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

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## The commercial property investment market

### Great uncertainty about the global economy

True to tradition, the property investment market was dull during the summer season. However, the low level of interest rates and the depressed stock markets provided strong grounds for expecting market activity to pick up considerably during the autumn and towards the end of the year.

The terrorist attacks in the USA revived the turmoil in the global financial markets. The stock markets reacted immediately, nose-diving on expectations of sharply deteriorating consumer confidence figures, especially in the USA, but in Europe as well.

Subsequently, the financial markets have stabilised, supported by the interest rate cuts resolutely announced by the western central banks, and by the downward trend in oil prices.

Owing to the downturn in the global stock markets, pension funds and life insurers in Denmark and elsewhere are now having difficulty meeting their solvency requirements.

The investment property market is always relatively slow to react compared with the financial markets. We believe that the response in the current situation is unlikely to be all negative.

### Economic slowdown triggering higher vacancy

At the time of writing, we are unable to determine the duration of the current economic slump. There is no doubt, however, that weakening economic growth will have a negative impact on the demand for commercial leases. Other things being equal, this will lead to rising vacancy rates and a risk of stagnant or falling rents.

### How will the institutionals react?

Institutional investors' reaction to the situation will be driven by two factors drawing in opposite directions:

Due to their long-term pension obligations, institutional investors will obviously not be motivated to sell property to improve their liquidity, no matter how their solvency ratios develop. However, property portfolios will gain greater portfolio weightings as shareholding assets dwindle, and that may cause some investors to become overweight in real property relative to their portfolio allocation targets, in turn making them want to reduce their exposure in the property market.

On the other hand, property generating a stable and regular return and leased to quality tenants will increasingly become an attractive investment alternative to extremely volatile stock markets, and to placements in the bond markets, which are characterised by a very low level of interest rates, especially

those at the short end of the market. That may motivate institutional investors to increase their weighting of real property in their overall investment assets.

We expect the healthy institutional demand for attractive investment property to continue in the Danish market, mainly because we believe that several of Denmark's most important institutional investors are still underweight in property relative to their portfolio targets, even after the drop in share prices.

At the same time, institutional investors will undoubtedly be very cautious when investing in property in the months ahead, and some investors will probably wait for a greater degree of stability in the global economy. That could marginally lift net initial yield targets.

**Lower inflation rate could influence net initial yield target**

A lower rate of inflation is another factor that could cause a marginal lift in net initial yield targets on property investments.

An economic slump, signs of rising unemployment and lower energy prices are all factors that could lead to a lower rate of inflation. Lower inflation means lower rent increases, as most commercial leases are linked to the net price index. This would, initially, have a negative effect on forecast rates of return and thereby increase first-year direct yield targets.

If a property is acquired at a net initial yield of 6.5%, and assuming an annual rate of inflation of 2.5% over a 10-year leasing period, the net present value of net rental income during the 10-year period, at a discount rate of 6.0% would equal about 53% of the capital employed.

However, if we change the inflation assumptions, budgeting for 1.5% inflation in the first two years and for 2.5% thereafter, the net initial yield target increases to 6.61% to offset the lower rent increases in the first two years.

As our estimates indicate, it is clearly relevant for a landlord, when negotiating a new lease, to include a regular minimum rent adjustment in addition to the ordinary adjustment based on the net price index.

**Still healthy demand from private investors**

The low level of interest rates will help to sustain the healthy and stable demand from private investors, a group that traditionally invests in property on a leveraged basis. We expect strong demand for the rest of the year from private investors for depreciable property, especially prime location retail property with a limited vacancy risk.

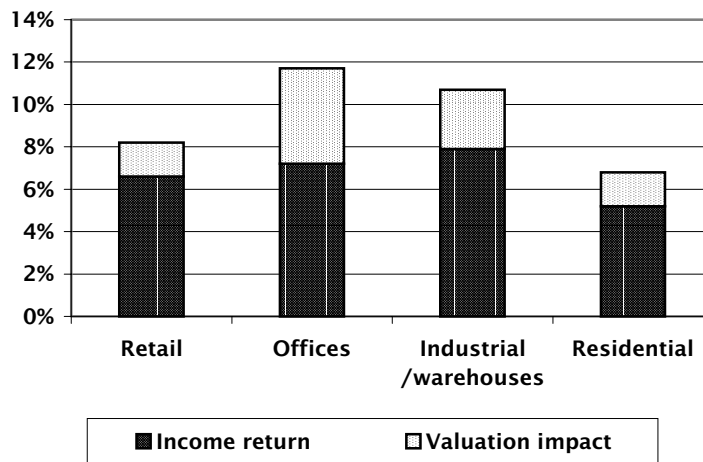
However, the risk for rising vacancy rates resulting from the economic slump will make investors focus more and more on a property's current vacancy situation and the short and long-term re-letting opportunities. In particular, property development projects for office and warehousing purposes are expected to be in weak demand in the coming period.

**New property market index**

In the past few years, Sadolin & Albæk have prepared an annual price index showing developments for commercial property in the Greater Copenhagen area. This index is now being complemented by an index of the total return on property investment prepared by the British company Investment Property Databank in cooperation with Ejendomsforeningen Danmark, a number of key institutional investors and a few private property investors.

This new DEI/IPD Danish property index reveals a total return of 10.0% on property investment in 2000 (defined as the income return plus value adjustment as a percentage of the capital employed). Calculated by sector, the return varies from 6.8% on residential property to 11.6% on offices.

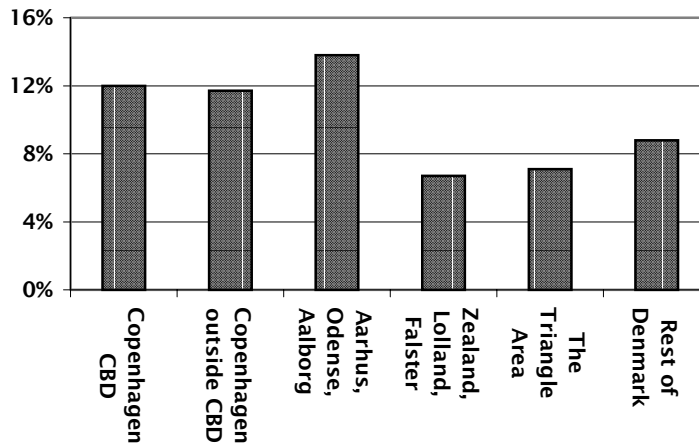
**Total return on property investments in 2000**



Source: DEI/IPD Danish property index

There are substantial geographical variations and the best performers were the most liquid office markets in the major cities.

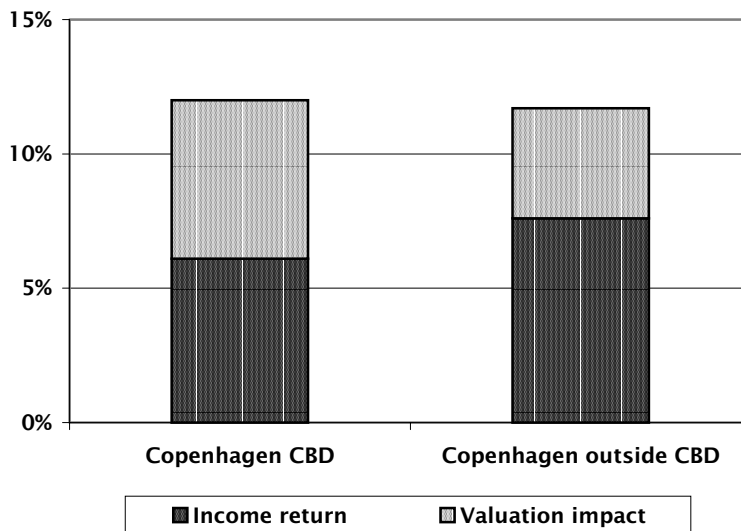
**Total return on office property in 2000**



Source: DEI/IPD Danish property index

The total return of about 12% on Copenhagen office property is distributed as shown in the figure below.

**Total return on office property in 2000**



Source: DEI/IPD Danish property index

The Sadolin & Albæk property price index for 2000, which was published in February 2001, revealed average capital growth in Greater Copenhagen office property of about 6%, which corresponds well with the new price index from Investment Property Databank.

**The DEI/IPD Danish property index underestimates price developments for residential property**

The 1.5% increase in residential property prices indicated by the DEI/IPD Danish property index seems rather low, considering the increase of about 10% in residential rental property, as indicated by the data recorded by Statistics Denmark for the first half of 2000. It therefore follows that even though Statistics Denmark's index for the second half of 2000 is yet to be published and this index is based on quantitative recordings of the prices of residential rental property traded, it would seem that the DEI/IPD Danish property index underestimates the price developments in residential property in 2000.

Obviously, any price index is a reflection of its underlying property portfolios. The new price index incorporates the portfolios of a number of key institutional investors, but only includes relatively few property portfolios held by private investors.

Institutional investors have portfolios of residential rental property consisting of relatively new, prime location property of excellent constructional quality. The overall market is much more varied and the institutionals that have provided data to the DEI/IPD Danish property index are most likely underweight in relatively old residential rental property based on cost-driven rent.

A reliable property price index should be closely correlated with three factors:

First of all, the number of data recordings used for the index is obviously very important. Secondly, the portfolios included should reflect the overall property investment market. Thirdly, it is absolutely essential that the start-of-year and end-of-year yield targets used reflect the terms and conditions applying to transactions in the market, as these targets form the basis for calculating value growth.

We wish the people behind the DEI/IPD Danish property index the best of luck in attracting a wider group of property owners to report transactions to the new index. For residentials, in particular, we believe it is essential to include more private investors and property companies with portfolios of relatively old residential rental property in the index.

## Proposal to make residential developments tax-exempt

### Government initiative seeks to encourage new residential developments

In our last Newsletter (June 2001), we touched on the considerations to enhance the financial incentives intended to promote residential developments, which are so absolutely necessary, especially in Greater Copenhagen.

In its draft budget, the Government proposes to temporarily lift, from 2002 to 2004, the existing 15% tax on institutional investors' capital return on investments of up to DKK 1 billion per year in residential developments.

To qualify for the tax favour, new residential projects must have a maximum cost of DKK 14,000 per square metre or DKK 1,450,000 per dwelling. Another requirement is that the local authorities get the right to assign 25% of the new dwellings.

In spite of its commendable intentions, the proposals will hardly be sufficient to relieve the housing shortage in Greater Copenhagen.

### This proposal will not relieve the housing shortage in Greater Copenhagen

When pension funds take part in residential developments, it is essential for them to be able to offer their members preferential letting rights to new, quality flats. As a result, they prefer high-quality developments to ordinary subsidised housing.

When tax exemption is accompanied by a cap on acquisition costs, the pension funds will be encouraged to build quality dwellings in areas where land prices are lower than in the metropolitan area.

Obviously, the 14,000 per sq.m. cap means that, other things being equal, residential developments built on the less expensive provincial plots will be of a higher quality than similar developments in Copenhagen.

In addition, the "risk" of the local authorities using their right to assign dwellings is not as high for quality dwellings in provincial cities, where there is already a reasonable supply of less expensive dwellings.

In our view, the proposal, if passed in its present form, will simply encourage the pension funds to build in areas where land prices are lower than in the metropolitan area.

As a result, it will hardly influence the housing supply in Greater Copenhagen.

**Government VAT income from residential developments clearly outweighs the economic impact of tax exemption**

Assuming an average net initial yield of 5.0%, the economic value of the tax exemption on an investment of DKK 1 billion annually would equal DKK 7.5 million per year. The net present value of the tax exemption over a 20-year period with an average inflation rate of 2.5% p.a. and a discounting rate of 6% would be approximately DKK 105 million.

Considering the fact that VAT on the construction price alone amounts to about DKK 150 million, the Government is showing very little determination to provide an economic incentive that would encourage new residential developments.

**Commercial conditions for residential developments are improving**

On the other hand, it has to be said that the market conditions for residential rental property have become quite attractive.

By itself, a slowdown in commercial developments, possibly as a result of the general economic slump, would impede growth in building prices relative to the rates recorded in recent years.

In addition, residential property offers a very high letting probability - a fact that increasingly attracts investors at times when vacancy statistics for commercial property begin to rise as a result of an economic slump.

Finally, the recent interest rate cuts will contribute towards making net initial yields on residential rental property more competitive relative to investments in the bond market. The effects of this improvement should not be underestimated.

We will have to wait and see over the next 12 months whether these improvements to the economic framework are enough to boost new residential developments.

**Major political initiative needed in the housing sector**

We maintain our view that the shortage of new residential developments in Greater Copenhagen could pose such a major obstacle to retaining a satisfactory supply of labour in the region that a major political initiative is necessary in the housing sector.

**The office letting market**

**Activity in office lets has weakened, but not by a great deal**

Fuelled by economic uncertainty, not least within the IT and telecommunications sectors, activity in the office letting market had weakened slightly even before the terrorist attacks in the USA.

Clearly, demand for office space diminishes when the risk of an actual recession increases.

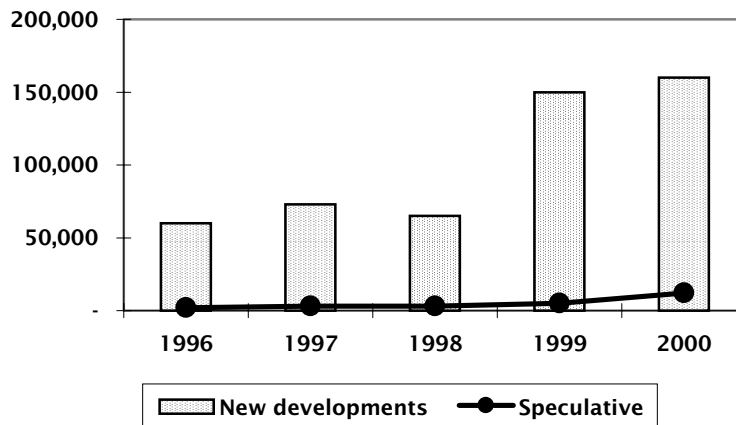
So far, however, the atrocities in the USA have only had a slight impact on the Danish market for office lets. We only have one example of ongoing considerations or negotiations for a new corporate headquarters being suspended or discontinued following the terrorist attacks.

**Softening rental market has not led to lower rents**

Office vacancy rates remain very low. Although the rate has risen to an estimated 2.3%, compared with 2.1% 12 months ago, and even though a number of companies are due to vacate relatively old CBD property within the next few months in favour of new domicile developments, we do not expect any dramatic increase in office vacancy rates over the next 12-24 months.

A main reason for this outlook is that even though the volume of new office developments has risen sharply in recent years, only very few of them were started without being pre-let. During the boom in the first half of the 1980s more than 50% of new office developments were begun without being pre-let. Each year since 1995, speculative developments have made up less than 5% of total developments.

**New office space (sqm) in Greater Copenhagen, 1996-2000**



Source: Sadolin & Albæk • ONCOR International

Rents have become stagnant due to the weaker conditions seen in the letting market during the past six months, but they have not fallen. Prime rents in Copenhagen are still stable at DKK 1,700 per square metre net of operating costs.

**Tenants in a better negotiating position**

On the other hand, tenants have gained a better position in lease negotiations.

Instead of a 10-year period of interminability, fully indexed rent and no discounts, tenants are now increasingly able to ne-

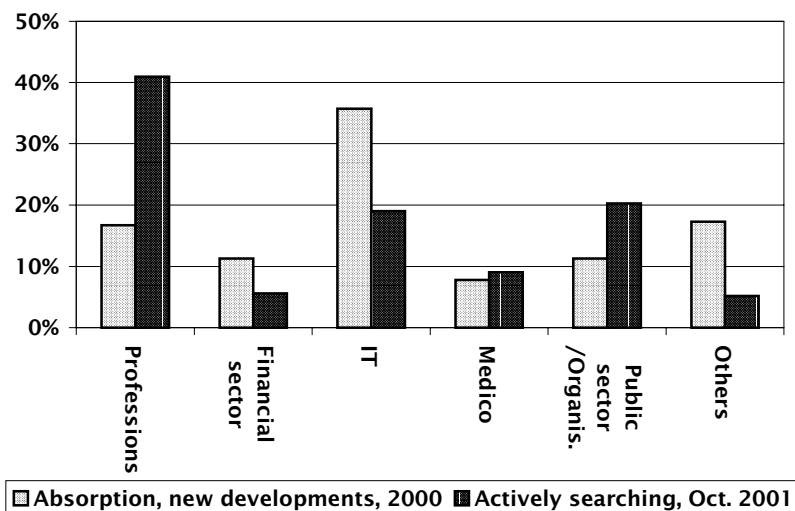
gotiate shorter minimum terms on leases in new developments and rental discounts have once again become more frequent.

Quite a number of prime location development projects have been approved by the local planning authorities, and they are fully planned and waiting for the 'go ahead', especially in the southern waterfront areas, such as the *Havnestaden*, *Sydhavnen* and *Ørestad*. Therefore, we would not rule out that the rents for some of these projects will be reduced in order to attract tenants. Unlike the waterfront areas north of the CBD, where we expect no price competition to speak of, these southern areas may offer quite attractive opportunities to secure modern standard leases at rents that could well become very attractive within a few years.

**Industry demand profile has changed**

Nearly 40% of the total of new office developments in 2000 were absorbed by the IT and telecommunications sectors. As shown in the figure below, the demand profile for office lets has changed considerably from 2000 to 2001: although the IT sector still takes up a large share of the market, the stronger demand is now deriving from the professions and the public sector.

**Distribution of occupants, office lets concluded and demanded**



Source: Sadolin & Albæk • ONCOR International

During the most recent economic slump in 1992-1994, the public sector absorbed a very large proportion of vacant office space. During that period, central government secured a number of very attractive office leases at rents that, with the benefit

of hindsight, we now consider extremely attractive, as the fact that central government will always be a stable and attractive tenant was skilfully exploited.

Therefore, we believe that central government will probably try to exploit any weakness that may occur in the rental market in the period ahead in order to secure quality premises at very competitive rents.

**Growth in property taxes much higher than inflation rate**

It has now become the standard for new developments that in addition to the rent, the tenant pays all operating expenses, apart from the building envelope and the administrative expenses of the building.

In the new corporate headquarters on the Copenhagen waterfront, these operating expenses have become quite substantial, and a charge of DKK 350-400 per square metre is not unusual.

The main reason is the sharp rise in official property valuations, which has pushed land tax and service tax to a total of more than DKK 250 per square metre.

**City of Copenhagen should consider lowering its land tax rate**

There is no doubt that if the City of Copenhagen wants to retain its position as the country's most dynamic region for office developments, city officials must consider lowering its property tax rates in the light of recent years' sharp rise in official property valuations and the resultant increase in property taxes.

For example, the land tax rate would be an appropriate tool, and lowering it would also make new residential lets more profitable. This would be an effective contribution to increasing the housing supply and enable the City to attract even more taxpayers.

## **Cap on retail space opportunities in CBD**

**No further expansion of retail space in CBD**

The 1997 Planning Regulations Act introduced new rules for space allocation for retail purposes. The purpose was to limit new shop and shopping centre developments outside of city centres. Section 5 (d) of the Act prescribes that space allocated to retail purposes should be located near the centre of a city or town.

When the Act took effect, the different regional planning authorities, including the Greater Copenhagen Authority, were given the job of determining the maximum space for new developments and for rezoning existing developments into retail space.

In that connection, the total gross floor space for retail purposes in the Copenhagen CBD was capped to the existing space. As a result, the overall floor space for retail purposes in the most essential area of the Danish retailing industry cannot be expanded.

Some quite remarkable consequences of this decision are now being seen: for example, Danske Bank has shut down its branch located on the corner of Amagertorv and Købmagergade, undoubtedly one of the best locations on Copenhagen's main pedestrian street, *Strøget*.

According to the local plan for the area, the ground floor is zoned for public-oriented service trades, such as retail outlets, restaurants, and similar activities. The ground floor cannot be used by any of the professions.

Nevertheless, the cap on retail space means that the property cannot be rezoned from banking to retail purposes.

**Establishing a retail shop would require space elsewhere in CBD to be rezoned**

Presumably it was not the intention of the Environment Minister and the parliamentary majority backing him that the amended Planning Regulations Act was to prevent the establishment of a retail shop at one of the prime CBD locations. However, this example illustrates the unfortunate consequences of the Government imposing detailed zoning regulations in matters that were better handled by local authorities.

Naturally, the market will find a solution to the current situation. By closing down a corresponding amount of retail space elsewhere in the CBD, a new retail location on *Strøget* could obtain approval without violating the cap imposed. However, this does not rectify the basic problem that a government ruling intended to keep the retail trade in the city centres has in fact the exact opposite effect.

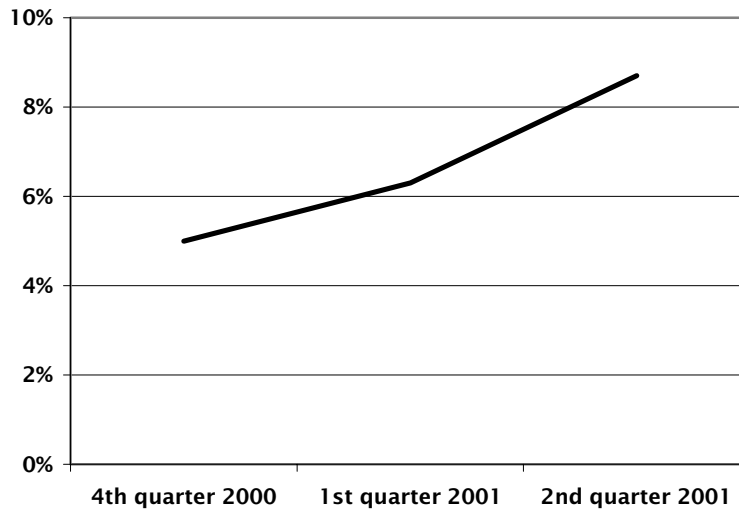
## International property markets

**New York after the terrorist attacks**

It is still too early to estimate the long-term effect that the terrorist attacks on New York and Washington will have on the US property markets.

As shown in the figure overleaf, the office vacancy rate on Manhattan rose from 5.0% to 8.7% during the first half of 2001. The total vacant space covers 3.3 million square metres.

### Office vacancy rates on Manhattan



Source: Newmark & Company • ONCOR International

The terrorist attacks on New York rendered a total of 2.7 million square metres permanently or partially unusable. This is more than the total office space available in the Copenhagen CBD and equals 27.8% of the office space in New York's Financial District and 7.3% of the city's total office space.

About 500 companies were displaced by the attacks, including Merrill Lynch, Deutsche Bank, The Bank of New York, Solomon Smith Barney, Lehman Brothers, American Express and AON.

Theoretically, all the displaced companies could choose to remain on Manhattan, but this has obviously proved impossible and a number of them have, temporarily at least, taken space elsewhere, mainly in New Jersey.

A lot of the office space that has come on the market during the past 12 months as a result of the downscaling dotcoms is now being re-let, at least short-term.

This alone triggers a sharp fall in Manhattan's office vacancy rate, presumably to 3%-4%, and at least for a period of time.

**Office owners have opted not to exploit the temporary boom in demand**

The New York property owners have opted not to exploit the current situation.

Already the day after the attacks, REBNY, The Real Estate Board of New York, set up a "space bank" of short-term offices available at rents covering operating expenses and taxes only. For

longer-term leases, REBNY has appealed to landlords not to ask more than the going rates on 10 September 2001.

**Still too early to forecast the long-term effects on the property market**

There is hardly any doubt that the events of the last few weeks have fuelled the risk of a global economic recession. In fact, most observers are already taking for granted that the US economy will go into recession.

Forecasts also project that a turnaround in the US economy will now happen 6-9 months later than previously predicted, i.e. not until in the second half of 2002.

Obviously, an economic slump will have a negative impact on the property market. Economic uncertainty means that many companies will put off any plans they may have for expansion, and redundancies undermine demand for space.

**Potential long-term structural changes to the market**

Proposals have already been put forward internationally relating to a number of potential, longer-term structural changes to the commercial property markets.

First of all, it would be safe to assume that, at least for a period of time, companies will not be prepared to pay a premium to ordinary market rents in order to secure prestigious premises in international landmark buildings, especially on the top floors.

This implies a softening of the CBD-markets relative to decentralised office areas on the outskirts of the major cities.

In fact, a similar trend was already discernible in London following terrorist attacks there several years ago, events that were dwarfed by those in New York.

In addition, many companies will undoubtedly develop a strategy of having head office functions located at multiple addresses in different cities and countries in order to reduce their vulnerability. Innovations in data transmission will serve to enhance this trend.

**Surge in demand for space suitable for back-up data centres**

The experience from New York revealed how vulnerable many companies are in terms of their central data facilities. In the USA, there has already been an increase in demand for space for secure back-up data centres that are located well away from central corporate data facilities.

