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

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## The Greater Copenhagen commercial property rental market

### Crisis in CBD office property market?

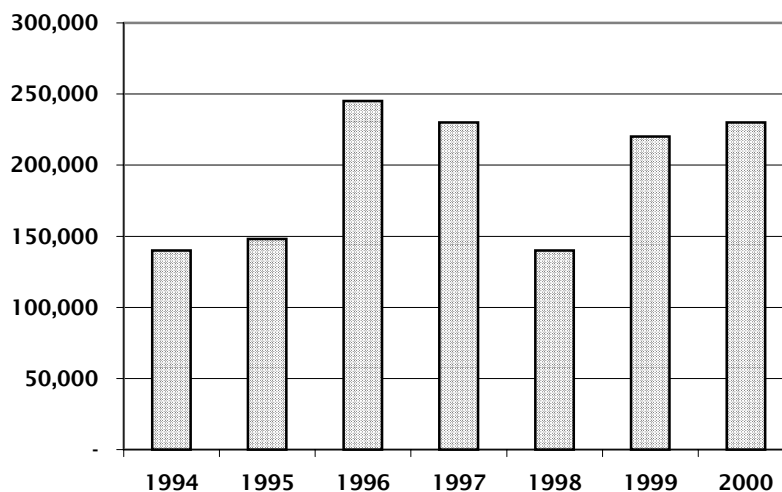
Lately, the question of whether the Copenhagen CBD office property market is headed for recession has been widely debated.

The matter is generally triggered by concern that with the many new projects contracted in recent years, especially on the city's waterfront from the Tuborg site and Kalkbrænderihavnen in the north end to Sydhavnen in the south, a number of older properties in CBD locations will be vacated by users relocating to the new sites. Another factor has been recent months' turbulence in the IT industry.

### Market expected to absorb vacated CBD premises

Tenants relocating from the CBD, most of them to new waterfront headquarters, will vacate about 130,000 sqm, or some 4.7% of the CBD office space. Arrangements have already been made for some 40,000 sqm of this space, whereas the remaining 90,000 sqm will gradually be vacated from 2001 to 2003. Considering the annual new letting activity of from 140,000 sqm to 250,000 sqm during the past seven years, it seems realistic to assume that the market will absorb the vacated premises reasonably fast.

### Net new office lets in Greater Copenhagen



Source: Sadolin & Albæk

### Shortage of parking space makes it difficult to let CBD property

One reason why businesses are relocating from the CBD is the shortage of parking facilities. Almost 70% of the space being vacated is located in CBD property without designated parking spaces. The introduction of additional traffic and parking restrictions in the CBD will have a negative effect on the CBD's

ability to attract the type of office businesses that are necessary not only to create a dynamic city centre environment, but also to help secure a customer base for the city's hotels, restaurants and other service industries.

**Residential conversion only a good solution in exceptional cases**

Undoubtedly, the City of Copenhagen would prefer to have the vacant CBD office locations converted for residential purposes. However, this would not be technically or financially feasible for most of the properties due to be vacated over the next 6 to 18 months. For many of the properties originally built for office purposes, it would be quite difficult to convert them to residential units, considering the regulations for the number of staircases, fire safety and similar requirements, all of which make conversion to residential purposes far too costly.

Moreover, as many of the properties involved have been renovated in recent years, many of them are most likely burdened by substantial latent VAT adjustment liabilities, which would fall due for cash payment if the properties were converted into residential units.

**Crises in IT and telecoms industries affecting office property market**

Accounting for more than 30% of committed contracts for new office space, expanding companies in the IT and telecommunications industries have been major drivers of recent years' strong market performance.

However, the situation has changed. Many dotcoms have experienced considerable turbulence, and some of them have collapsed. Most leading global IT companies have seen a downturn in both hardware and software sales, and their earnings capacity has weakened substantially. Following recent years' very aggressive expansion, the telecommunications sector is also seeing a slowdown in growth rates and a resulting need for restructuring.

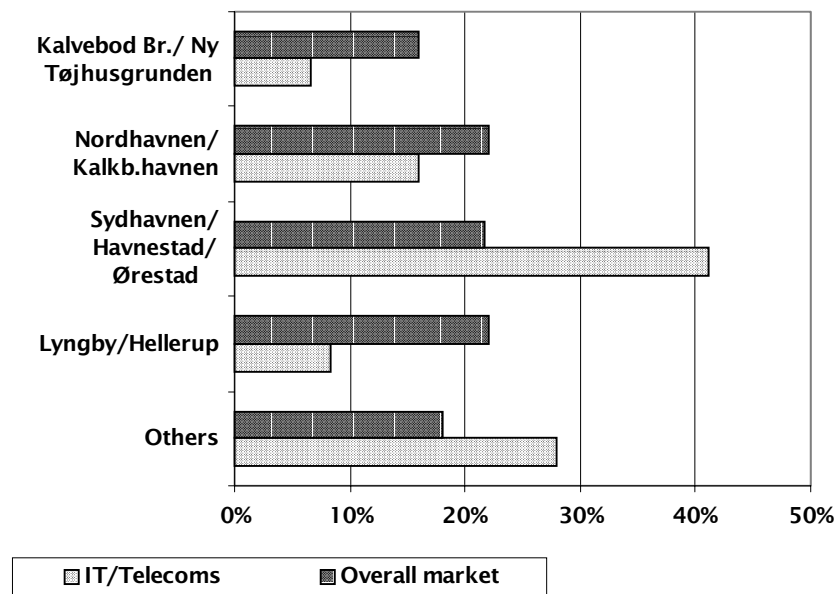
As a result, IT and telecoms companies have either initiated layoffs or they are not hiring new staff at the same rates as seen previously. This has an immediate impact on the office property market, translating into weaker demand for space, fewer new leases being signed and existing leases being terminated. Furthermore, these businesses, and the dotcoms in particular, are now beginning to realise that they do not need all the space they leased during the boom of 1999-2000. Instead, they are now trying to sub-let or assign such leases in order to limit their financial losses.

**North-of-CBD areas the least affected by IT crisis**

The chart overleaf shows the distribution of new developments for office pre-lets in general and of new office space pre-let to IT and telecommunications companies, covering new developments contracted from mid-1999 to May 2001.

As can be seen from the chart, new developments for IT and telecom companies are not the dominant factor in the areas north of the CBD, i.e. Nordhavnen, Kalkbrænderihavnen, Tuborg Havn and the other areas in the Lyngby/Hellerup corridor. The same applies to the development sites at the southern end of the CBD, Kalvebod Brygge and Ny Tøjhusgrunden. These are all areas with a large contingent of users in the professions, trade and professional organisations as well as trade and service.

**New office developments, by location**



Source: Sadolin & Albæk • ONCOR International

The analysis reveals that during the period from 1999 to 2001, IT and telecoms companies preferred to locate in the Sydhavn/Havnestad area, the “Others” category and the areas west and north-west of Copenhagen. Accordingly, the strongest impact of the slowdown in new investment in these sectors will presumably be felt in the office markets of these local areas.

**The crises in the IT and telecoms sectors are a temporary phenomenon**

The fall-out among the pure dotcoms was hardly unexpected. During a short period of time, venture capitalists provided substantial amounts for the expansion of Internet companies whose business concepts and earnings bases could be said to be extremely shaky.

We believe that, in retrospect, the crises in the IT and the telecoms sectors will prove to be a temporary phenomenon. Ac-

According to leading international analysts, demand for information technology and telecommunication services, and especially for data transmission capacity, will recover from the growth pause and experience renewed exponential growth.

Combined with the structural developments in the Øresund region and the added demand for sites conveniently located to attract labour from both the Danish and the Swedish parts of the region, this gives us reason to expect recovery and renewed expansion in the Sydhavnen and Havnestaden office markets.

**More new office developments scheduled for Ørestad**

Central Ørestad failed to catch the IT and dotcom wave. The companies that will be relocating to Ørestad are based in other sectors: members of the professions, the financial sector and the trading and service sectors are currently showing a healthy interest in relocating to Ørestad. The efforts to develop Ørestad as a business district are set to gain further momentum because the new zoning plan is designating large parts of the Sydhavnen area for residential developments.

**Biotech industry attracted to the Øresund region**

Substantial efforts have been made in the Øresund region in recent years to specifically attract biotechnology companies and their R&D activities.

The region's international competitive strength within this sector was further emphasised this spring, when *Biogen*, the well-run, high-profile US biotech player, announced that it would be building a substantial production facility in Hillerød, a town 40 kilometres north of Copenhagen that is fast becoming a leading location for biotech production both in the region and in northern Europe.

Biogen chose Hillerød after doing thorough research on the quality of the available workforce and other key factors. Sadolin & Albæk introduced Biogen to the Hillerød site and acted as adviser to the Municipality of Hillerød during the subsequent negotiations. There is no doubt that the municipality's very competent approach to the matter and the speed of the negotiations were strongly contributing factors to Biogen's decision.

Furthermore, Novo Nordisk has announced that it will expand its Hillerød facilities, and several other biotech companies, including Genmab and CMC Biotech, have also announced that they are planning on or considering building new facilities in the area.

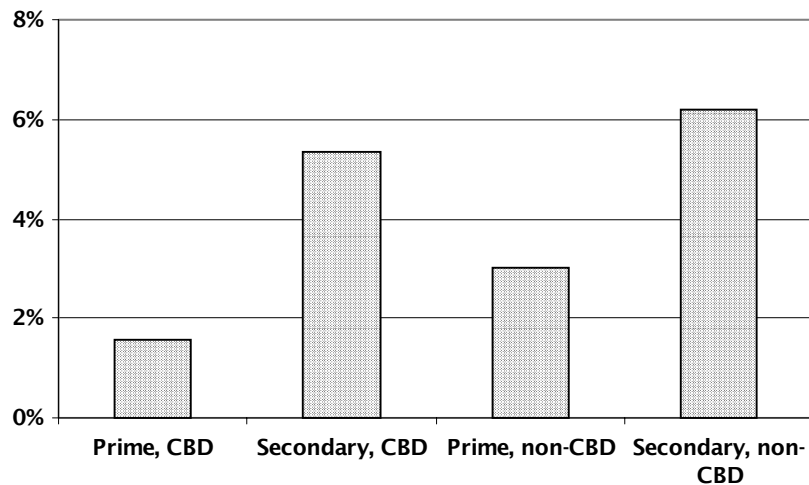
Although these decisions will initially benefit Hillerød, they will also have very substantial derivative effects on the entire Copenhagen area and the Øresund region. By international standards, biotechnology R&D and production represent a major

area of growth within knowledge-intensive industries, which are, on balance, less cyclical than other high-tech sectors. The Øresund fixed link has created a "Medicon Valley" encompassing Copenhagen and southern Sweden. Perhaps motorised traffic should not be the only factor used to pay for and calculate the benefits of the fixed link facility: the derivative effects such as the multi-billion kroner investments it helps to attract should be included as well.

**Non-CBD office rents have risen the most in recent years**

Greater Copenhagen office property has performed well in the last couple of years, as demand has reduced vacancy rates while lifting rents.

**Average annual increase in market rents for office premises, 1997-2000**



Source: Sadolin & Albæk • ONCOR International

As indicated by the chart above, secondary property recorded the strongest increase in average market rents for office premises from 1997 to 2000 at about 6% annually, which was more than double the average general increase in prices, whereas prime rents recorded a weaker rate of growth more in line with the rate of inflation.

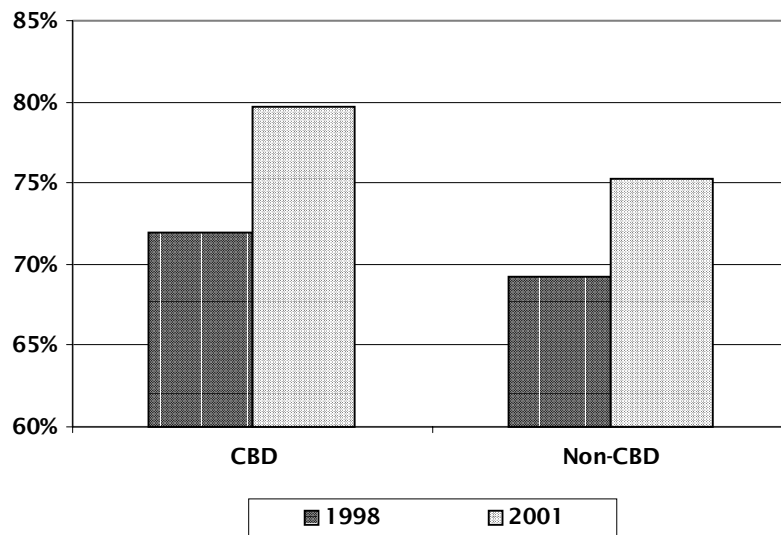
The relatively weak increase in prime office rents is the natural result of the large supply of construction opportunities in the Greater Copenhagen area. Accordingly, added demand for premises will be balanced by new developments, and to a large extent rents will reflect movements in construction prices. In addition, sharply rising secondary rents are a common phenomenon during times of favourable economic conditions. In a

weak market, vacancy rates in secondary property are high and property owners are prepared to accept relatively low rents, whereas in a strong market they are in a much stronger negotiating position vis-à-vis prospective tenants.

**Gap between prime and secondary rents has narrowed**

As can be seen from the chart below, the average market rent for secondary CBD property is now at almost 80% of the prime rent, as compared with about 72% three years ago. For non-CBD property, the current figure is about 75%, up from about 69% three years ago.

**Average market rents for secondary office premises as a percentage of market rents for prime office premises**



Source: Sadolin & Albæk • ONCOR International

However, we believe the gap between prime and secondary rents will widen once again in the years ahead: First of all, office businesses have begun to demand a much higher quality of premises. Secondly, the current gap has now narrowed so much that a large part of the discount available from selecting secondary property is now being offset by the much greater efficiency provided by modern property.

Finally, there are signs that the minor slowdown in economic growth could trigger a slight increase in secondary property vacancy rates.

**The investment property market**

**Is the investment property market past its peak?**

Investment property prices have increased constantly for the past five years. However, several factors are now pointing to a slightly weaker market trend.

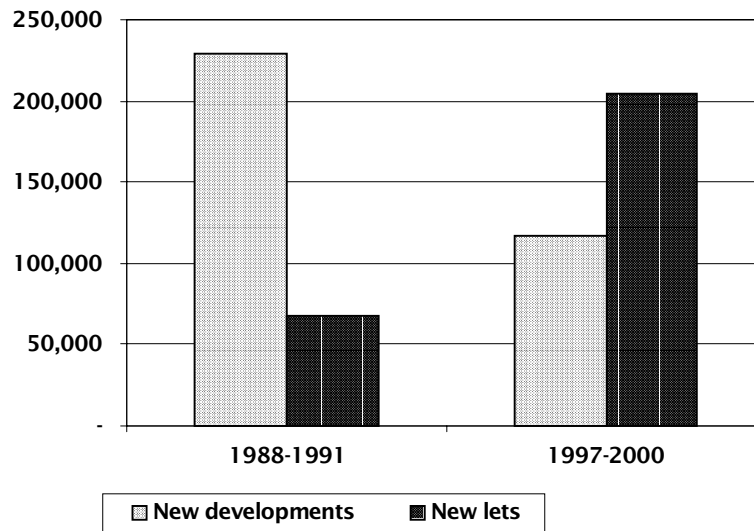
The Danish economy is growing at a slower pace with a relatively weak domestic market and stagnation in consumer spending. Economic trends in several large export markets, including the United States and Germany in particular, may also give rise to some concern.

To this should be added the above-mentioned international crises within the IT and telecommunications industries and, for the office property market, the surge in new developments in recent years.

**No similarities with the situation in 1989-1991**

A comparison of a few key figures indicates that the situation in the property market is in no way similar to that of the previous boom cycle prior to the 1991-1992 recession.

**Average new developments and net new office lets (sqm) per year**



Source: Sadolin & Albæk • ONCOR International

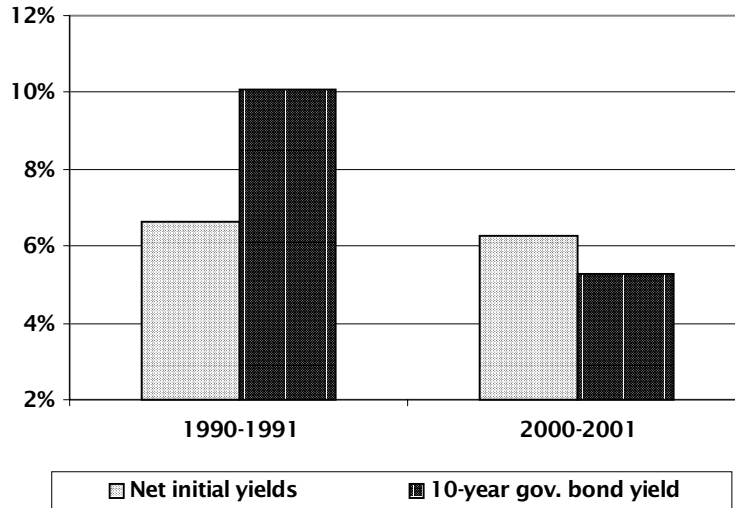
As can be seen from the chart above, average new developments during the four years from 1988 to 1991 totalled 230,000 sqm and average annual net new office lets were less than 70,000 sqm.

The situation was different during the four years from 1997 to

2000, with average new office developments of 117,000 sqm per year and average net absorption reaching nearly 200,000 sqm per year.

Moreover, investors' risk of incurring an excessive interest burden is far smaller today than it was around 1990.

**Prime yield and the 10-year benchmark bond yield**



Source: Sadolin & Albæk•ONCOR International

In 1990-1991, immediately before the recession, prime investment properties were sold at net initial yields of 6.50-6.75%. During this period, the bond yield stood at around 10% resulting in a negative yield gap of more than 300 bps.

In 2000-2001, the yield gap is positive as the net initial yield for prime property investments exceeds the bond yield by 100 bps.

Therefore, anyone believing that the investment property market is heading for a crisis which is in any way similar to that of the early 1990s would be misconstruing the current market signals. There appears to be no trend of a general decrease in investment property prices, and the current cash flow from property investments is highly competitive compared with bond market investments.

**Following a growth pause, the positive trend will continue Investment**

We believe that the investment property market is slightly unsettled and in the middle of consolidation at the moment. However, with the right timing, investments in such a jittery market may prove quite attractive in the long term.

Several leading institutional investors consider themselves to

**property in strong demand but in low supply**

be underweight in real property, and investors are therefore willing to make property investments.

However, as is the case with the international investors who monitor the Danish investment property market, Danish investors seem slightly frustrated by the short supply of realistically priced investment property.

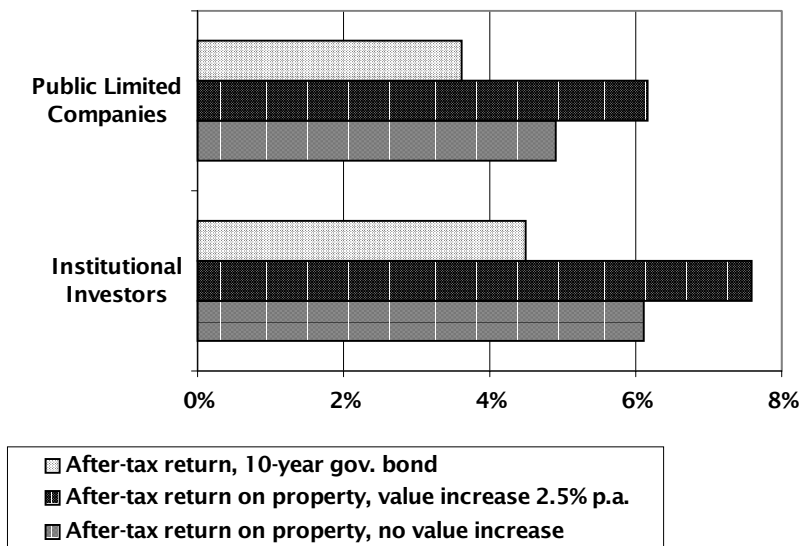
Companies considering sale and leaseback arrangements of an operational nature could take advantage of the situation to obtain quite favourable terms and conditions, especially if the company holds large property portfolio offering generally useful characteristics and locations.

**Property returns are highly competitive compared with bond market investments**

A cash flow analysis of a property investment over a 10-year horizon substantiates that the return on properties is quite attractive as compared with alternative bond market investments.

The chart below illustrates the yield to maturity after tax for a 10-year government bond and the implied rate of interest after tax of a non-depreciable investment property. It is assumed that the property is bought at a net initial yield of 6.5%, and the implied rate of interest is calculated on the assumption of a value increase corresponding to the rate of inflation (estimated at 2.5% per year) and on the assumption of no value increase.

**After-tax return on a 10-year horizon**



Source: Sadolin & Albæk • ONCOR International

For public limited companies in which both the bond return, operating profit from properties and capital gains on properties

are calculated using a 32% tax rate, the after-tax return on the property investment without a value increase is 1.3 percentage point higher than the return on the benchmark bond. Assuming value growth of 2.5% per year and a sale after 10 years, the after-tax return on the property investment is some 2.5 percentage points higher than the bond return.

For institutional investors paying 15% tax on bond and property returns, the property investment is even more attractive. Even without a value increase, the after-tax return on the property investment is more than 1.6 percentage point higher than the return on a bond investment, and assuming an annual 2.5% value increase, the after-tax return on the property will be some 3 percentage points higher than the bond investment return.

**Differences in the taxation of companies and institutional investors will affect investment patterns**

The current yield and capital gains on institutional investors' property investments are taxed more leniently than those realised by public limited companies. Conversely, institutional investors are not entitled to charge depreciation on properties for tax purposes.

Other things being equal, these tax differences will make institutional investors concentrate increasingly on office properties and residential properties.

Public limited property companies, on the other hand, will gain comparative advantages by investing in depreciable properties, including retail property, warehouse properties, industrial properties and properties used for hotel and teaching purposes.

**Deregulation appears to be on the cards for institutional investors' investments in new residential developments**

For some years, the aim of the official tax policy was to abolish or at least reduce such tax anomalies.

Therefore, one can only wonder why there is now political consensus to solve the unacceptable housing shortage, especially in the Copenhagen area, by granting additional tax favours to institutional investors, presumably in return for the local authorities getting the right to assign dwellings.

There is definitely good reason to increase the tax incentive for new residential developments. However, it is difficult to see any reasonable cause as to why privately-owned property companies, which are both willing to and capable of contributing to new rental property developments, should not be given the same tax advantages as institutional investors, provided they are willing to submit to the same terms and conditions in respect of giving the local authorities a right to assign dwellings.

**International property markets**

**United States –** The international report in this issue focuses on specific, major

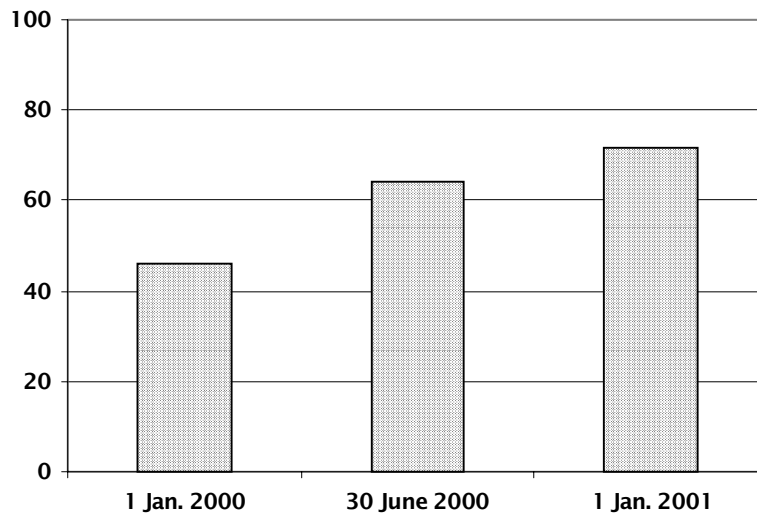
**growth pause or recession?** property markets in the United States. The US economy appears to be stagnating after many years of constant and very strong growth.

The crisis within the IT and telecommunication sectors was initially felt in the North American market, where recent years' growth has been largely driven by developments within these sectors.

The most noticeable concentration of companies and workplaces within the IT sector in the United States is found in Northern California around the Bay Area – San Francisco, Santa Clara, Palo Alto and Oakland. Above all, the property market in these areas has felt the consequences of the substantial expansion and subsequent crisis of the dotcoms.

**Large fluctuations in the office rental market in San Francisco** In 2000, particularly in the first half, the San Francisco property market was characterised by substantial excess demand for office premises and rapidly rising rents with the average office rent being asked rising by as much as 55%.

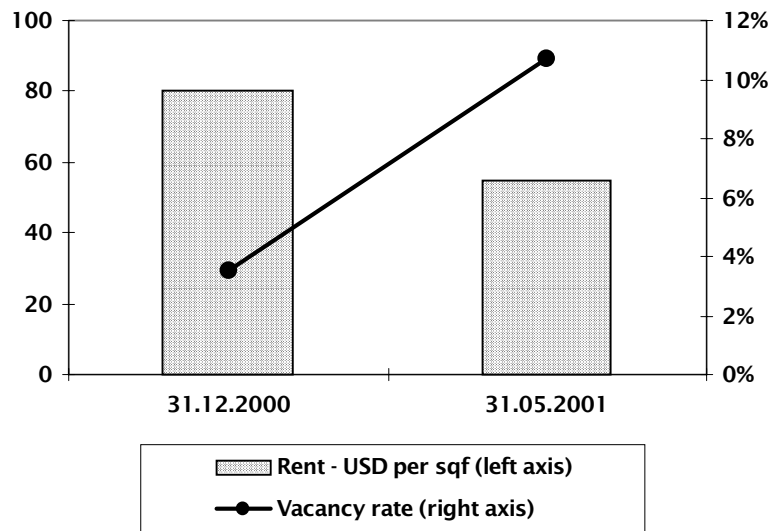
**Average office rent asked (USD per sqf) in San Francisco**



Source: TRI Commercial • ONCOR International

However, already in the autumn of 2000, the first signs of a crisis emerged, and during 2001 to date, the market has experienced a dramatic setback.

**Rent and vacancy rates for prime offices in San Francisco**



Source: TRI Commercial • ONCOR International

As it appears from the chart above, the market rent for prime office premises in San Francisco dropped by more than 30% in less than 6 months, and the vacancy rate surged from a little more than 3.5% to nearly 11%.

Other sub-markets in San Francisco are even worse off. The areas with the largest concentration of dotcoms have seen the market rent dropping by more than 50% within a short period, and the vacancy rate has increased to more than 25%.

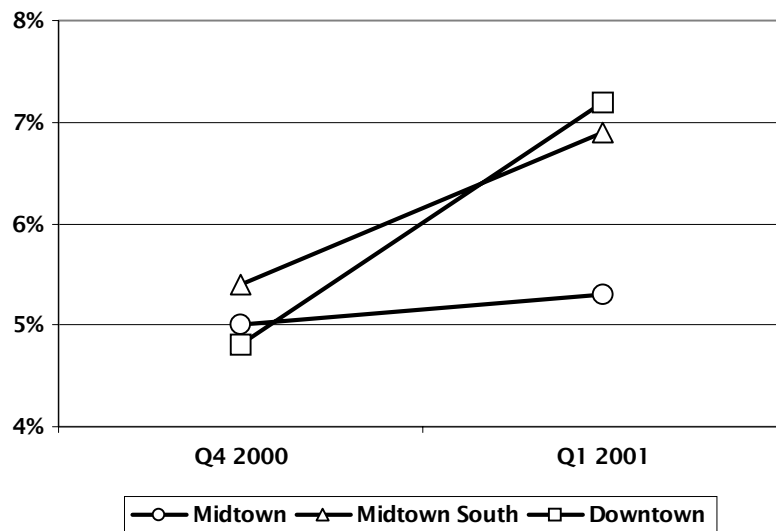
Not all markets in North America have seen such dramatic developments, however.

### Rising vacancy rates in New York

The office market in Manhattan comprises about 38 million sqm and is one of the most dynamic office markets in the world. Trends in this market during recent quarters show that the dot-com fall-out has also affected the property markets here, although on a less dramatic scale than in San Francisco.

For Manhattan as a whole, the vacancy rate rose from 5.0% in the fourth quarter of 2000 to 6.3% in the first quarter of 2001.

### Office market vacancy rates



Source: The Newmark Company • ONCOR International

As appears from the chart, the various office districts in Manhattan did not show the same trend.

The Midtown market, which was never favoured by technology companies, only showed a moderate increase in vacancy rates. The Midtown South and Downtown markets, on the other hand, accommodating far more technology companies, were hit harder by the IT crisis. In the Midtown South market alone, more than 100,000 sqm were offered for sub-letting within 3 months by Internet companies, advertising companies and other new media businesses. In the Downtown market, many new Internet companies also had to sub-let their offices to cut expenses and improve their cash flows.

#### Still high letting activity and stable rents

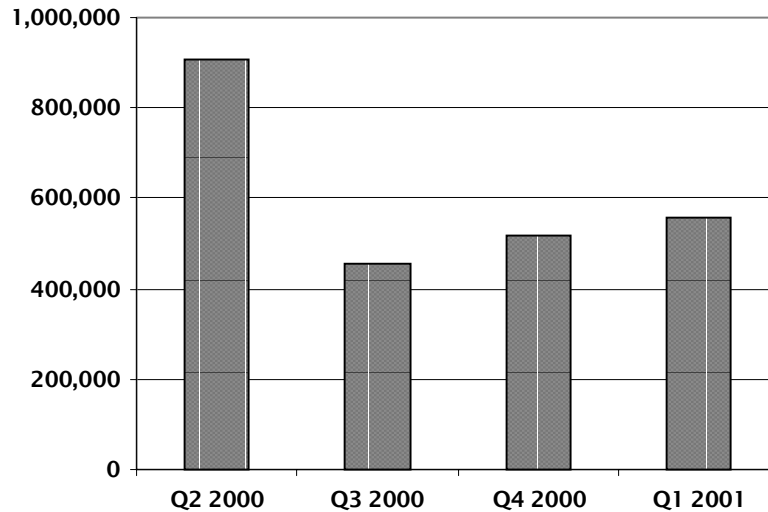
So far, rents have remained fairly stable, but there is an increasing tendency for tenants to negotiate incentives. The typical rent-free period has therefore been extended from 3 to 6 months, and the landlord's contribution to the tenant's own improvements has nearly doubled.

Although rents are likely to fall in the months ahead, the market does not in any way appear to be facing a crisis. New developments, at their lowest level for many years, are fully pre-let, and forecasts for developments in the number of workplaces remain fairly positive.

Moreover, the market turnover is still fairly high, and letting

activity has even increased in recent quarters.

**Office letting (sqm) in Manhattan**



Source: The Newmark Company • ONCOR International

The same trend is found in a number of other major North American markets, and apart from the fairly large amount of office space the dotcoms are trying to sub-let, all the talk of a US recession does not appear to have had a general impact on the property market.

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