Greater Copenhagen office vacancy rates**



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

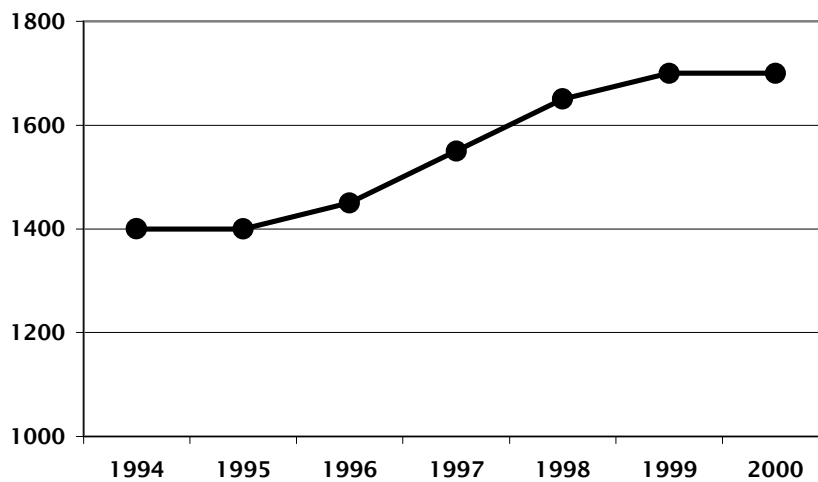
Undoubtedly, the cyclical downturn and the continued demand for modern and flexible office premises offering a high level of comfort will almost certainly lead to increased vacancy in the existing office stock.

In particular, this will impact the less sought after and somewhat peripheral office locations and other property where the layout and technical standards fail to meet today's requirements for flexibility and comfort.

**Prime rents stable**

New developments often command rents of DKK 1,500-1,600 per sqm net of taxes and operating expenses.

**Prime office rents in Copenhagen (annually in DKK per sqm)**



Source: Sadolin & Albæk • ONCOR International

However, the market is apparently unable to break through the "magic" barrier of DKK 1,700 per sqm as it did during the previous boom cycle.

Nor do we expect to see new head office developments leased at rents above that level, excluding taxes and operating expenses. On the other hand, we would not rule out that new office property with more up-to-date facilities than conventional head office space could attract higher rents.

This could well be the case in new office developments that provide a high-quality product adapted to small and medium-sized businesses' needs for flexibility, efficient space utilisation and comfort. Terms shorter than the standard 10-year lease, air conditioning, high transmission capacity cabling, joint reception and café facilities, shared meeting and conference rooms and similar facilities are factors that would justify higher rents.

## The residential property market

### Housing shortage in Copenhagen rising strongly

Many new jobs have been created in the wake of the positive developments in the business sector in Copenhagen and the capital region, especially in the IT, telecommunications, pharmaceutical and biotech industries. Coupled with a larger uptake by institutions of higher education, this is a key factor in the substantial net migration to Copenhagen. The continued fall in the size of the average household has also fuelled demand.

Due to the strong demand for housing and the very small volume of new developments over the last few years, the housing shortage in central Copenhagen has now taken on extreme proportions.

As a result, prices of small, prime-location freehold flats have doubled over the last four or five years.

### Greater imbalance between rented and owner-occupied property

The current system imposing a maximum rent increase on older rental property prevents the few fortunate enough to be tenants in older property from having to pay more than DKK 300-350 per sqm per year in rent. Typically, the landlord faces expenses of DKK 200-250 per sqm for taxes, exterior maintenance and the like, leaving only the tenant's net costs of DKK 100-150 per sqm to provide a return on the capital invested.

The great number of people unable to rent flats are left having to pay as much as DKK 15,000 per sqm for corresponding freehold flats.

Assuming a rate of interest of 6%, this implies interest expenses of DKK 900 per sqm before tax and DKK 600 after tax on top of mortgage repayments.

Accordingly, the existing rent regulations that apply to older rental property in combination with the current housing shortage create an increasing imbalance between owner-occupied property and the rental market. Surely, the time has come for true deregulation of the legislation imposing maximum rent increases on older residential rental property.

### How to boost residential developments in Copenhagen?

Gradually, political circles have come to recognise that new initiatives are needed to create a sufficient supply of housing stock in the Greater Copenhagen area.

In its upcoming zoning plan, the City of Copenhagen is expected to designate a number of quite large and attractive areas for housing development: in Nordhavnen, Sydhavnen and Østamager, which are located north, south and south-east of

the city centre, respectively. However, this initiative will hardly in itself be enough to lift the volume of new housing developments for middle-income groups to a level that will secure the city of a sufficient and varied future supply of housing stock.

On balance, the tax cut on pension fund property investments will, as explained above, have a certain positive influence.

An institutional investor acquiring a new residential development at a net initial yield of 5.0% would have a first year return of 3.7% after tax under the old rules and 4.25% after tax under the new rules.

However, we do not believe that this factor will in itself be enough to boost the volume of new residential developments significantly.

**Necessary to lower taxes on residential property**

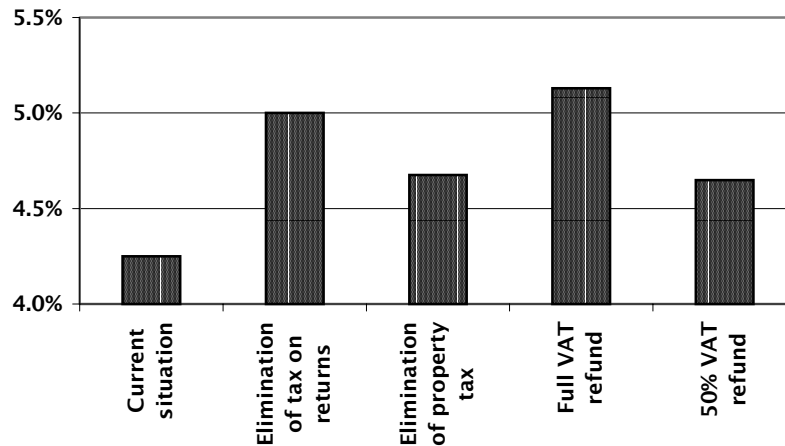
Unless there is political will to alleviate the housing shortage by accelerating subsidised housing, politicians will have to reduce taxes on residential property, either by lowering the tax on residential housing returns, eliminate the land tax or lower the VAT rate on new developments.

We have analysed the potential impact that different ways of lowering housing taxes would have on net initial yields on new residential developments. We based our calculations on a land price of DKK 2,000 per sqm, a construction price including VAT of DKK 12,000 per sqm, rent of DKK 950 per sqm and operating expenses of DKK 250 per sqm, of which the land tax is estimated at DKK 70 per sqm.

The figure below illustrates the impact on the net initial yield after tax for an institutional investor given the current rate of taxation and the following factors:

- elimination of the tax on property returns;
- elimination of the land tax;
- a full refund of VAT on construction costs; and
- a 50% refund of VAT on construction costs.

**Institutional investors' net initial yields after tax on new residential rental property**



Source: Sadolin & Albæk • ONCOR International

A further reduction of the tax levied on institutional investors' return on property investments would not benefit other types of investors, such as private investors, property companies or foreign investors.

Indeed, it would increase the risk of providing institutional investors with a monopoly on rental property, and that would be undesirable given their common practise of offering rental opportunities to their own members before turning to the general public.

Eliminating the land tax for both new and existing property would certainly be a very popular move, but the general economic impact could hardly be justified.

**Reintroducing VAT refund scheme on residential developments makes sense**

In this debate, there is a tendency to forget that when VAT was originally introduced in Denmark, the rate applying to residential developments was in fact lower than the general rate due to a VAT refund scheme under which the builder received a fixed amount per sqm.

The scheme made good sense, because it gave a relatively larger reduction to less expensive housing and was therefore not a motivating factor for expensive developments.

The rule was abolished around 1973, when residential building activity had become unacceptably high from a general economic point of view.

Given the current situation, however, there is good reason to consider introducing a modern version of the VAT refund scheme for residential developments.

There is a risk that, if measures to that effect were not introduced, the favourable business and economic developments in the Copenhagen area would suffer because the city would not have a sufficiently varied housing stock to attract and retain a skilled work force.

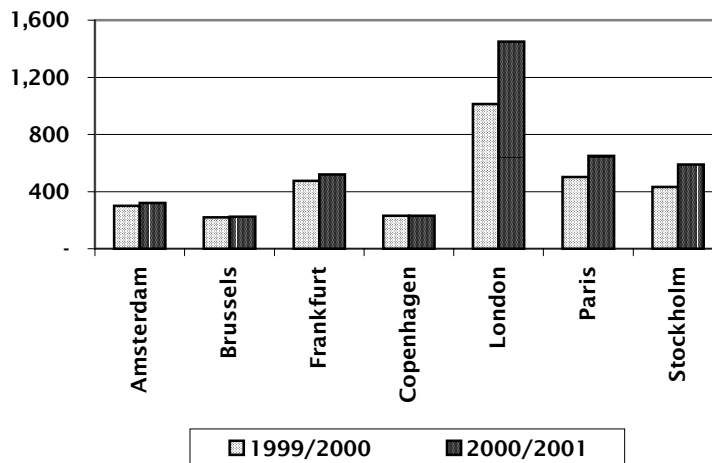
### International property markets

#### Office markets in Europe developing favourably

The office markets in Western Europe have generally seen favourable developments over the last 12 months. Prime rents are either stable or on a slight upward trend in most major cities, while they have surged by 30%-40% in London, Paris and Stockholm.

As can be seen from the figure below, market rents are at about the same levels in Amsterdam, Brussels and Copenhagen, and all three cities also experience much greater rent stability.

Prime rents (annual EUR per sqm) – office markets



Source: Sadolin & Albæk • ONCOR International

Another characteristic of these markets is the relatively small gap between prime rents and the general level for secondary locations, unlike the rather volatile markets of London, Paris or Stockholm, where secondary rents are often less than half of the prime rent levels.

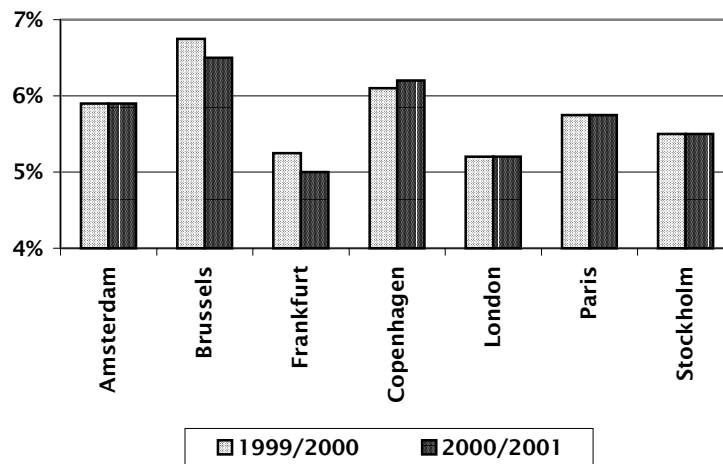
There is hardly any logic or unequivocal explanation as to why CBD rents in some markets can be twice as high as non-CBD rents, while in other markets, companies only accept paying a 25%-50% premium for prime location sites. Clearly, some markets have their “Golden Triangle” with locations that are so attractive to some businesses that they are willing to pay a very high rent instead of relocating to alternative, non-CBD premises.

Statistics from the last ten years show the cyclical nature of rent levels in these “Golden Triangles” and that they are much more volatile than prime rents in cities such as Amsterdam, Brussels or Copenhagen.

**Stable prime yield targets on European property**

The stable prime yield targets indicate investor confidence in continued favourable rental markets in Europe, although a few markets are experiencing a slight downward trend.

**Prime yields on office space**



Source: Sadolin & Albæk • ONCOR International

In terms of yields, Amsterdam, Brussels and Copenhagen are also at comparable levels, ranging from just under 6% to about 6.5%.

Yield targets on investment property are much lower in Frankfurt and London, due to expectations of a continued upward trend in rent levels.

**Very stable rents for industrial property**

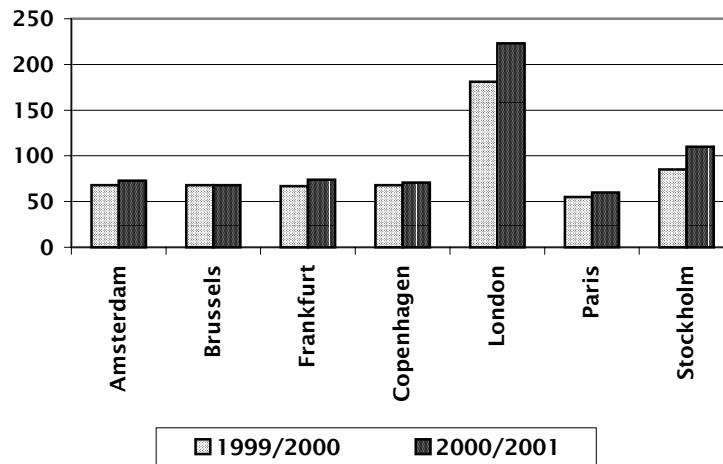
The rental market for industrial, warehousing and distribution facilities has been quite attractive with declining vacancy rates on the back of recent years' generally favourable developments in the European economies and in employment.

For most markets in this segment, rents are quite stable with many markets having very similar levels of about EUR 65-75 per sqm per year.

Exceptions to this trend are London and Stockholm, as both cities have seen substantial rent increases from higher levels over the last 12 months.

In particular, prime warehousing and distribution space in the London area is priced several times higher than the levels seen in all other markets in Western Europe. For example, current rents for warehousing facilities in London are on a level with the prevailing office rents in Amsterdam, Brussels and Copenhagen.

**Prime rents (annual EUR per sqm) – warehousing and industrial facilities**

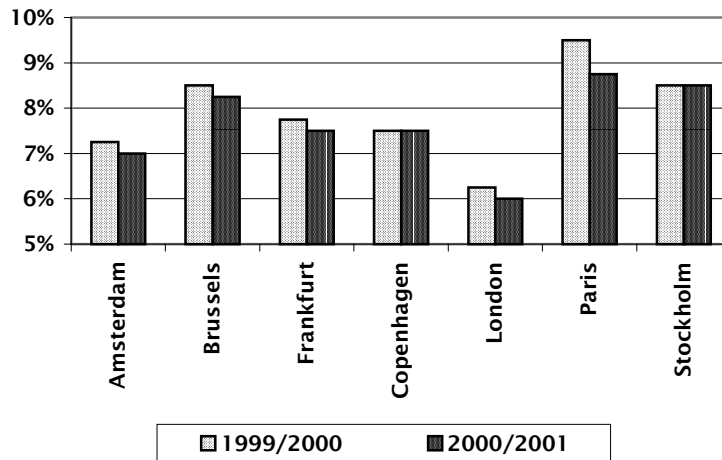


Source: Sadolin & Albæk • ONCOR International

**Falling net initial yield targets for industrial and warehousing facilities**

Institutional investors have increasingly demanded modern warehousing and distribution facilities in recent years. In addition, a number of specialist property companies and property funds have been set up for the sole purpose of investing in this segment.

### Prime yields on industrial and warehousing facilities



Source: Sadolin & Albæk•ONCOR International

This trend is driven by the attractive combination of a relatively strong rental market for warehousing and distribution facilities and the fairly low level of interest rates. Moreover, unlike property for specific production purposes, modern warehousing and distribution facilities have become a rather standardised products, for which finding a new tenant does not generally involve major conversion expenses.

Accordingly, investors looking for a stable current yield well above the bond yield see attractive opportunities in this segment. Furthermore, specialist property funds are being established with good-sized portfolios ensuring their investors of an attractive risk diversification.

On the other hand, the growing demand for such investment property has depressed the net initial yields in several major European markets.

Still, in most markets, warehousing and distribution facilities still offer investment opportunities at net initial yields of 200 bp or more above the 10-year bond yield. Inclusive of the ongoing rent indexation, the overall return on such property would still seem quite attractive.

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