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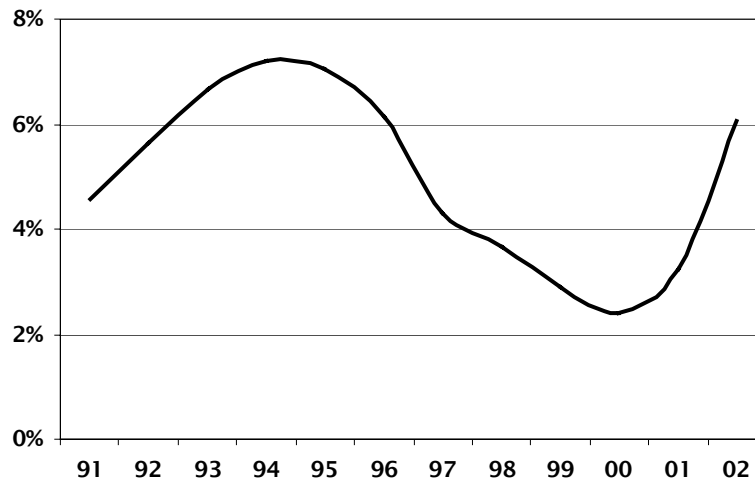
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## THE OFFICE PROPERTY LETTING MARKET

**Decreasing rental demand causing surge in office vacancy**

In recent years, office vacancy rates have been very low in the Greater Copenhagen area. Over the past 12 months, however, vacancies have surged.

Office vacancy rates in Greater Copenhagen



Source: Association of Property Owners in Denmark

As shown in the figure above, office vacancy is currently 6.1%, a 3.8 percentage point increase relative to 12 months ago.

This trend is attributable to several factors: First, rental demand has weakened, mainly due to the slowdown in economic growth. In addition, new developments have been massive during the past few years, and although these premises have been predominantly pre-let, tenants have left behind office vacancies.

Finally, the very dramatic slowdown in the IT and telecoms sectors has resulted in a fairly large amount of office space being sublet by companies that contracted major new developments a few years ago in reliance on continued growth.

**“Financial vacancy” significantly lower than actual vacancy**

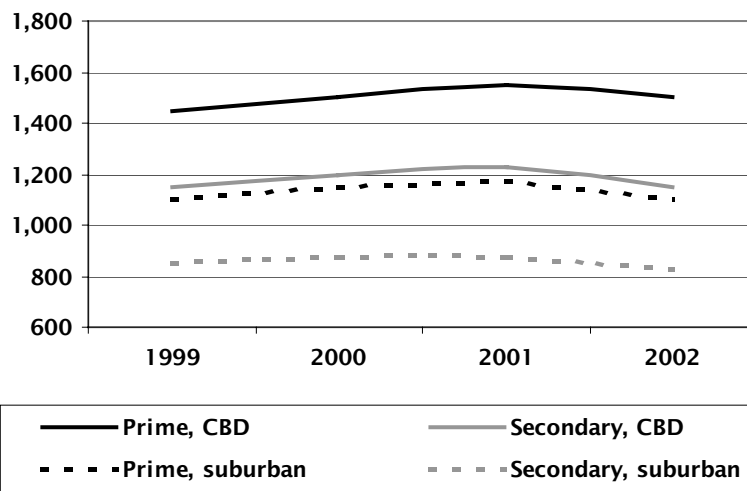
Although the increased vacancy is naturally reflected in the return on investor property portfolios, the rent loss inflicted on investors in today’s market is significantly less than what actual vacancy rates would indicate. A sharply increasing share of premises offered to let are leased premises which the tenant is not occupying and therefore seeks to sublet or assign. From the property owner’s perspective such premises are rent-bearing and consequently not classified as “financial vacancy”.

**Market rent down 3-6% on average over the past 12 months**

The increased supply of vacant office space exerts a negative pressure on rent levels in central Copenhagen and peripheral areas.

The prime rent for new waterfront office space is relatively stable at around DKK 1,650-1,700 per sqm p.a. plus operating costs, while average rents have dropped by 3-6% over the past 12 months.

Average office rents (DKK per sqm p.a.)



Source: Sadolin & Albæk • ONCOR International

As can be seen from the figure above, the current market rent for office space is now by and large back to the 1999 level.

We expect the market rent to stabilise at the current level, and we therefore do not anticipate a further general decline in the market rent for office space, even with a continued economic slump for the rest of the year.

**Current market offering prospective tenants very good opportunities for leasing premises at competitive rent levels**

In the current office rental market it is not uncommon for premises to be offered to let on very competitive terms relative to the general market level.

Suppliers of modern office space can currently be divided into three main categories: Property developers offering built-to-suit projects, property owners offering vacant premises in existing property, and existing tenants offering excess premises to sublet.

Rent terms for new developments reflect the price of land, construction costs and expected proceeds from a sale of the project.

If a project cannot be pre-let at a rent making it sufficiently profitable for the developer, the project will not be contracted.

The rent for existing floorage of the same quality as new developments is somewhat lower in the current market. In the current market, existing property can only attract tenants if rents are competitive relative to rents charged on new developments.

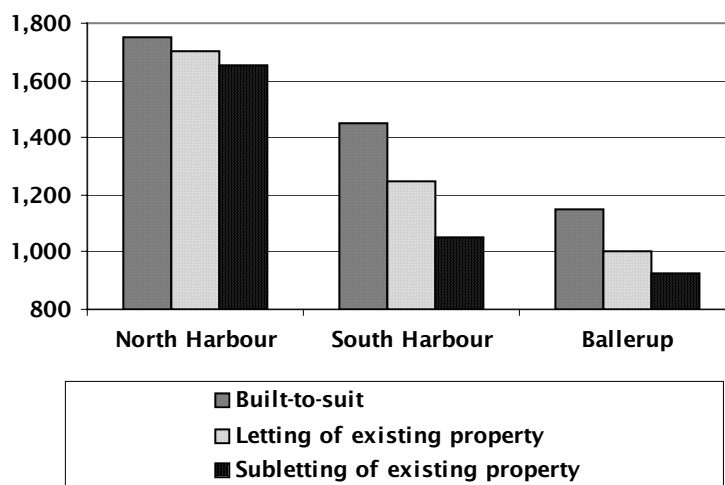
In subleases, however, it is possible to obtain very competitive lease terms as compared with the general market.

Companies that downsize or close activities for which they have long-running interminable leases are more interested in subletting their excess space quickly than they are in optimising rents. It is more important for such companies to cut their losses, for which provisions have typically already been made, by quickly entering into subleases than to wait for tenants willing to pay a higher rent.

The best opportunities for prospective tenants naturally lie in the sub-markets in which long-term leases for new developments have been made in the past few years with international IT and telecom businesses.

This applies especially to *Sydhavnen* and *Lautrupparken* in Ballerup, which are characterised by a high concentration of new developments and an overweight of high-tech businesses.

Office rents (DKK per sqm p.a.) in selected areas



Source: Sadolin & Albæk • ONCOR International

The figure above shows the current rent levels for modern office

space in three selected Greater Copenhagen areas.

The rent level for subleases in the waterfront districts north of central Copenhagen is only some 6% lower than the rent level for new developments. Sublease rents in *Sydhavnen* and *Lautrup-parken* are more than 20% lower than the level for built-to-suit projects.

The premises offered to sublet will naturally be absorbed when the economy regains momentum, and as the remaining period of interminability shortens, the gap between prices in the market for ordinary leases and the market for subleases will narrow.

Office users in search of modern office space at competitive rents currently have extremely good prospects, which might well have vanished in just one or two years' time.

## THE PROPERTY INVESTMENT MARKET

### Steady, healthy demand for office property

A few leading Danish institutional investors have, in practice, introduced a temporary freeze on property investment. The main reason is that due to the fall in share prices they currently consider themselves overweight in property relative to their strategic goals in respect of overall asset allocation. However, there is also some indication of general market uncertainty.

Nevertheless, investor appetite especially for prime investment property let on long-term leases remains steady and healthy.

Accordingly, a number of pension funds and insurance companies continue to show an interest in property investments that provide quite attractive yields relative to the historically low bond yields. The same applies to an increasing number of high net worth private investors.

### Investment property generated strong value growth in 2002

Sadolin & Albæk's 2002 property price index shows an average increase in investment property prices of approximately 8% in 2002 – a surprisingly strong figure considering the general economic situation.

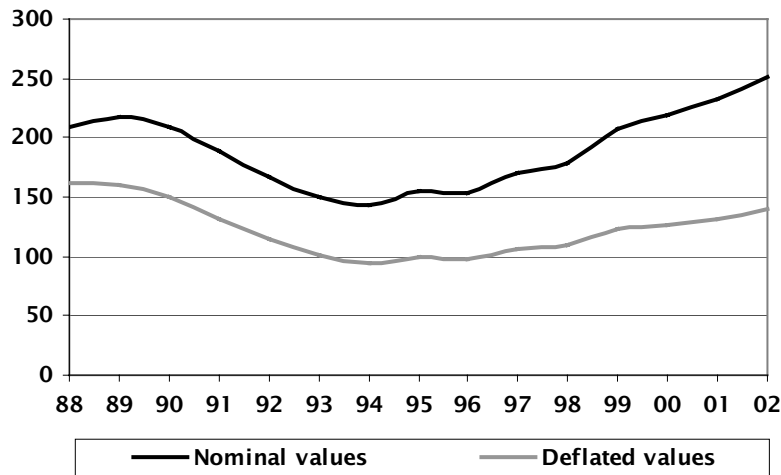
The average price increase covers substantial variations within the individual property segments, each of which respond very differently to economic decline.

Residential rental property is rightly held to be the investment property segment offering the highest degree of letting probability with rent levels not being particularly cyclical.

Accordingly, the trend in residential rental property prices is more

closely linked to the level of interest rates, and the very low interest rates have therefore triggered steep price increases in this segment.

S&A property price index (index 100 = Q3 1984)



Source: Sadolin & Albæk • ONCOR International

Next is retail property where the trend in rent levels is naturally more cyclical. But this segment also benefits from a high degree of letting probability. In addition, domestic consumption is expected to grow at a fair rate in 2003. As a result, retail property prices also rose nicely in 2002.

Conversely, the more cyclical property segments, such as office and warehousing/industrial facilities, recorded considerably weaker growth in value. The investors' yield requirements for these segments have not been lowered in step with the drop in interest rates, as re-letting and rent trends are considered to be more risky.

It is important to note in this connection that stagnating or falling market rents do not feed directly through to the actual rental income of a property.

As a result, a weaker rental market will therefore, all other things being equal, have an adverse impact on the value of a property, but the full effect will only feed through in the longer term.

**German prop-** For several years, a number of very large German open-ended

**erty funds, a presence to be reckoned with** property funds have closely monitored the Danish property market, especially the market in Greater Copenhagen.

The purchase by *DEKA Immobilien* of the new head office of the law firm *Plesner Svane Grønberg* in the northern waterfront district shows that the German funds are ready to turn interest into actual investments.

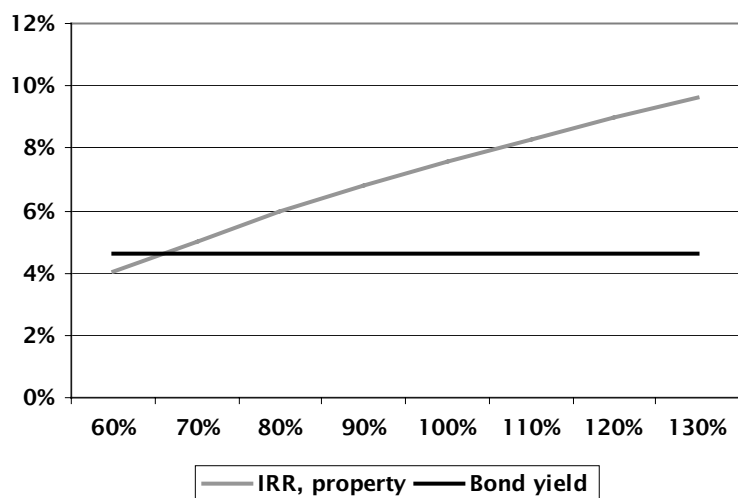
Although only a very limited number of properties and property projects match the German investors' demands in terms of size and quality, we expect other large and medium-sized German funds to follow suit.

We do not believe, however, that the potentially significant foreign demand for Danish investment property will in itself result in declining net initial yield requirements. The German property funds view the Danish market as an interesting but, from a European perspective, small property market, in which yields must be competitive relative to the investment opportunities available in other markets.

The interest of these investors in Denmark will therefore have a significant positive impact on market saleability and liquidity, but it will hardly have any noticeable effect on general price levels.

**High overall property investment return, even without expected value increases** The net initial yield on prime investment property, let to a prime tenant on a 10-year interminable lease, is currently about 6.5%, approximately 200 bp above the risk-free rate of interest provided by the 10-year benchmark government bond yield. To this should be added that the regular indexation of rents increases the yield, making the overall return on property investment quite attractive even without taking account of a possible appreciation.

**IRR as a function of the end value after 10 years as a percentage of initial value**



Source: Sadolin & Albæk • ONCOR International

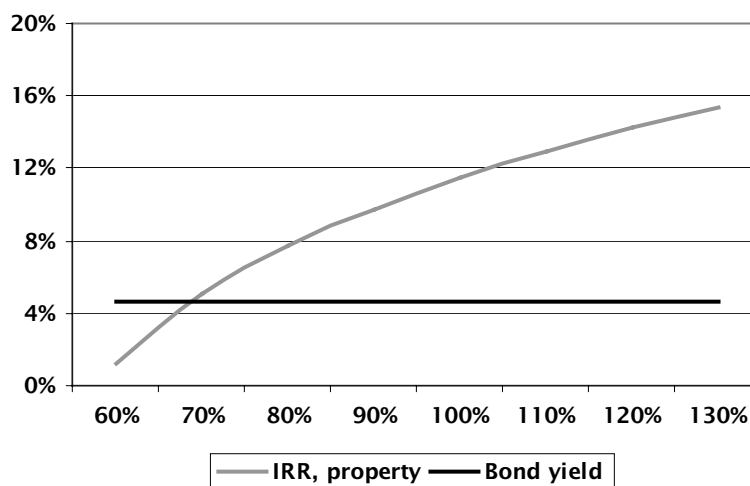
The figure above shows the internal rate of return (IRR) on a property investment over a 10-year horizon as a function of the property value at the end of the period analysed as a percentage of the purchase price. The calculation is based on the assumption that the investment is made at a net initial yield of 6.5% and that indexation equals 2.0% p.a.

As can be seen, the investment will generate a pre-tax IRR of around 7.6% p.a., provided the property value after 10 years is equivalent to the purchase price. If the property value increases by the assumed rate of inflation of 2.0% p.a. or a total of 22% over 10 years, the pre-tax IRR will be approximately 9.1% p.a.

Even if the property value drops to two-thirds of the purchase price, the overall pre-tax return will still be on a par with the risk-free interest rate.

If the investor chooses to debt finance the purchase with say 60% of the total amount invested as a bullet loan with a maturity of 10 years and a fixed rate of interest of say 5.75%, the overall return on the capital invested, that is 40% of the purchase price, will naturally be much more dependent on the appreciation of the property.

**IRR (60% debt financing) as a function of the end value after 10 years as a percentage of initial value**



Source: Sadolin & Albæk • ONCOR International

As shown in the figure above, this type of debt financed investment will generate a pre-tax IRR of around 11.5%, provided the property retains its value.

If the property value increases by the rate of inflation of 2.0% p.a., pre-tax IRR will be as high as 14.5%.

**Most investment property offered for sale failing to meet institutional investor requirements**

The supply of prime office property investments is declining as a result of the sluggish rate of new office developments. However, we have recorded a quite large supply of existing property, typically let on short-term leases. Nevertheless, the weak rental market has made institutional investors focus even more on long-term leases with tenants of indisputably good financial standing. The same applies to a certain extent also to private investors.

By contrast, risk tolerance remains somewhat higher in the large property companies that accept short-term leases if they are confident that property location and quality ensure a good re-letting potential in the long term.

As regards office property in more peripheral locations, current investor demand could well be described as weak. Accordingly, turnover in this type of property, which attracts only few, more speculative investors, is not high, and we have seen a re-emergence of the trend that characterised the crisis from 1992 to 1994 when deals were often based on seller financing, seller guarantees or property swaps.

**Lease indexation clauses affect net initial yield** The majority of business leases in Denmark contain provisions on annual rent adjustments in step with the percentage increase in the net consumer price index, often with annual minimum or maximum indexation clauses.

In an economy where some analysts are not ruling out an almost Japanese-like scenario with no inflation to speak of, an increasing number of investors attach great importance to annual minimum indexation clauses.

Assuming a property is purchased at a net initial yield of 6.5% and sold 10 years later at the same price, and assuming that the rent is adjusted annually by the net consumer price index, the investment will yield a pre-tax IRR of 7.25% p.a. over the 10-year period, provided the rate of inflation remains at 1.0% p.a.

However, if rents are adjusted by a minimum rate higher than the assumed annual rate of inflation, investments will naturally generate the same yield over the investment period, even if the property is purchased at a lower initial yield. If a lease provides annual minimum indexation of 2.5% p.a., the property will consequently generate an IRR equivalent to the one stated above if investments are made at a net initial yield of 6.12%.

**Foreign investors prefer property with minimum rent adjustments** The Danish property market is one of the few markets in which investors find rent indexation in commercial property equivalent to the rate of inflation and annual minimum indexation.

We believe that an increasing number of foreign investors are aware of the benefits to be had from such provisions and especially from the fact that in a market characterised by low inflation this type of property will generate an increasing current return, at least during the period of interminability.

**Retail property investment market dominated by private investors** The retail property investment market, high street property in particular, is increasingly dominated by private investors, including limited partnerships.

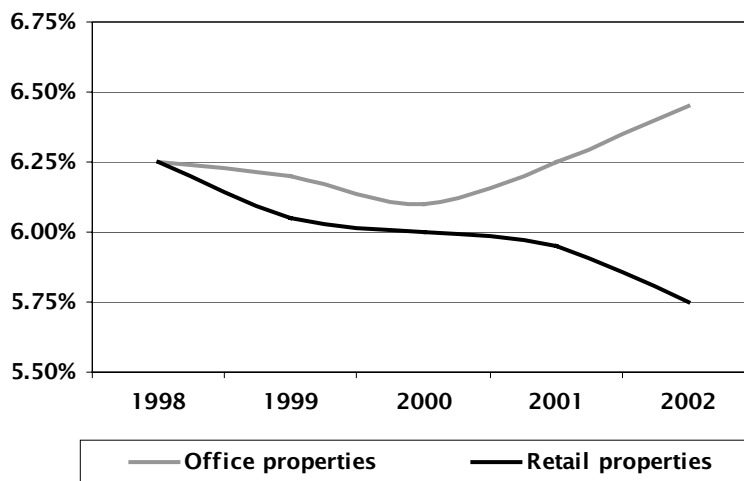
Despite very handsome turnover figures in high street property, we recorded no investments in this market by institutional investors, property companies or foreign investors in 2002.

On the contrary, a number of foreign investors that have previously been active in the Copenhagen market, including *Redevco* and *PRICOA*, reduced their high street property portfolios in 2002.

Limited partnerships often operate with a very high degree of loan financing, and it should hardly be surprising that lower interest rate levels have reduced initial yield requirements. The net initial

yield requirement for prime property has dropped 25 bp to 5.75%, and we have seen even lower yields in a few single transactions.

Net initial yield for prime office and retail property



Source: Sadolin & Albæk • ONCOR International

Yield requirements for prime office and high street retail property were previously almost identical, but today high street retail property is traded at net initial yields significantly lower than the level recorded in the office property market.

It might be claimed, and with some justification, that it is not a healthy sign when the high street retail property investment market is completely dominated by a single group of investors whose investments are, moreover, motivated to a very large extent by tax considerations.

However, we do not believe this market to be on the verge of serious crisis.

Letting probability for prime retail space is very high, and taking into account that private investors normally opt for long-term fixed-interest financing, we consider the risk of liquidity problems and forced sales rather unlikely, even if the market should weaken further from its current state.

**Prime retail property turnover set to decline dramatically in the com-** We do not foresee significant increases in prime retail rents in the short or medium term, and taking into account that current net initial yields on high street retail property are at historical lows, there is little likelihood of any major value increases for this type of property in the years ahead.

ing years

If depreciable property is later sold at a price exceeding the tax depreciated value, investors will be subject to retaxation of any tax depreciation made.

This may have the result that although a property investment generates profitable operations and a regular cash inflow, a sale will trigger recovery of any tax depreciation in excess of the property equity. This “lock-up” effect, whereby selling an investment property triggers a tax charge exceeding property equity, may very well result in a dramatic reduction of the supply and turnover of retail property, especially high street retail property, in the coming years.

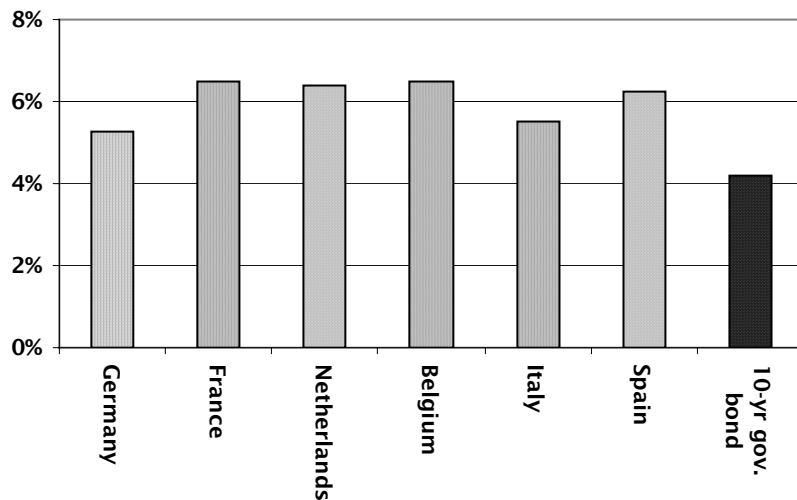
## EUROPEAN PROPERTY MARKETS

**Is property business still a local business?** The old saying that ‘property business is local business’ undoubtedly still applies. Nonetheless, it is quite remarkable that all major western European property markets currently display almost identical trends.

This is primarily attributable to the global phenomenon of increased economic integration, not least among the European countries. Countries throughout western Europe are experiencing a slowdown in economic growth, and demand for commercial space is correspondingly low. This drives up vacancy rates in virtually all markets, resulting in generally stagnating or falling rents.

Bond interest rates are low both inside and outside the euro zone, which means that property investment markets are generally quite strong, despite relatively depressed rental markets. Demand now focuses particularly on property with secure income, that is, property let to tenants of good financial standing on long-term leases, whose current return seems quite attractive given the present bond market yields.

**Net initial yield on prime office property**



Source: Sadolin & Albæk • ONCOR International

As can be seen from the figure above, net initial yields on prime office property in the major euro-zone property markets fluctuate within a relatively narrow band of between 5.25% and 6.5%. The premium return on property relative to the return on the risk-free rate of interest is currently 100 bp or more in all markets.

**Most investment markets dominated by private investors and investment funds**

Institutional investors worldwide are seeing their share portfolios depreciate. As a result, investment property portfolios now typically represent a much larger share of total investments than they did one or two years ago.

Consequently, some institutionals consider themselves overweight in property. Although they may be tempted by property markets offering competitive returns, these institutionals are not inclined to increase their exposure to property further.

On the other hand, we have recorded a strong demand from private investors and investment funds who are by nature not governed by strategic portfolio considerations.

In addition, private investors often make use of a very aggressive loan financing element. Since the financing rate is often lower than the initial yield on property investments, they are often able to achieve a very high and stable current return on invested capital.

**A number of international pension funds increasing their**

In recent years, the European property business has begun to apply benchmarking to ensure increased transparency in the market and more accurate performance measurements.

**property allocation** This, combined with the increasing recognition that investment property has a yield and risk profile which seems more attractive than the one offered by bonds and shares, has caused a number of international pension funds to allocate up to 20% of their total investments to property.

**Weak rental market but strong investment market in London** Developments in London, the largest and most liquid property market in Europe and perhaps worldwide, confirm the general trend of a weak rental market and a strong investment market.

In 2002, new office lets in London were less than half the 2001 level, and the office vacancy rate has increased substantially.

It is estimated that at least 50% of office vacancies in London are offered to sublet by existing tenants. Just as in Copenhagen, companies paying rent for unoccupied premises are more interested in quickly finding a tenant than they are in obtaining optimum rents. As a consequence of this and other things, the market rent for office space has declined more than 10% over the past 12 months.

**Foreign private investors dominating the London market** Activity in the investment market, on the other hand, is considerable. While the investment market for property let on short-term leases has suffered as a natural consequence of the weakened rental market, demand for property let on long-term leases to tenants of good financial standing remains strong.

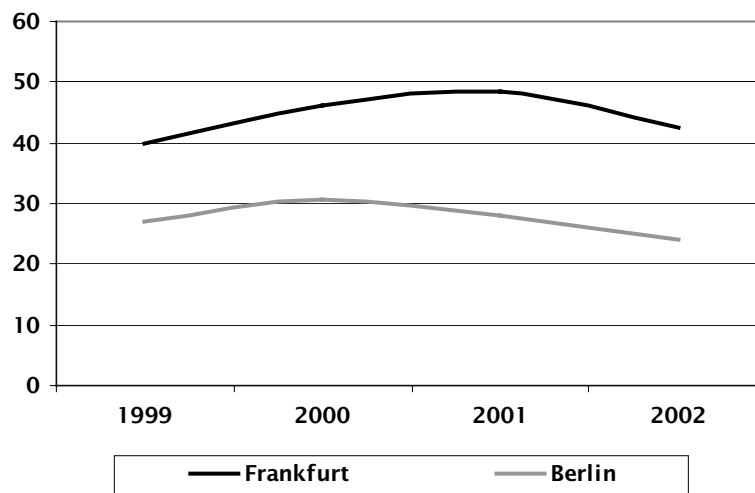
Due to the combination of low yields and ultra long-term leases, UK property investments may be loan financed at a very high loan-to-value ratio, often 80% or higher. Especially foreign private investors, including investors from the Middle East and the Far East, demand this type of relatively high-leverage investments that can generate a very high return on their invested capital.

**Weak economic climate in Germany increases vacancy rate and drives down office market rents** The German economy is on the verge of recession. Private consumption is very sluggish, and exports are suffering from the weakening of USD against EUR. Accordingly, economic growth is expected to be weak at less than 1% this year.

Over the past 12 months, office vacancy rates in Frankfurt have increased from around 3% to 9% of which more than half is let, but not occupied, office space offered to sublet.

As can be seen from the figure below, prime office rents in Frankfurt and Berlin have dropped more than 10% over the past 12 months, and considering the weak economic climate a continued fall in rents cannot be ruled out.

**Prime office rents in EUR per sqm per month**



Source: Sadolin & Albæk • ONCOR International

**Increased share of private savings invested in property**

Due to falling share prices and very low interest rate levels in recent years, the open-ended property funds (Offene Immobilienfonds) attracted a large share of private savings in 2002 as well.

In the first six months of 2002 alone, the total assets of the 19 open-ended property funds increased by approximately EUR 10 billion.

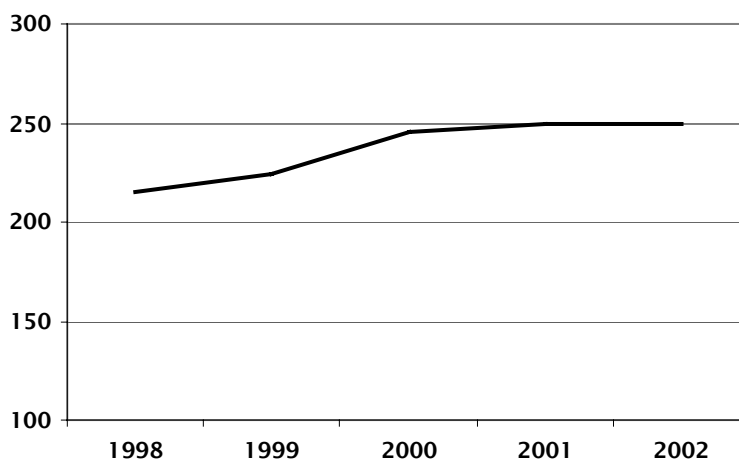
Although these funds invest in a variety of foreign markets, most recently including Denmark, they naturally retain a substantial part of their assets in their domestic market, especially in the largest and most liquid areas, such as Frankfurt, Berlin, Munich, Hamburg and Dusseldorf. Despite a weak domestic rental market, the net initial yield on prime investment property in these cities is relatively stable at around 5.25%.

**Brussels market deviates from general trend**

The property market in Brussels has also felt the chilling effects of the crisis in the IT and telecoms sectors. In some of the areas that have traditionally attracted high-tech businesses, such as Zaventem near Brussels Airport, office vacancy rates are now at more than 20%.

On the other hand, the office market in central Brussels, in particular Quartier Leopold, is distinctly stable with an office vacancy rate of less than 3% and stable rents.

Prime office rents in Brussels in EUR per sqm p.a.



Source: Sadolin & Albæk • ONCOR International

**EU enlargement provides the foundation for a stable market**

It is estimated that the EU enlargement by 10 new member states will in itself generate a need for more than 200,000 sqm of office space. Accordingly, there is clearly reason to believe that the office property market in central Brussels will continue its stable growth performance unaffected by the general economic climate in Europe.

Considering that prime office space in Brussels is traded at net initial yields of around 6.5%, a yield pick-up of 2.3% relative to the 10-year benchmark euro bond, investors would be well-advised to take an interest in this market, especially if they expect continued weak European growth rates and continued low interest rate levels.

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