

**NEWSLETTER**

**Commercial property in Denmark and abroad  
June 2002**

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## STAGNANT OFFICE RENTAL MARKET

### Weak demand for office leases

The first half of 2002 saw very weak activity in the office rental market.

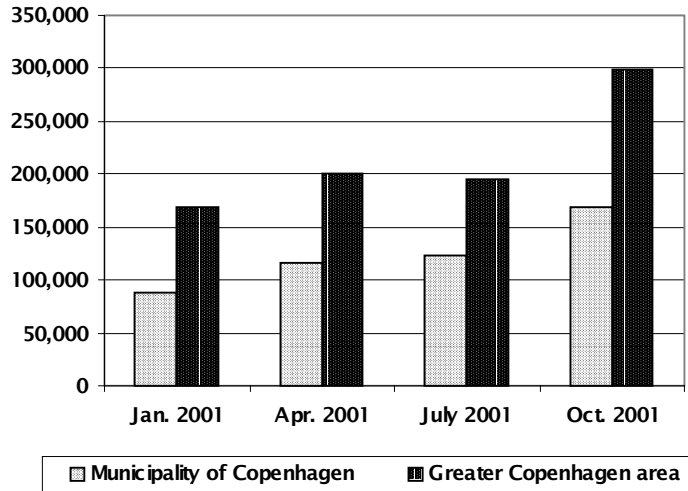
There is widespread support for the view that the current, very weak business cycle is a temporary phenomenon and that the economy will begin to recover in the second half of the year. Nevertheless, businesses have been very reluctant to lease new space and a number of users who have actively been seeking new space have stopped looking, at least temporarily.

Particularly, the weak market has impacted office vacancies in the Copenhagen CBD, where a lot of office space has been vacated during the past 12 months. Some 12-24 months ago, more than 80% of vacated CBD space was re-let within six months. Now the average vacancy period has lengthened substantially.

### Vacancy rate almost doubled in less than a year

As a result, office vacancy rates have risen sharply, both in the CBD and in the Greater Copenhagen region in general.

Vacant office space, m<sup>2</sup>

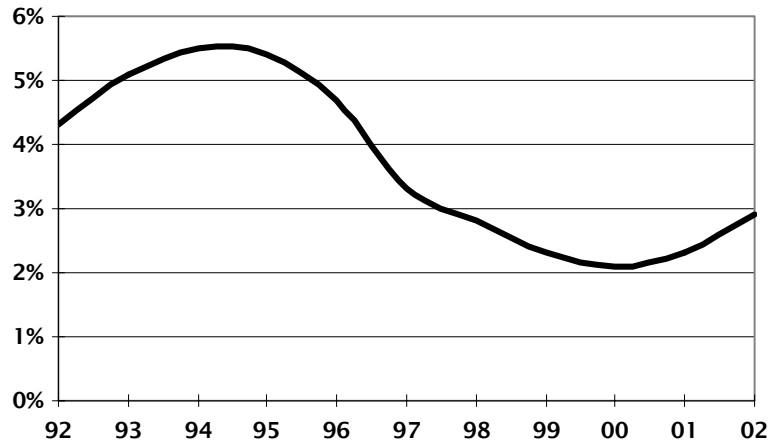


Source: The Danish Forest and Landscape Research Institute

As can be seen from the above figure, vacant office space in the Copenhagen CBD rose from some 90,000 m<sup>2</sup> in January 2001 to some 170,000 m<sup>2</sup> in October 2001. It is estimated that vacancies in the Greater Copenhagen area rose from about 170,000 m<sup>2</sup> to about 300,000 m<sup>2</sup> during the period, and the trend is believed to have intensified during the past 12 months.

In a long-term perspective, however, office market vacancy rates remain at relatively low levels.

#### Office vacancy rates in Greater Copenhagen area

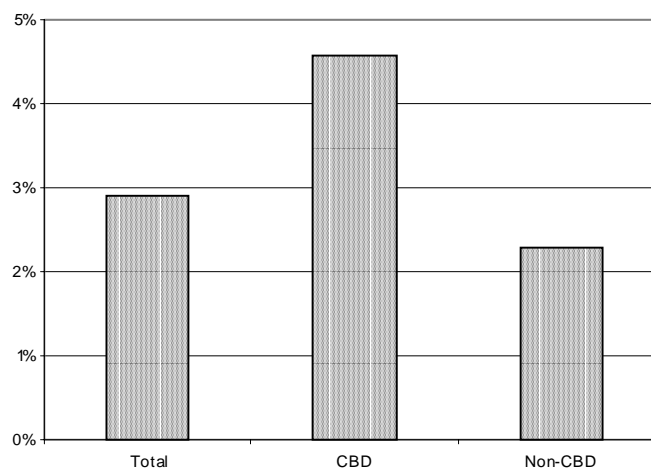


Source: Sadolin & Albæk

#### CBD vacancy rate significantly above market average

Recent years' relocation exodus from the CBD to new headquarters in the waterfront districts has pushed up the CBD vacancy rate well above the overall market rate.

#### Current office vacancy rates



Source: Sadolin & Albæk

**CBD vacancy – a structural problem?**

Clearly, the increased vacancy is mainly cyclical. However, we would not rule out that the CBD vacancies could develop into a structural problem that cannot be remedied by economic recovery.

Today, many large office users demand leases in modern developments. Such leases offer greater flexibility, options for open-plan offices, greater comfort, including air conditioning and parking facilities.

Most of the vacant CBD space does not meet these requirements and redeveloping them would be quite difficult. This would imply that the added vacancy in the CBD could be a relatively permanent phenomenon, which could spur considerations to redevelop the property involved into attractive residential units, a segment considered to have a stable, rising demand.

**Growing activity expected in office rental market**

We expect the sluggish office rental market will only be a temporary phenomenon and that market activity will make a strong recovery over the next 12 months.

Although many businesses have temporarily suspended their hunt for new premises, there is still a widespread need for new space.

Also supporting this view is the expectation that a modest cyclical recovery will take place over the next 12 months, which would stimulate new business investment.

**Vacancy in office market set to stabilise, but unlikely to fall**

Due to the increased dynamics of the rental market, the office vacancy rate is not set to rise further.

On the other hand, we would expect that much of the demand for new leases will still target new developments. Accordingly, increased activity in the rental market hardly means that the overall vacancy rate will return to the very low levels recorded at around the turn of the year 2000/2001.

**THE INVESTMENT PROPERTY MARKET****Very strong demand for investment property, but weak turnover**

The investment property market has also seen modest activity in the first half of 2002. We estimate that turnover has more than halved relative to the first half of 2001.

This was not caused by a poor investment climate or a lack of market liquidity. Investment property opportunities in Greater Copenhagen continue to attract many Danish and foreign institutional investors, property companies and private investors.

Institutional investors prefer new or thoroughly redeveloped property with long-term leases and tenants of good financial standing.

Supply in this segment has only been moderate, especially because this type of property is mainly offered to property developers as soon as a new lease has been signed. Obviously, in a situation with weak activity in the rental market, very few of this type of property are ever put up for sale.

**Investment property being offered at unrealistic prices**

There is a larger supply of non-prime, secondary-location property, which is not as easy to let.

Unfortunately, we see all too often that the prices asked for this type of property are not realistic considering the current market situation. Other things being equal, the potential for rent increases is smaller in a weaker office rental market and the vacancy risk is greater. This means higher initial net required returns.

If the seller is too aggressive in his pricing, which is sometimes the unfortunate result when an estate agent is eager to secure the listing, the property remains unsold. This is not because of a lack of interest from prospective buyers, including foreign investors taking a more speculative approach, but rather because the seller's expected price is ruled out by realistic investment calculations and business requirements.

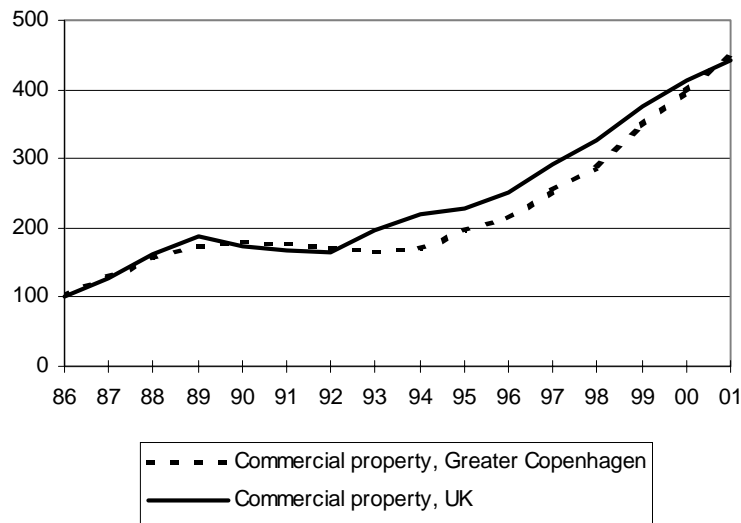
An efficient and liquid property market relies on the sellers' and buyers' realistic expectations being in equilibrium. There is hardly any reason to expect much lower vacancy rates over the next 12-24 months, nor do we expect a drop in interest rates that could lower the required return on property investments. Therefore, we believe that an increase in investment property turnover will require some sellers to lower their price expectations and accept the fact that the weaker rental market is causing stagnant prices on investment property.

**Investment property returns in a historical perspective**

At a recent property market conference organised by Danish business daily Dagbladet Børsen and Sadolin & Albæk, we presented an analysis of the overall return on investment property relative to other investment alternatives over a period of a number of years.

The overall return equals the current yield and price developments on the assumption that the current yield is reinvested in the same asset every year.

The chart overleaf shows the overall returns on investment property in Greater Copenhagen and in the UK.

**Overall return on investment property**

Source: Sadolin & Albæk / Investment Property Databank

As appears from the chart, these two categories of investment assets yielded largely identical overall returns from 1986 to 2001.

It would also appear that the Danish business cycle moves at a slight lag to the UK cycle: In the late 1980s, for example, the UK slumped slightly earlier than Denmark did, while the post-crisis recovery and price increases in the first half of the 1990s occurred 12-24 months earlier than in Denmark.

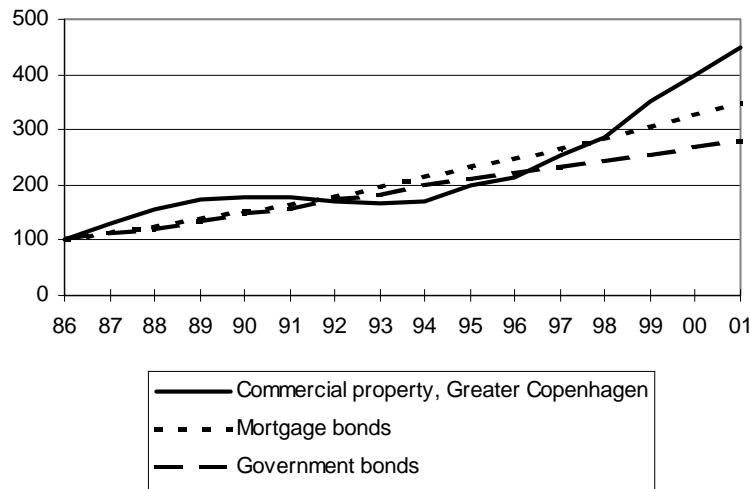
The chart also shows that the overall return on UK investment property was slightly lower in 2001 than in the preceding years. It is not surprising, therefore, that this year's overall return on Greater Copenhagen investment property is expected to be slightly below the figures recorded in recent years.

**Overall return on property investment substantially outperforming bond returns**

Considering the risk inherent to property investment, the overall investment return on the Greater Copenhagen property market should outperform the overall return on bond investments.

The chart overleaf shows the overall return on commercial property investment and on Danish mortgage and government bonds from 1986 to 2001.

### Overall returns - investment property and bonds



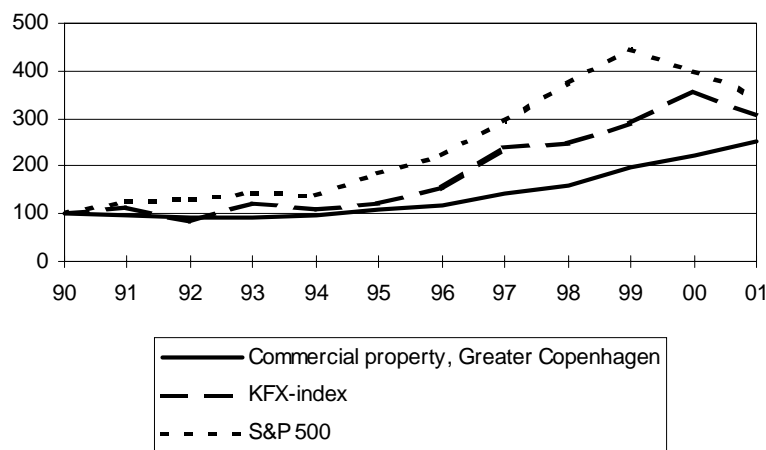
Source: Sadolin & Albæk

As can be seen from the chart, for every DKK 100 placed in the property market in 1986, investors now have assets of DKK 450, while a DKK 100 investment in the bond market is now worth DKK 345 for mortgage bonds and DKK 280 for government bonds. On the other hand, property investments are more volatile relative to the stable overall return provided by bond investments.

### Equity investments outperforming property investments

The chart below shows the overall return on property and equity investments (KFX and S&P 500) from 1990, when the KFX-index was launched.

### Overall returns - investment property and equities



Source: Sadolin & Albæk

Equities as represented by Danish blue chips (the KFX index) and the index of US blue chips (S&P 500) strongly outperformed the Greater Copenhagen investment property market during the period under review.

On the other hand, equity investment involves a much greater risk, as became very clear in 2001, when stock markets plunged.

### **Risk and return are related**

As any investor knows, the greater the expected return, the greater is the risk involved.

We have applied the *CAPM, the Capital Asset Pricing Model* in order to explain the relationship between risk and return on investments in property, bonds and equities. The model is based on the assumption that the return on an investment offsets the risk taken on the investment, thereby implying a linear relationship between risk and return. This linear relationship is called the *Security Market Line (SML)* or the benchmark line.

An asset on the benchmark line offsets the risk in line with the selected benchmark portfolio. An asset above the line provides a higher return than implied by the risk, while an asset below the line provides a lower return than implied.

The CAPM applies historical returns to measure the volatility of a return relative to a benchmark portfolio. The volatility is measured by the so-called *β-value*: a  $\beta$ -value of 1 indicates that the asset in question has a volatility identical to the benchmark portfolio. A  $\beta$ -value below 1 implies that the volatility of the asset is lower than that of the benchmark portfolio and, conversely, a  $\beta$ -value greater than 1 implies that the volatility of the asset is higher than the benchmark portfolio.

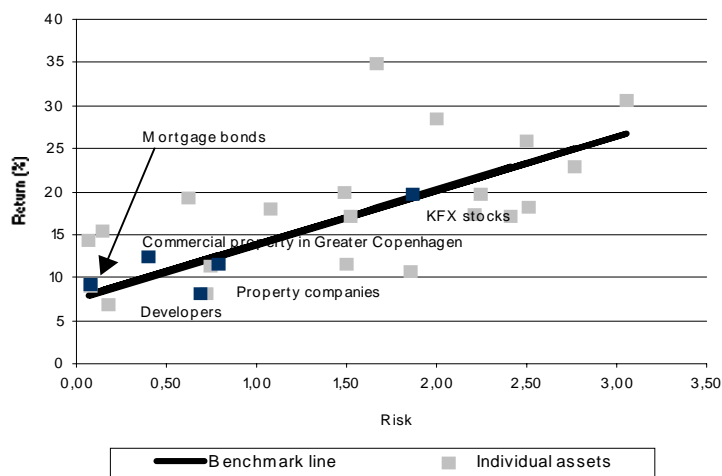
In our analysis, we applied a benchmark portfolio consisting of bonds (50%), KFX stocks (40%) and Greater Copenhagen investment property (10%). This portfolio composition is very similar to the typical institutional portfolio of Danish assets.

### **Risk and return on assets and bonds congruent with the benchmark portfolio**

The chart overleaf shows the results of our analysis. The black dots indicate risk and return on various asset classes, while the grey dots show risk and return on each of the 20 most traded stocks on the Copenhagen Stock Exchange.

Clearly, risk and return on assets and bonds are congruent with the benchmark portfolio. In other words, the return on the asset in question offsets the risk in accordance with the benchmark line. Not surprisingly, bond investments have a  $\beta$ -value substantially below 1, while the  $\beta$ -value of stocks is much higher than 1.

Benchmark line (SML) - 1986-2001



Source: Sadolin & Albæk

**Investment property has provided a greater return than the risk implies**

As an investment object, commercial property has a  $\beta$ -value of 0.4 and thus a much lower risk than the benchmark portfolio.

At the same time, investment property is above the benchmark line, indicating that the overall return on property during the period was higher than implied by the risk.

During the period, investment in listed property companies has involved greater risk than a direct investment in property without providing a greater return. The same applies to property developers, although we must emphasise that property developer stocks have performed extremely well in recent years.

We would emphasise that our analysis does not consider factors such as transferability, transaction costs or tax.

Institutional investors are subject to uniform taxation of their various asset classes, while taxation for private investors favours property over equities, at least as regards property investments eligible for tax allowances.

We would also point out that the model assumes 100% equity funding. A property investment funded partially by debt would involve both a higher risk and a higher return.

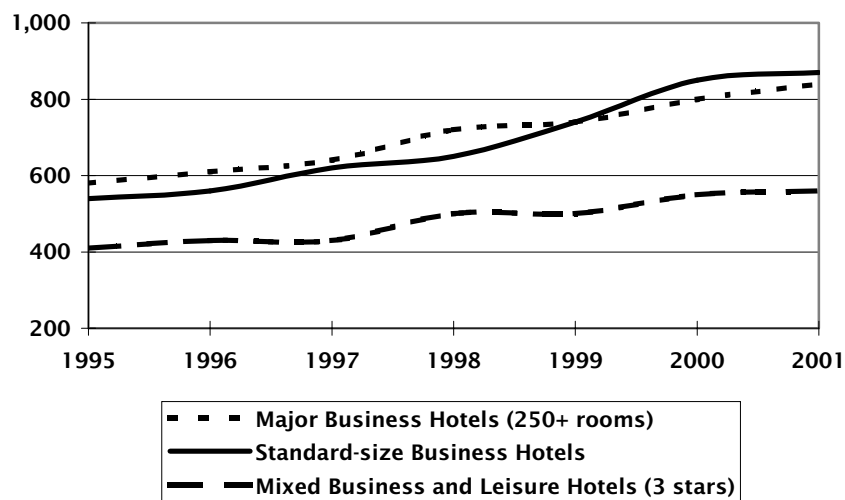
## THE HOTEL MARKET AFTER 11 SEPTEMBER

### Good performance by Copenhagen hotel market until 2001

The hotel market in Greater Copenhagen has been a strong performer over the past five years.

In spite of the moderate increase in the overall supply of hotel rooms, occupancy rates remained at the 70%-80% level with the average achieved room rate (excluding breakfast and VAT) rising strongly.

Average achieved room rate in DKK, hotels in Greater Copenhagen



Source: Sadolin & Albæk

The average achieved room rate has risen by about 50% over the last 5-7 years, strongly outperforming general price developments.

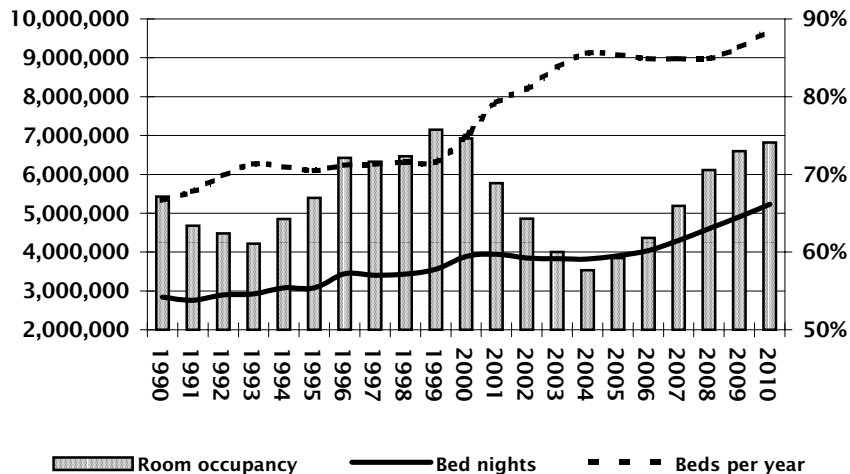
The good performance has considerably sharpened the interest of the major international hotel chains in establishing hotel operations in Copenhagen, and there has been a fair-sized increase in the city's hotel capacity over the past 12 months. In addition, several new projects are currently underway, while some previously announced plans to build new hotels have been shelved, at least temporarily.

### Increased supply will result in lower occupancy rates

The combination of the generally weak business cycle and the drop in the number of transcontinental travellers that followed 11 September means that demand for hotel stays is not set to increase by very much in the short term, even though the Copenhagen hotel market has suffered much less than many of the major international hotel markets.

Therefore, the increased supply will result in lower occupancy rates.

#### Supply and demand of hotel beds in Copenhagen



Source: Sadolin & Albæk

According to a forecast we have prepared of hotel room supply and demand until 2010, the number of hotel beds available per year will increase by about 25% from 2001 to 2004. In turn, this will push the occupancy rate to below 60%.

This will especially affect small hotels with secondary locations that are not affiliated with major hotel chains and therefore do not benefit from their distribution capacity. City hotels affiliated with hotel chains will experience a less dramatic decline, and the overall CBD hotel market will hardly see occupancy rates fall below 65%; which is not dramatically low in an international perspective.

#### Occupancy rates set to increase again from 2005

Our forecast indicates that occupancy rates will begin to rise again from 2005 and that the overall market will recover to well above 70% within a few years after that. This is explained by the combination of stronger growth in demand and stagnant supply.

#### Hotel property with long-term leases still offer an attractive investment

In recent years, hotels on 15-20 year leases to leading international chains have been in strong demand, especially from private investors. Such demand has been driven by the attractive combination of a secure cash flow above the financing rate and the tax allowances available to investors in hotel property.

Currently, demand is a bit subdued, mainly because increased caution in the financial sector has made it difficult for private inves

tors, including the so-called 10-man limited partnerships, to debt finance such investments to the usual extent.

We believe that once a temporary oversupply of rooms is soaked up, the hotel market will recover for a very favourable performance in five or six years' time. As a result, we maintain our view that hotel property leased to financially strong operators on 15-20-year leases at a fixed, indexed rent provides an attractive investment opportunity.

In today's market, such investments can be made at a quite competitive initial net return of just over 7%. At the same time, a long-term fixed-rent lease provides a safe return and the opportunity to divest the property after five years, for example, when the hotel market is expected to have regained its strength, while the lease will still have a number of years to run.

Assuming an unchanged required return, the investment would still yield a decent profit.

## INTERNATIONAL INVESTMENT PROPERTY MARKETS

### **Moderate trends in European office markets**

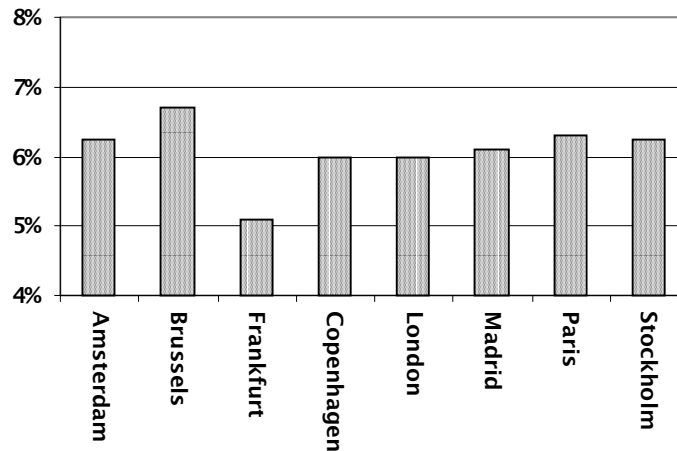
Generally, the Greater Copenhagen office rental market developed in line with most European markets in the first half of 2002. In other words, subdued rental activity and stagnant rent levels.

By contrast, the Stockholm market has been severely hit due to a dramatic plunge in rent levels resulting not least from the fact that Stockholm has probably suffered more than any other major European city from the crisis in telecommunications and among IT and Internet companies.

As in Copenhagen, investors' initial net required returns have been relatively stable with a slight, upward trend.

Once again Stockholm stands out, as initial net yields on prime investment property in this market have risen considerably in step with growing uncertainty in the office rental market and the declining rent level.

## Prime yields on office space

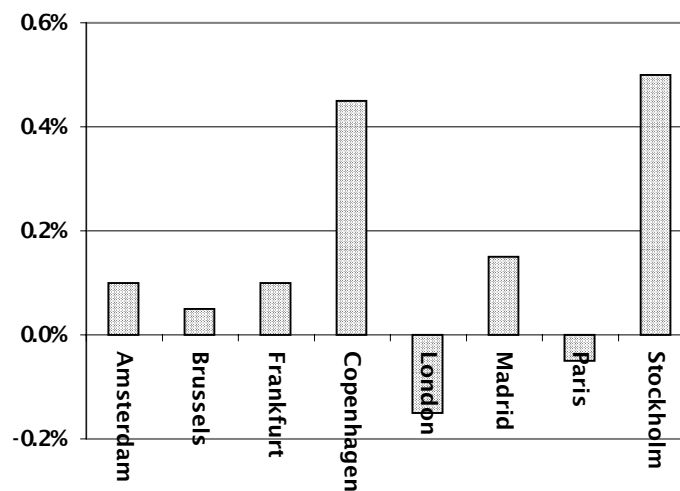


Source: Sadolin & Albæk •ONCOR International

**Required return on retail property lower than on office property**

Generally, investors have slightly higher net initial return requirements for prime office property than for retail property. In two markets, London and Paris, they have lower required returns for the office market.

## Required return premium, office relative to retail property



Source: Sadolin & Albæk •ONCOR International

Stockholm and Copenhagen stand out from most other markets, with required returns on retail property being about 0.5 percentage point lower than for office property.

The situation in Stockholm is explained by the crisis in the office market, which has driven up required returns considerably, a trend that has not been discernible in the retail property market.

For Copenhagen, the explanation is probably different: a combination of the very restrictive planning regulations for establishing new retail outlets and quite a substantial demand for retail property from 10-man limited partnerships.

These limited partnerships are eligible for tax allowances when investing in retail property. Tax allowances are not available to institutional investors, who therefore have slightly higher return requirements.

**Investment market dominated by German open-ended property funds and the private equity market**

There is a huge investment capacity and investment requirement in the European property markets.

For years, the key European property markets have been driven by the German open-ended property funds (Offene Immobilienfonds). Shares in these funds are typically acquired by private investors as an alternative to bank deposits, bonds or equities.

The combination of a low level of interest rates and uncertain equity markets in 2002 to date has lifted the net inflow of capital to these open-ended funds to new record highs. At 1 January 2002, there were almost 20 open-ended funds whose combined assets under management amounted to approximately EUR 55 billion.

In the first quarter of 2002 alone, the capital inflows to these funds amounted to approximately EUR 6.8 billion. The funds will be invested in the property market. Very often, investments in foreign markets have a gearing of as much as 50%.

Over the past five to seven years, the funds have gradually allocated more and more of their capital for investment in international markets; mainly London to begin with, but later in the Netherlands, Belgium, France, Spain, Italy and Austria, as well.

On the other hand, investments in Scandinavia have been modest to date, mainly because it has been difficult to compete with local investors in identifying modern, fully-let office investment opportunities.

A large number of funds have recently shown quite a strong interest in the Greater Copenhagen market.

We hope to see several of these investors succeed in making investments in Copenhagen, as this could eventually help to improve the market turnover, especially for the very large individual units. A

stronger turnover would benefit not only property developers, but also Danish institutional investors.

**Private equity funds expanding in the property market**

A significant number of private equity funds focusing on various property market segments have been established internationally in recent years. These funds attract speculative capital from both private and institutional investors and normally operate with expected internal rates of return of not less than 15%-20% over a five-to-ten year period.

Given this IRR requirement, they normally invest in property that does not meet traditional institutional investor criteria, such as developments, warehouse and industrial property or non-prime office property, and generally at a fairly aggressive gearing, which is often at around 70%.

In order to ensure sufficient critical mass when setting up in a new market, private equity funds often look for large, inhomogeneous portfolios with a potential portfolio discount in connection with the acquisition.

After having concentrated on a few, major European markets, especially France, in the past few years, private equity funds are now refocusing their demand on most European property markets. Sweden and Denmark are the main Scandinavian targets.

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