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NEWSLETTER

Commercial property in Denmark and abroad

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Sadolin & Albæk A/S

Nikolaj Plads 26, DK 1067 Copenhagen K

Tel: +45 33 11 66 55 Fax: +45 33 32 72 96

E-mail: sa@sa-oncor.dk Web: www.sadolin-albaek.dk

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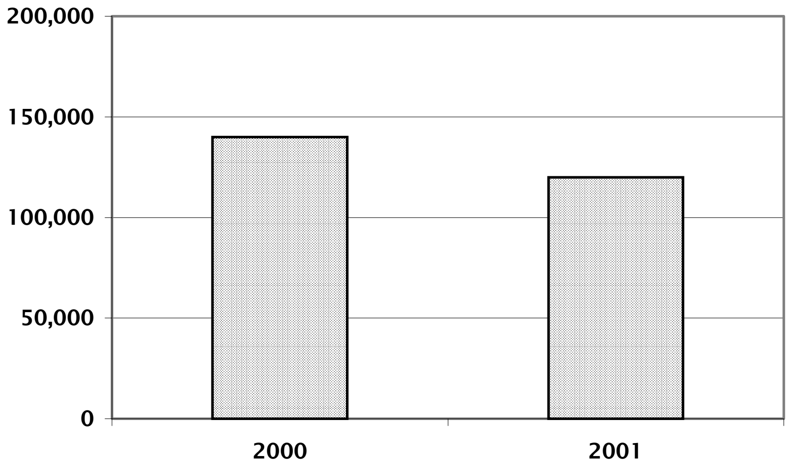
The Greater Copenhagen office rental market

Fair activity in the rental market during 2001

Despite the international economic slump, the office rental market saw a fair level of activity in 2001.

The market recorded healthy demand, especially for new developments, as the aggregate floorage of contracted project leases was only slightly lower than in 2000.

Contracted leases for new office developments, sqm



Source: Sadolin & Albæk•ONCOR International

Reluctance among tenants, but demand for small leases in modern property remains healthy

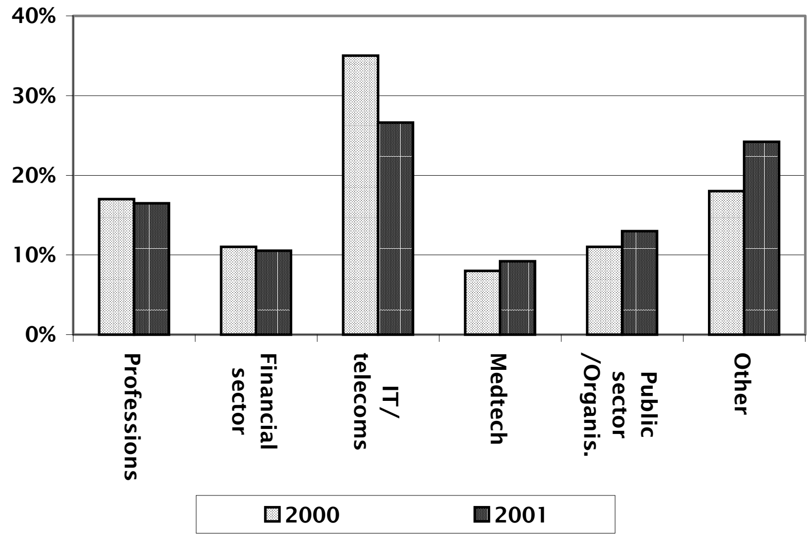
However, market activity clearly declined in 2001. Tenant reluctance is relatively strong at the moment, especially with respect to entering into leases for projects in which construction has not yet started.

On the other hand, demand for small leases in new property remains healthy. Presumably, demand for this type of property has existed for several years, but during the period 1998-2001 tenants were rarely able to find modern, top quality office space available. Thanks to a shift in the market there are now leasing opportunities for tenants requiring floor space of up to 2,000 sqm in new, attractive office property.

Change in industry structure among tenants seeking new developments

Due to the crisis in the IT and telecoms sectors, these industries are no longer as dominant on the demand side, although they still contribute fairly significantly to new lets.

Industry distribution, new office lets



Source: Sadolin & Albæk•ONCOR International

As shown in the figure above, the growth in office lets during 2001 predominantly took place in the "Other" category, mainly driven by head office facilities for manufacturing or commercial enterprises and shipping companies.

Rising vacancy in CBD office stock

The office vacancy rate in the Copenhagen CBD has been very low in recent years, averaging about 1.4%.

However, the effects of the many businesses relocating to new developments, especially to the city's waterfront, are now beginning to show. More than 100,000 sqm of CBD office space has been or will be vacated over the coming months, and that will, at least temporarily, trigger a relatively dramatic increase in the vacancy rate, presumably to as much as 4% or 5%.

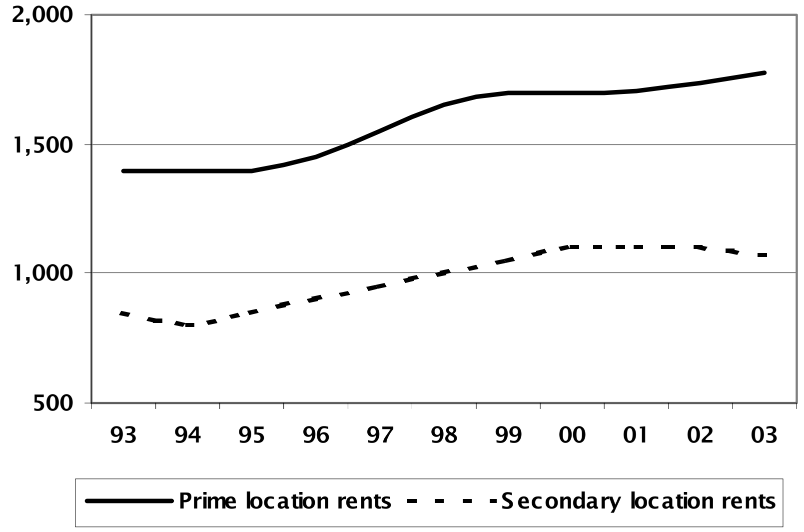
Office rents in older building stock becoming stagnant

While office rents in new waterfront property are set to continue to edge upwards, the added supply of office space in the older CBD building stock will probably lead to stagnant rents. Rents for secondary location property are likely to decline.

Also contributing to this are recent years' low vacancy rates, which have forced tenants frustrated in their search for a city centre location to take leases in secondary locations.

In a market offering fairly good opportunities to lease office property at attractive locations, rents will obviously come under pressure.

Copenhagen CBD office rents (annually in DKK per sqm excluding operating costs)



Source: Sadolin & Albæk•ONCOR International

As the figure above indicates, the spread between prime rents for modern office space and average rents for secondary office space at non-CBD locations barely changed from 1993 to 2000, apart from the very weak market in 1994. Now, the spread has started to widen again as a logical consequence of the weaker rental market.

Government likely to require less space

The market has been expecting the government to take advantage of this opportunity to secure attractive prime-location space. However, following the recent change of government, such expectations will be up for review.

It is still uncertain whether the new government plans to announce extensive staff cuts in government institutions. However, there is no doubt that the government will play a much less important role in the Greater Copenhagen office rental market over the next 12 months than was previously expected.

Relocating government institutions back on the agenda

From time to time, politicians discuss the merits of moving more government institutions to provincial locations. This issue has gained a lot of attention following the change of government, not least triggered by the decision not to build the new National Archives in the Ørestad.

In recent years, we have advised a number of Danish and foreign companies on setting up operations in Denmark. It is our experience that the availability of a qualified workforce is the dominant factor in a company's considerations on whether to establish operations. Most recently, this was confirmed by *Biogen*, the American biotech company, when it decided to establish a subsidiary in Hillerød, north of Copenhagen.

Also for the government, the workforce issue – and not regional policy considerations – ought to be the deciding factor. However inexpensive a site or a property may be, it cannot compensate for the lack of efficiency that a business or an organisation would experience if it is unable to attract qualified employees in sufficient numbers.

We would expect that a government institution if relocated would only be able to entice a limited number of its employees to follow. As a result, relocating government institutions to areas with a much more limited supply of labour than in the Greater Copenhagen area, could trigger an unfortunate state of competition for qualified labour to the detriment of businesses and local authorities.

Therefore, we see good reason to expect that the government's intention of maintaining and further improving public sector efficiency will mean that no significant government institutions will be relocated.

Still a high level of new developments in locations outside the city centre

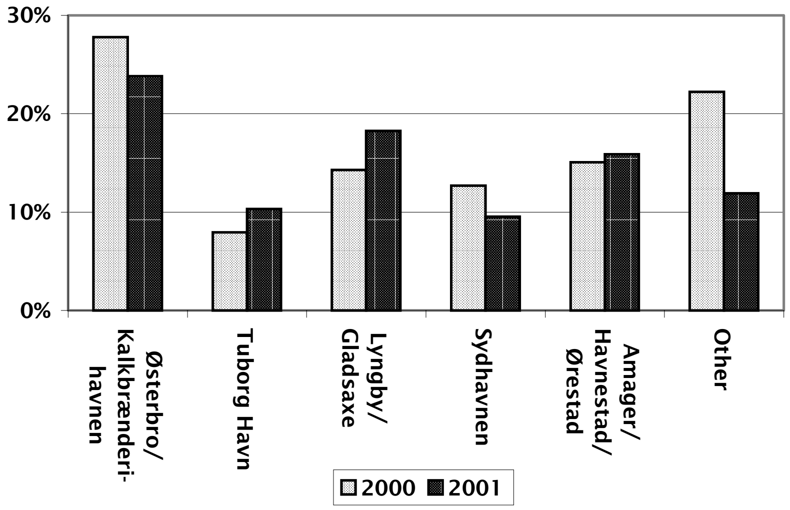
Of course, the slowdown in the rental market is also having an effect on areas outside the city centre. Vacancy rates are rising in areas dominated by IT and telecoms companies, including Ballerup and Birkerød, northwest of Copenhagen.

The supply of vacant office space is also increasing in other decentralised areas, although in many cases the space being offered is of a secondary quality and in secondary locations.

However, contracting for new developments fell only very slightly from 2000 to 2001, and we expect to see several significant leases concluded for new office projects in 2002.

Office users continue to keep waterfront locations in high demand. Apart from this area, the strongest demand is being recorded in the areas along the ring motorway from Lyngby to Gladsaxe, which offer extremely good motorway access, and in central Ørestad, Ørestad City, not least because the new Metro is due to open in October 2002.

Office projects, by location



Source: Sadolin & Albæk•ONCOR International

The figure above shows the distribution of building projects by location contracted in 2000 and 2001.

Clearly, new projects are increasingly being concentrated in the main development areas, whereas the level of activity in the "Other" category, including established office areas, such as Birkerød, Ballerup and Glostrup, would appear to be declining.

We are convinced that, as the sites in Kalkbrænderihavnen, Tuborg Havn and central Lyngby areas are developed and built-up, building activity will begin to focus on Gladsaxe, Sydhavnen and, especially, Ørestad City.

Growing vacancy rates in existing office stock to be expected outside city centre as well

Considering the stagnating employment figures, the substantial volume of new developments should not be seen as an indication of an overall increase in demand for office space. As a result, the new developments will cause vacancy rates in the existing building stock to rise, in both CBD and non-CBD locations.

Although this is unlikely to be a very dramatic increase, we anticipate a risk of structural vacancy in certain decentralised office areas, as seems to be the case in a few older industrial districts in the vicinity of Copenhagen.

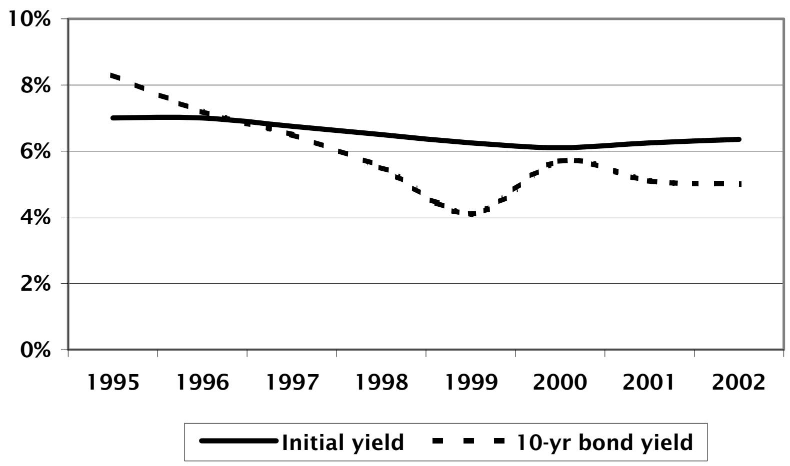
The investment property market

High stable institutional demand

Softer economic trends and a setback in the rental market usually weaken demand for investment property all other things being equal. However, this does not seem to be the case for the time being, and no factors indicate that investor appetite will abate in 2002.

Due to declining interest rates coupled with slightly rising initial yields on investment property, the current yield on property investments has become very attractive relative to bond investments. The yield gap is now some 1.25 percentage points, the highest level in recent memory, except for a short period in 1999 when long-term bond yields were unusually low.

Initial yields on investment property and bond yields



Source: Sadolin & Albæk•ONCOR International

Institutional investors' exposure to property too low

Furthermore, most Danish insurers and pension funds have a relatively low exposure to property.

Both in Denmark and abroad, the usual portfolio strategy objective is to weight property by about 10% in an ideal long-term investment portfolio. However, many investors will increase the weighting of property to about 12% of total investment assets owing to the recent drop in yields and the continuing uncertainty surrounding equity markets.

The figure overleaf shows the proportion of property relative to the total investment assets of a number of major Danish insurers at year-end 2000.

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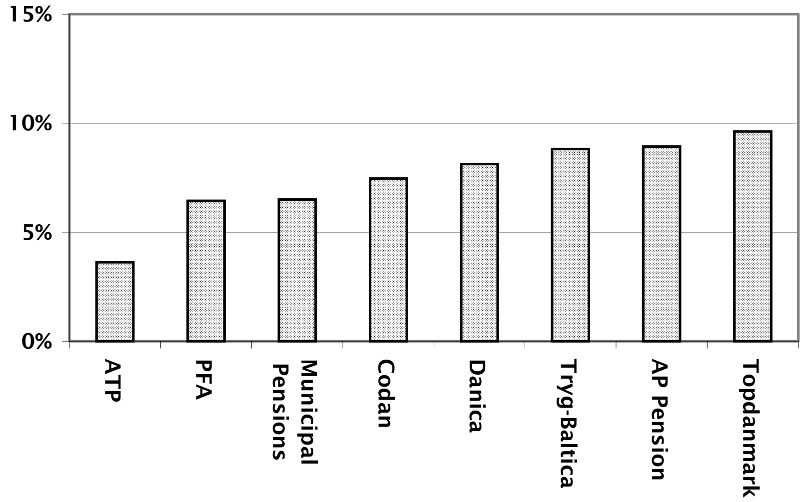
Property relative to total investment assets



Source: Respective annual reports for 2000

The picture is slightly blurred as regards pension funds. A number of "old" pension funds have property portfolios accounting for 9-11% of total assets, while some new pension funds, including the funds that have been formed in the past five years in connection with the pension schemes set up under collective agreements, generally have portfolios with a property weighting of up to 2% of total assets.

Even though the above figures do not include the effect of lower share prices in 2001, the institutional investment industry in Denmark generally has too little exposure to property, viz. just in excess of DKK 20 billion.

Strategy adjustments underway

In recent years, the majority of institutional investors have concentrated their investments on new corporate headquarters, chiefly located on the Copenhagen waterfront. However, the slowdown in building starts will curtail these investment opportunities.

Therefore, many institutional investors are adjusting their property investment strategies.

Some investors will probably enhance their exposure to foreign markets, where there is a greater supply of prime office property available on long-term leases.

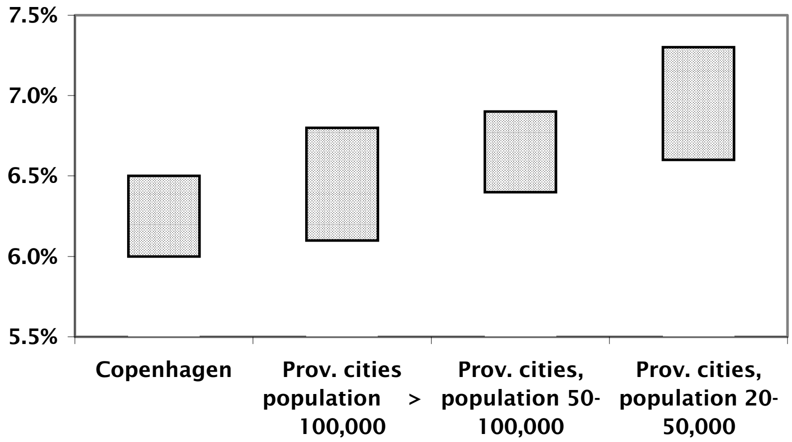
Furthermore, we forecast greater focus on secondary location office property, new residential rental property as well as new distribution property available on long-term leases.

Retail property market dominated by private investors including limited partnerships

The prime retail property investment market, which was previously a core market to institutional investors, is now completely dominated by private investors including limited partnerships, consisting of 10 partners investing at net initial yields that are slightly lower than the yields acceptable to institutional investors.

Initial yields on prime retail property in Copenhagen CBD have been about 6.0-6.5% in recent years. Thus, keen investor demand has not translated into a significantly lower required yield. The main reason is probably that especially new limited partnerships consisting of 10 partners usually have a very high degree of loan financing and that, therefore, the financing rate determines the required yield.

General initial required yield for prime property, net



Source: Sadolin & Albæk•ONCOR International

Fall in initial required yield for prime property and in small and medium-sized provincial cities

By contrast, provincial cities have recorded declining initial yield levels for prime location residential property. Whereas net initial yields on prime location retail property in these areas – except for Århus – ranged between 7.0 and 7.5% just a few years ago, prime property is now yielding about 6.75% in many markets.

There is no doubt that mounting prices primarily mirror demand by private investors and limited partnerships that focus on the financing rate and financing opportunities rather than an objective assessment of the potential for higher rents.

New legal requirements on investment property valuation

Investment property accounting has been heterogeneous so far. Some investors and companies carry investment property at cost less accumulated depreciation in their accounts, while others choose to record it at the public land assessment and yet others use the market value for their valuation.

As from the accounting year 2002, companies whose principal activity is property investment can no longer pick any one of these principles. Now, Section 38 of the Danish Company Accounts Act requires such companies to book their investment property at the estimated market value. The provision forms part of the implementation of international accounting standards, IAS, into Danish legislation and thus tallies with international accounting practice.

We approve of this initiative, which enhances the transparency of accounts and the "true and fair view", regardless that the market value may be evaluated by the company itself and that no external market estimates are required.

It must, however, be expected that – in line with their foreign peers – an increasing number of Danish property investors will opt for valuation documented by independent parties, confirming the credibility of the valuation.

The new provisions of the Danish Company Accounts Act also ensure that companies that mark their investment property to market will make a provision for tax on property gains triggered by a sale at book value. Despite upward revaluation of property to market value, some property investors omit to enter latent property gains tax under liabilities in their balance sheets, merely indicating it in a note to the accounts.

The change only applies if the main activity is property investment

The new principles apply only to companies whose main activity is property investment. Other companies still have the choice of stating their property at cost less accumulated depreciation or at fair value.

Companies having spun off their property assets are hardly obliged to appreciate this property to market value under the new legislation, if the principal activity of the spin-off is the letting of property to the operating companies in the group.

International commercial property markets

Mounting vacancy in office stock in many European markets

European office property markets were affected by weaker global economic trends in 2001. Most of the major markets in western Europe recorded rising vacancy in office stock.

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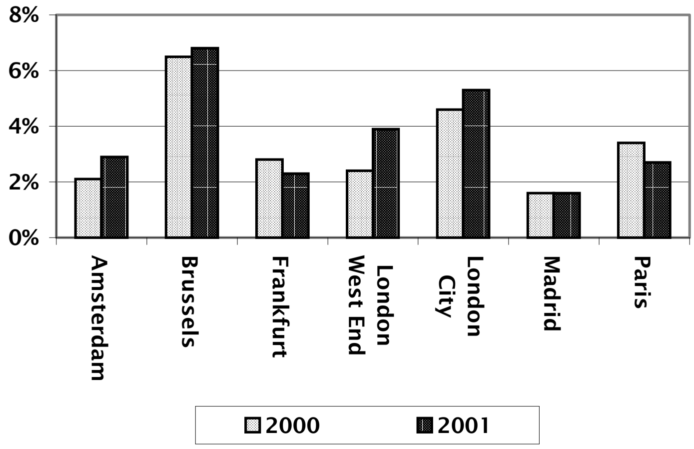
Office market vacancy rates



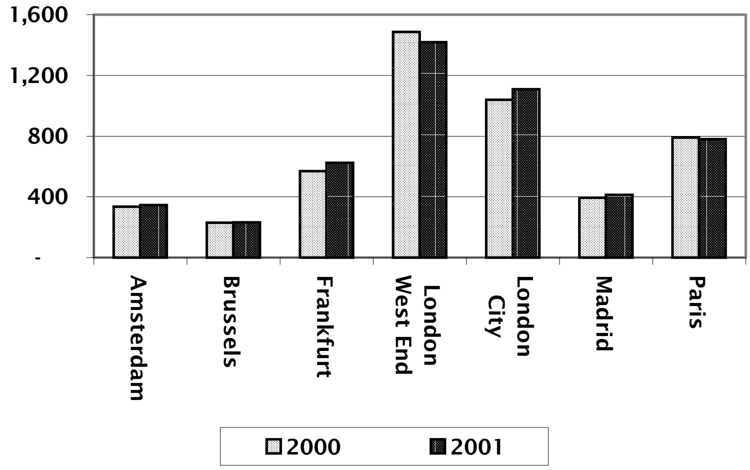
Source: Sadolin & Albæk•ONCOR International

It is important to stress that the development is by no means dramatic. In recent years, speculative investment in new developments has been moderate in all markets. At the same time the demand for modern office leases has been buoyant, which means that mounting vacancy has hit property of a secondary quality and location in particular. The weaker rental demand will no doubt put rents under pressure in many markets.

Stagnant rent levels in 2001 – decline in 2002

As appears from the figure below, prime office rents were fairly stable in 2001. But the current economic trends will undoubtedly lead to higher vacancy rates in many markets, which in turn may result in lower rents.

Prime office rental rates (annually in euro per sqm)



Source: Sadolin & Albæk •ONCOR International

The risk of slipping rent levels is considered to be highest in respect of secondary location office space, while rents are likely to remain largely stable for modern office property in prime locations.

Large supply of office space to sublet

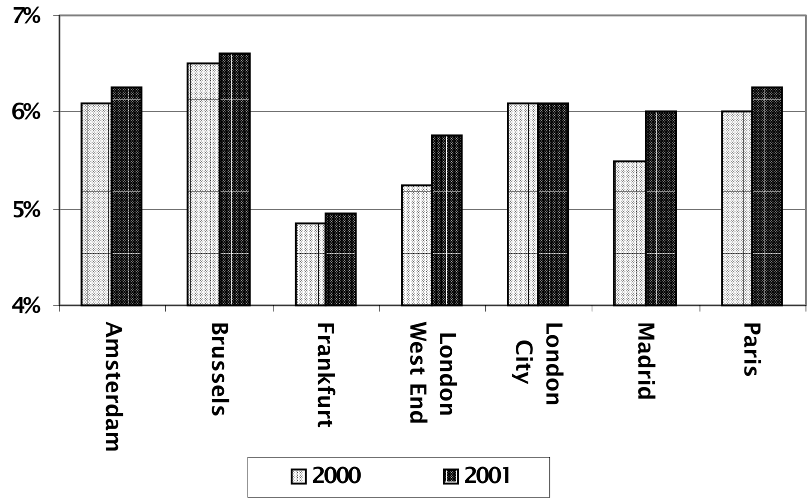
In the past 2-3 years, many lessees in most markets have let office space on long-term leases in anticipation of staff expansion that did not materialise. The implication is a rather large supply of modern office space offered as sublets.

The most important action for such companies is to trim the cost of office space quickly rather than optimising the lease long term. Therefore, sublessees will often succeed in obtaining rather attractive rent levels.

Lower rents have only marginally increased the required yield

A higher vacancy risk will on balance prompt a higher required yield, all other things being equal. This trend has been seen in most markets, but notably in the West End of London, in Paris and Madrid.

Net initial yield on prime office property



Source: Sadolin & Albæk •ONCOR International

Larger spread in initial required yield

The downturn in European bond yields has no doubt contributed to stabilising investment markets. Especially the lower euro bond yields and uncertain equity markets have directed significant liquidity to the German open-ended funds (Offene Immobilien-Fonds). This liquidity is intended for property investments.

As German funds usually prefer to invest in modern, prime location office property let on long-term leases to tenants of indisputably good financial standing, the initial required yield for such property will hardly pick up.

By contrast, lower rents may increase the required yield on secondary-quality property let on short-term leases. The risk relating to letting is higher in respect of this segment and lower interest rates are outweighed by the banking industry's harsher credit quality assessments, and there is also an upward trend in the interest margins for property financing.

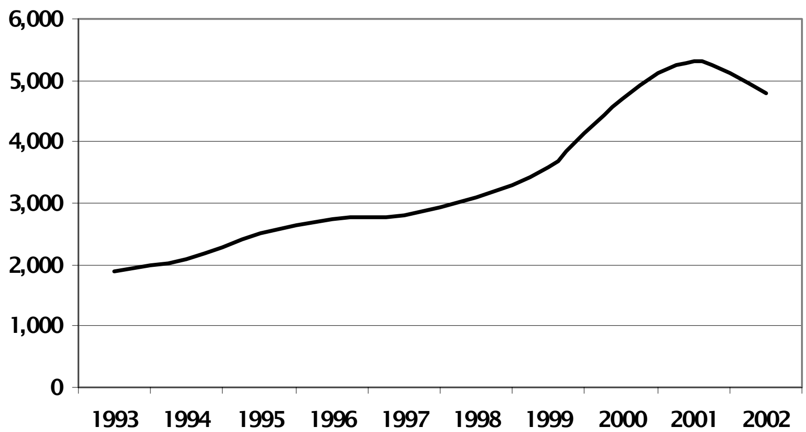
Office property market in Stockholm hard hit by crisis in IT and telecoms

In Europe, the office property market in Stockholm was hardest hit by the crisis in IT and telecoms. Having surged, office property vacancy rates are in the region of 5%.

Furthermore, a great number of companies have postponed plans for recruitment or have cut headcount and the "hidden" vacancy – the office space that is not fully utilised nor leased out – probably amounts to 3-5% of the total office stock.

It is therefore no surprise that rent levels have tumbled following a continuing steep rise from 1993 to early 2001.

Prime office rents in Stockholm (annually in SEK per sqm)



Source: Sadolin & Albæk / NewSec

Prime rents for modern office space in Stockholm's "Golden Triangle" are illustrated in the figure above. In the areas of Greater Stockholm where IT and telecoms companies have been most dominant, such as Kista, the development is even more pronounced. The average office market rate in Greater Stockholm is estimated to have dropped by more than 15% relative to the peak of just over a year ago.

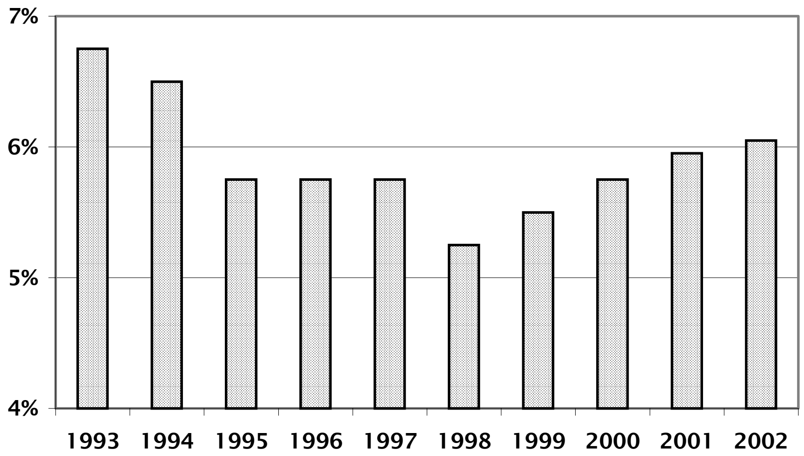
Belated halt in new developments

Obviously, a higher vacancy rate and lower rents will spur a setback in new developments. But a number of significant building projects are actually in progress, which leads us to expect an even higher office vacancy rate and a tendency for rents to continue falling.

Higher initial required yield for investment property

Required yield in the Swedish property market has not increased much despite the sour office rental market. Also in Sweden, low bond yields have contributed to consolidating the property market.

Initial yields on prime office property in Stockholm



Source: Sadolin & Albæk / NewSec

Nevertheless, we consider the risk of an even higher required yield and ensuing low commercial property prices to be fairly large.

First, the performance of the rental market will probably be subdued at least in the next couple of years. Secondly, the relatively weak Swedish krona, which has benefited Swedish export companies, has stepped up the risk of inflation. Higher interest rates are therefore likely, and there is hardly any doubt that this will prompt a higher required yield.

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