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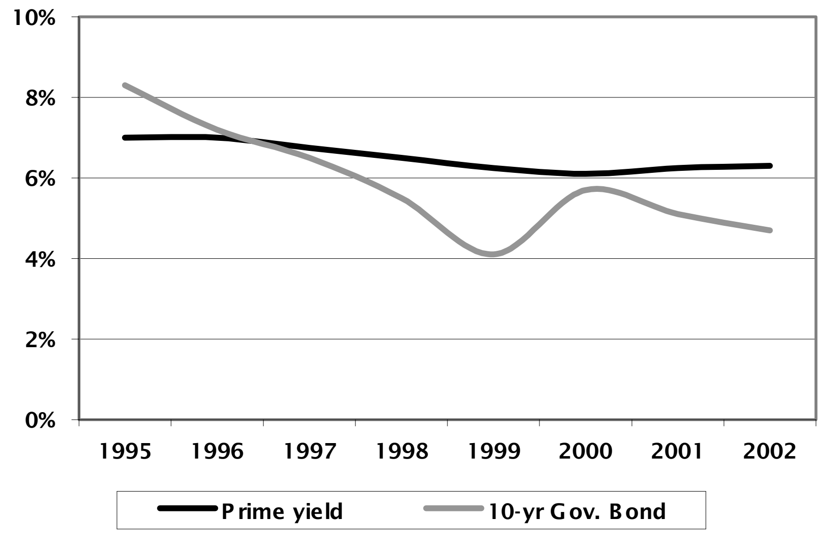
THE INVESTMENT PROPERTY MARKET

Widening yield spread leading to stronger demand for investment property

Stock market volatility and the low level of interest rates have resulted in considerable demand for investment property in 2002, especially for fully let units, as these offer a direct yield with a substantial premium to bond yields.

Prime yield and the 10-year benchmark bond yield



Source: Sadolin & Albæk

As shown in the figure above, the yield spread – the first year premium on prime investment property relative to the 10-year government bond yield – has widened during 2002 to currently stand at about 150 bp. This mark has only been surpassed once in recent memory: in 1999, when bond yields were extremely low.

Assuming that the long-term value growth of investment property equals inflation, overall returns on property investments are highly competitive relative to bond investments.

Risk premium also increasing for investment assets other than property

We must emphasise, however, that the required returns on other investment assets have also increased relative to government bond yields.

For example, this applies to corporate bonds, for which the premium return to low-rated bonds has widened substantially relative to the return on the benchmark bond.

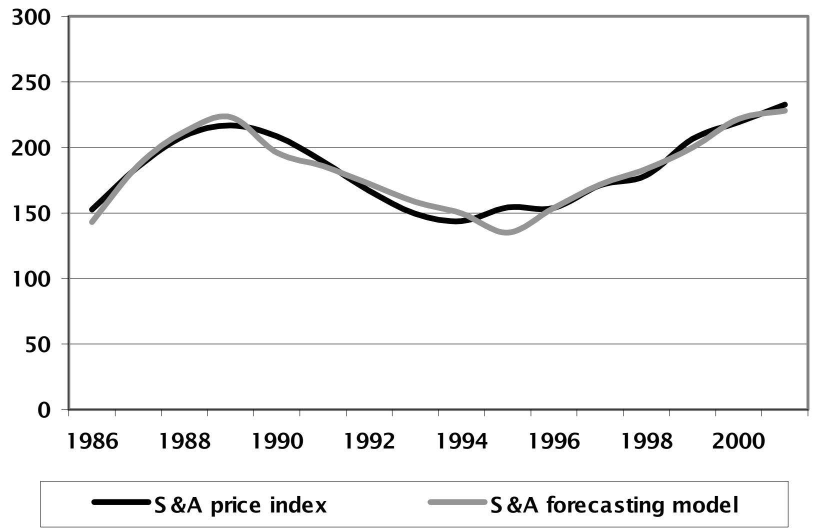
Stable, slightly upward trend forecast for investment property prices

We have developed a forecasting model to estimate price trends for commercial property in the Greater Copenhagen area by analysing the historical relationship between trends in commercial property prices and a number of macroeconomic variables.

The model systematically analyses the relationship between price and bond yield trends, development in GDP, employment figures for Greater Copenhagen and for Denmark as a whole, consumer spending, the net price index and the retail price index.

In the analysis, we found a significant correlation between trends in commercial property prices and employment at national level at a one-year time lag, and we have used that as the basis for our forecasting model.

The S&A price index and the S&A forecasting model



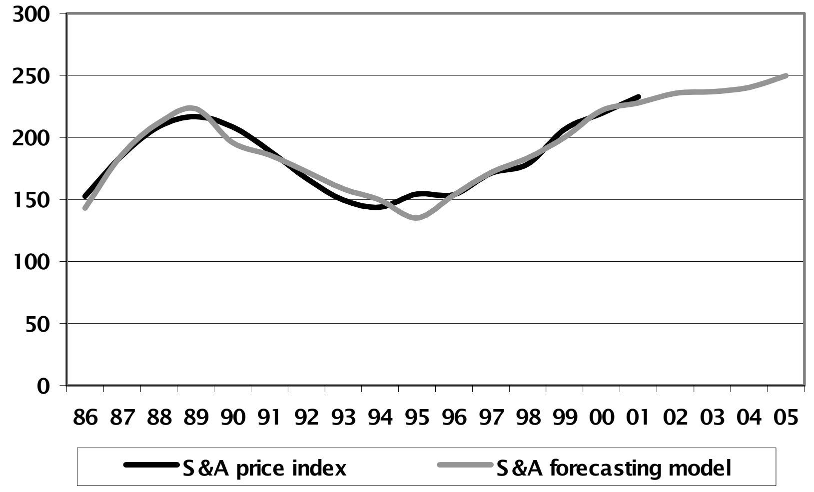
Source: Sadolin & Albæk

Accordingly, we can base our forecast for commercial property prices on a forecast for employment.

Using Danske Bank's forecast for employment, we have worked out a forecast for commercial property prices in the Greater Copenhagen region until 2005.

Based on Danske Bank's employment forecast for the next few years, the figure overleaf suggests a stable, slightly upward trend in commercial property prices in the years ahead.

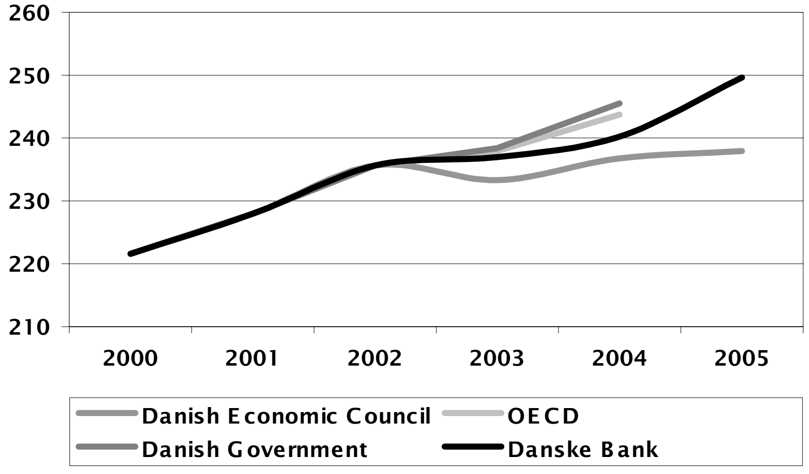
Forecast for commercial property prices based on Danske Bank's employment forecast



Source: Sadolin & Albæk

As any employment forecast is of course based on estimates, we have also prepared forecasts for commercial property prices on the basis of employment forecasts issued by the Danish Economic Council, the OECD and the Danish Government.

Price forecast based on alternative employment forecasts



Source: Sadolin & Albæk

As can be seen from the figure, the four employment forecasts give us reason to expect that, after prices stabilise in 2003, the commercial property market will return to favourable price trends in 2004 and 2005.

Demand remains strong for investment property providing a steady cash flow

The pre-letting volume of new head-office space has shrunk considerably relative to the level 12-24 months ago. In turn, this means that investors receive very few offers for fully let head-office developments.

We continue to record strong demand for such projects from both Danish and international investors.

With demand strongly outweighing supply, this indicated that prices would rise and that investors would lower their net initial yield requirements. This has not been the case, however. Instead, net initial yield requirements for prime investment property have been stable, perhaps even with a slightly upward trend. It would appear that the market players would not favour the poor supply of new head-office property triggering lower required yields and rising prices. As a result, the increased market internationalisation has boosted the general return on Copenhagen property investments, bringing it more in line with the returns available in other markets.

Increase in sale-and-leaseback transactions to be expected

Although we have seen an increase in the number of sale-and-leaseback transactions in recent years, with the sale being structured as an operating lease, the Danish market is not even close to the level of activity being recorded for this market segment in other European countries.

However, conditions on the capital markets lead us to expect a substantial increase in sale-and-leaseback transactions over the next 12-24 months.

The depressed stock markets have made raising equity capital more expensive, and relatively large increases in margins on bank loans have been recorded both in Denmark and in other markets.

That also makes operating sale-and-leaseback transactions involving property attractive to parties other than companies looking to reduce their balance sheets and enhance their capital strength or companies wanting to realise the hidden assets of their property portfolios.

For more and more firms, therefore, the higher costs of raising capital on both the equity and debt markets are making operating sale-and-leaseback transactions the cheapest way to raise capital. Of course, this applies especially to companies with prime-location, general-purpose property, as they will be especially attractive to traditional property investors looking for this type of fully let investment property with long-term leases.

Investor demand for depreciable property rising sharply

The market has seen a stable increase in demand from private investors for depreciable investment property in recent years.

This type of investment is often based on a high degree of debt financing. As a result, prices on depreciable property are strongly driven by the level of interest rates.

Although the rising margins imposed by the financial sector will mean that the lower bond market yields will not be fully reflected in bank lending rates, we believe that there may be a sharp increase in demand for depreciable investment property from private investors, including from the so-called 10-man limited partnerships, during the remainder of the year.

THE COMMERCIAL PROPERTY RENTAL MARKET

Weak activity in office rental market in the first half of 2002

The Greater Copenhagen office rental market saw weak activity in the first half of 2002. Many businesses that had been actively looking for new space elected to put off a decision on a new head office due to the uncertain economic conditions.

Turnover in the rental market increased during the late summer months, however, especially among companies requiring 500-1,000 m^2 of space. On the other hand, companies with greater space requirements have not become more mobile, as they generally have longer investment horizons than small businesses.

Office market vacancy rate appears to have stabilised

There were two main reasons for the substantial increase in the office market vacancy rate recorded in the second half of 2001.

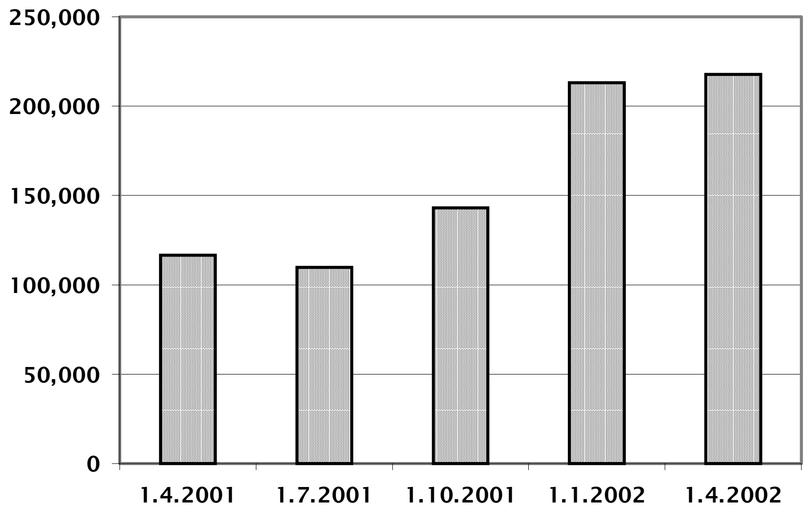
First of all, large volumes of CBD office space were vacated when the many new head offices under construction, several of which are on the city's waterfront, were completed. This should not have come as a surprise to the market: the leases for these new developments were signed 12-24 months earlier.

Secondly, the property market felt in the second half of 2001 the impact of the global crisis on the IT and telecommunications sector, which caused numerous businesses to revise their expansion plans, while others had to shut down their operations.

The vacancy rate in the office rental market appears to have stabilised in the first half of 2002.

The wave of relocation from the CBD to new waterfront head offices would appear to be over, at least temporarily. It would also appear that the property market is no longer feeling the impact of the "dot-com" collapses.

Vacant office space in the Municipality of Copenhagen



Source: The Danish Forest and Landscape Research Institute

As the figure shows, the amount of vacant office space in the Municipality of Copenhagen nearly doubled between 1 July 2001 and 1 January 2002. On the other hand, the amount of vacant space appears to have stabilised at just over 200,000 m^2 in the first quarter of 2002.

The vacancy rate in the Municipality of Copenhagen is now higher than the Greater Copenhagen average. This is especially because it is difficult to attract new tenants to the stock of older office properties in the CBD: office users are increasingly looking for modern and flexible office premises with parking spaces.

A few CBD office properties being redeveloped for other purposes

Consequently, it is highly encouraging to see that a few properties are being refurbished for other purposes. A large office property near the main square at City Hall is being converted into a hotel, and we have also seen a few initial examples of older CBD commercial property being redeveloped for housing purposes.

We believe that quite a number of small CBD office premises in what must be considered below average condition will be redeveloped for housing purposes in the next few years.

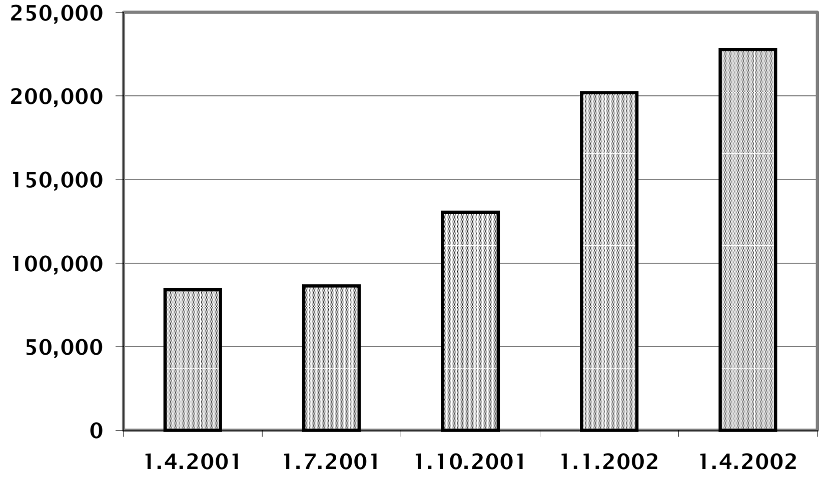
In that connection, the law prevents newly established residential units from being categorised as freehold flats if the property in question already contains residential units, and this obstructs the redevelopment of commercial premises for housing purposes. It seems incomprehensible that the government's housing package (described below) does not consider this quite obvious barrier to the conversion of office premises into residential units in property with both residential and commercial leases.

On the other hand, most property owners will not consider it feasible to convert large office properties that have been renovated within the last ten years into residential units. Such property is often valued at prices of about DKK 17,500 per m^2, based on expected net rent of, say, about DKK 1,200 per m^2 and a net initial yield of 7%. The combined investment in such redeveloped residential units is often too high, if the conversion costs including VAT run to, say, DKK 7,500 per m^2 and the owner also has to pay a latent VAT liability when converting the property.

Office vacancy outside the Municipality of Copenhagen has almost trebled

There have been even more dramatic changes to office vacancy rates in the rest of the Greater Copenhagen area: the amount of vacant office space exploded from about 85,000 m^2 in the spring of 2001 to about 225,000 m^2 only a year later.

Vacant office space in Greater Copenhagen area outside the Municipality of Copenhagen



Source: The Danish Forest and Landscape Research Institute

It should be noted, however, that although this looks like a dramatic increase, the vacancy rate is still relatively low at about 3%.

Apart from a few office districts in peripheral locations whose vacancy appears to be of a structural nature, even a weak economic upturn would, in our view, help to absorb the office vacancies relatively fast.

Low vacancy

Rising vacancy rates are also being detected in warehouse and in-

rates, but trend towards structural vacancy in older warehouse and industrial property

dustrial property, although they remain at a very low level.

Vacancy rates, Greater Copenhagen area industrial and warehousing facilities

Source: Sadolin & Albæk

Vacancy rates in Greater Copenhagen industrial and warehousing facilities have doubled in recent years, but remain very low compared with the overall property stock.

It should be noted that with a large proportion of warehousing and industrial property being owner-occupied, there may be more space vacant than what is actually registered as being to let.

Even with the low vacancy rates for industrial and warehousing facilities, it is important to keep in mind the fact that re-letting times have risen considerably for older industrial property. We see this as an indication of structurally driven vacancy for older industrial space that does not meet demands from modern businesses for rational production and logistics facilities.

THE MARKET FOR RESIDENTIAL RENTAL PROPERTY

Government housing package fails to modernise outdated rental regulation system

For several years, Greater Copenhagen has suffered a severe shortage of vacant housing. Unless the urgent need for new residential units is accommodated, the housing shortage could become a growing bottleneck for demographic and, in turn, business and commercial developments.

Therefore, the government's housing report entitled "More homes – growth and renewal in the housing market" attracted considerable advance interest.

We find it disappointing – but hardly surprising – that even a right-of-centre government does not dare modernise the outdated rules for rental regulation in the old residential housing stock. The government has no plans to eliminate the rental regulations currently applying to older residential rental property, even though the low rent payable in older residential property is a key contributor to the lack of mobility in the residential market.

Rental restrictions are the main reason why senior citizens and singles choose to retain their large rented homes in the older housing stock, even when they would be better off living in smaller, more modern and contemporary housing. The problem is that many 150-200 m^2 flats in the older housing stock cost less than modern 70-80 m^2 flats designed with senior citizens in mind.

Rents in older residential property not based on direct yield

The hopelessly outdated rent regulation system applying to the older housing stock limits the legally obtainable rent to between one-third and one-half of the rent obtainable in a non-regulated market, which means that older residential rental property is often traded at net initial yields of between 1% and 3%.

However, most investors attach little importance to the net initial yield. Their key concern is the long-term rent potential that arises if flats are completely refurbished when vacated as the law then allows them to be re-let at market prices.

Rental regulations do not promote ongoing refurbishment of older housing stock

The current rules promote comprehensive refurbishment of dwellings that are vacated. On the other hand, they provide no incentive to owners to improve dwelling standards on a regular basis; quite the contrary, in fact.

A dwelling that is partly refurbished when vacated could have unfortunate implications for its owner: it could mean that the dwelling does not meet the requirements for the owner to comprehensively refurbish it and subsequently introduce a market-driven rent.

Older residential rental property being converted into cooperative housing

Although older residential rental property is being traded at historically low initial yields – in other words at high, and still rising, prices – the vast majority of this type of property, when traded, is still being taken over by tenants under their statutory right of first refusal and converted into cooperative housing.

At first glance, it is surprising that tenants who are protected against rent increases elect to take over and convert their dwelling to cooperative housing at prices that imply a significant increase in their housing expenses.

The explanation is quite simple, however: the pricing of cooperative housing is also subject to a maximum price system intended to prevent cooperative owners from making a profit on a subsequent sale of a cooperative residential unit. However, it is quite legal to base the valuation of cooperative housing on the combined value of the property, provided such value can be documented by way of a valuation provided by an official property valuer.

And it would appear that some official valuers are prepared to appraise cooperative property at prices that in our view are completely unrelated to the actual value of the property as rental property. This means that shortly after a property has been re-categorised from a rental to a cooperative property, its official value could be substantially higher than the actual purchase price. Tenants who for years have enjoyed paying a cheap rent can then sell their cooperative flats and realise a substantial – and tax-free – gain.

While it was never the intention that the rules would allow such transactions, this nevertheless shows that price regulation mechanisms introduced by undoubtedly well-meaning politicians cannot disable the market mechanism.

Government proposing tax deductions for new housing developments

In our view, the Government's housing package contains an important proposal that could boost the development of new rental housing.

The Government intends to propose introducing tax deductions on housing developments corresponding to the cost of construction. From our information, it would appear that both institutional and private investors will be eligible for the tax deduction, which will be available in the tax year in which the operating permit is issued.

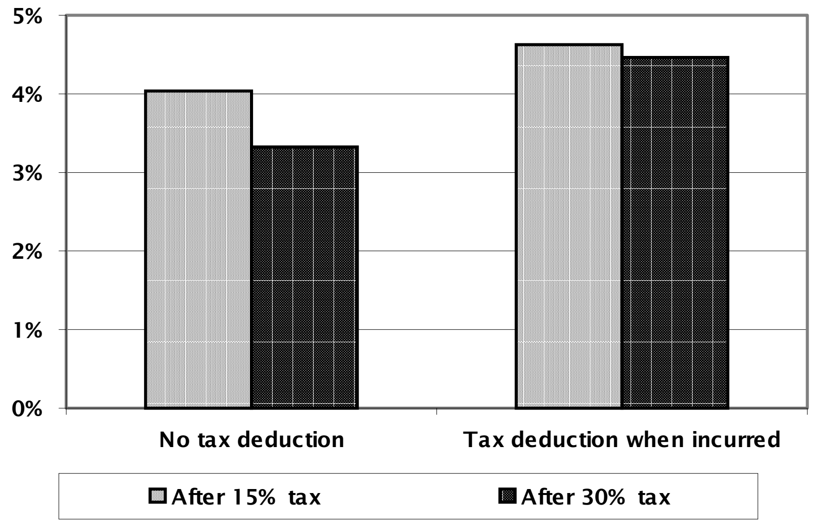
The Government proposes to allocate a total of DKK 1 billion annually from 2003 to 2007 for this purpose; the bill will also fix a maximum construction cost both per square metre and for each flat.

Although the Government's proposal does not directly take this into consideration, we would assume that the tax deduction would be subject to retaxation of recovered depreciation on a subsequent sale of the property.

Proposed tax deduction would lift the post-tax net initial yield by about 60 bp for institutionals and twice that for corporations

If we assume that a new residential property generates a net initial yield of 4.75% before tax, the first year's return on capital invested after tax is just over 4.0% for institutional investors subject to 15% taxation. For corporations (subject to 30% taxation) the first year's return after tax is about 3.3%.

Net initial yield on new residential rental property



Source: Sadolin & Albæk

The chart above shows the effect on the first year's net initial yield after tax on the capital invested if construction costs are deductible in the year the permit is issued. In our estimates we assume that there is no tax deduction for the investment in land, which is assumed to be 15% of the overall investment.

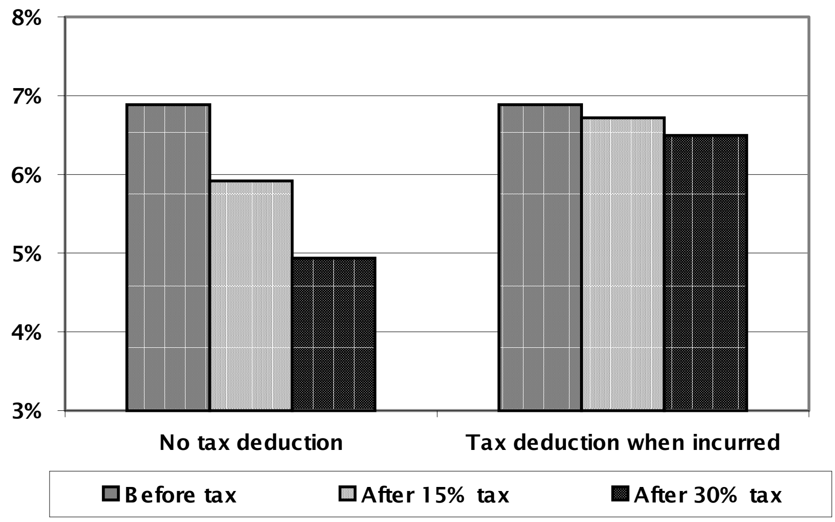
If we assume correctly that the investor will be subject to retaxation of deductions on a sale of the property, the long-term investment consequences of this proposal for deductibility of development costs when incurred should be carefully analysed. To this end, we have prepared an analysis of the internal rate of return on an investment in residential rental property over a 20-year horizon.

For this purpose we made the following assumptions:

- 15% of the investment relates to the land, 85% to the building.
- There is a net initial yield of 4.75% before tax.
- There is a 2.25% annual increase in net operations.

- The property is fully let during the analysis period and no investments are made during the period.
- The property is sold at the end of year 20 at a price providing the buyer a net initial yield of 5.5%.
- Tax deductions are subject to retaxation on a sale, and the seller is liable to pay property gains tax.

Internal rate of return on investment in residential rental property after 20 years



Source: Sadolin & Albæk

Based on these assumptions, the internal rate of return on the investment over a 20-year investment horizon is almost 7.0% before tax. For institutional investors, the tax deductibility improved the IRR after tax by about 80 bp. The benefit to corporations is about twice that, as the IRR after tax increases from just below 5.0% to about 6.5%.

We have good reason to expect that tax deductibility of development costs when incurred will serve to boost rental property developments in the private sector and it will be extremely interesting to see how these considerations manifest themselves in a bill.

We would be particularly interested to see whether the maximum deductible construction cost to be introduced will in fact make it possible to build new residential property in the Greater Copenhagen region, where both land and construction prices have consistently remained higher than in the rest of the country.

Another very interesting aspect is whether the proposed scheme, which will apparently have an overall investment limit of DKK 1 billion per year, will actually be open to everyone or whether the administrative requirements will be designed to favour certain builders, types of project or geographical areas.

INTERNATIONAL PROPERTY MARKETS

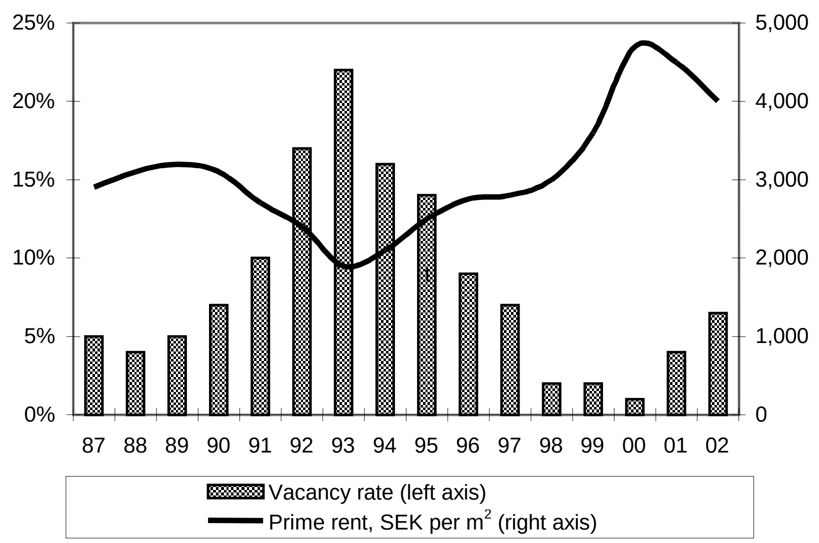
The international report in this issue focuses on the office markets in Stockholm and Oslo.

Six-fold increase in Stockholm office vacancy rate in past two years

The Stockholm office market is highly volatile. The general vacancy rate rose from less than 5% to more than 20% in 1988-1993, only to plummet in the following years and end at 1% in 2000. Over the past two years, the vacancy rate has again risen drastically, partly as a result of the severe impact of the crisis in the IT and telecommunications sector.

As a number of new office developments are due to be completed in 2002-2003, the vacancy rate should be expected to rise above its current level of 6.5%. In particular, office vacancy will reach substantial proportions in the Kista area, where numerous IT and telecommunications businesses are located and which has seen a large volume of new development activity.

Vacancy rate and prime rent, Greater Stockholm office market



Source: NewSec Analys AB

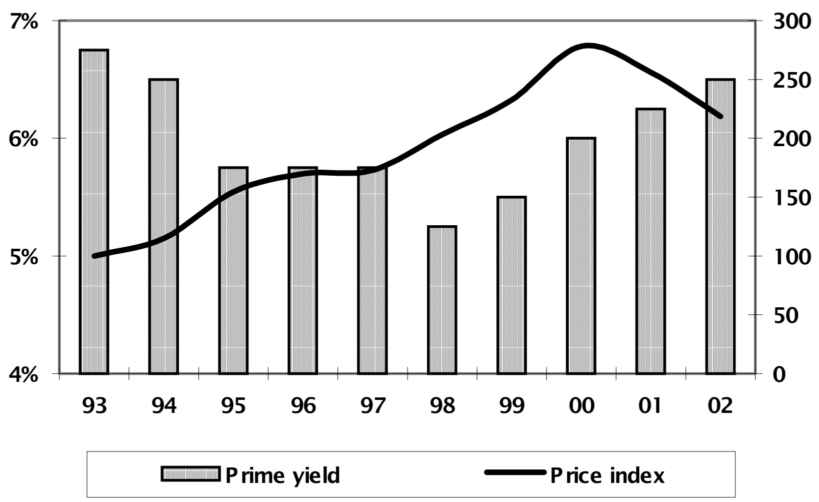
Prime rent has dropped 15% in two years

The prime office rent in the Stockholm CBD has dropped by about 15% since peaking in 2000, but it still remains above the level recorded during the previous boom cycle. However, it should be noted that the CBD prime office rent, which is currently at SEK 4,000 per m^2 per year, is substantially higher than rent levels in decentralised areas, where modern office space can be leased at half the rent being asked in the CBD.

Prices on Stockholm office property down by 20% since 2000

In a historical perspective, the current prime yield on office property of about 6.5% is relatively high and the required yield has risen by 125 bp since 1998.

Left axis: prime yield; right axis: price index



Source: NewSec Analys AB

Due to recent years' rising required yields and falling rent levels, prices on office property at Stockholm CBD locations have dropped by about 20%.

On the other hand, the current drop has only eliminated a small part of the gains recorded since the 1993 trough.

As shown in the figure above, office property prices are still double the 1993-level even with the decline of the last couple of years.

Oslo has also experienced rising vacancy and lower office rents

Office vacancy rates have also risen in Oslo, although not to the same dramatic extent as in Stockholm. The vacancy rate is now at about 6.5%, up from around 3% two years ago, but it is expected to stabilise at this level.

The weakened demand for office space has depressed rent levels. Over the past 12 months, office rents have dropped by about 15% and are currently at around NOK 2,200 per m^2 per year. In other words, office rents are back below the level recorded during the boom cycle in the late 1980s.

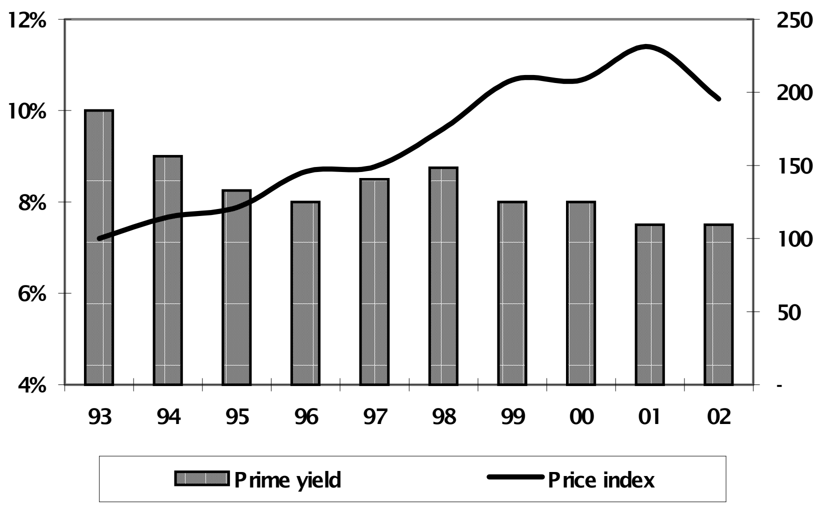
Office rents in Oslo (annually in NOK per m²)

Source: DnB Næringsmegling AS

Required net initial yields on Oslo investment property stable

The 100 bp drop in long-term interest rates during 2002 has kept required net initial yields stable in spite of the increased vacancy and lower rent level.

Left axis: prime yield; right axis: price index



Source: DnB Næringsmegling AS

As appears from the figure above, the current required prime yield on Oslo office property is about 7.5%.

Although this is fairly high by western European standards, it should be seen in relation to the fact that Norway has higher short- and long-term interest rates than the other countries of western Europe, both in- and outside the eurozone.

Investor demand for investment property with long-term leases is quite good at the moment, driven by the lower interest rate level. On the other hand, there is currently a widening spread between the sellers' price expectations and investors' expected return when it comes to the more difficult to let non-prime, secondary location property.

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