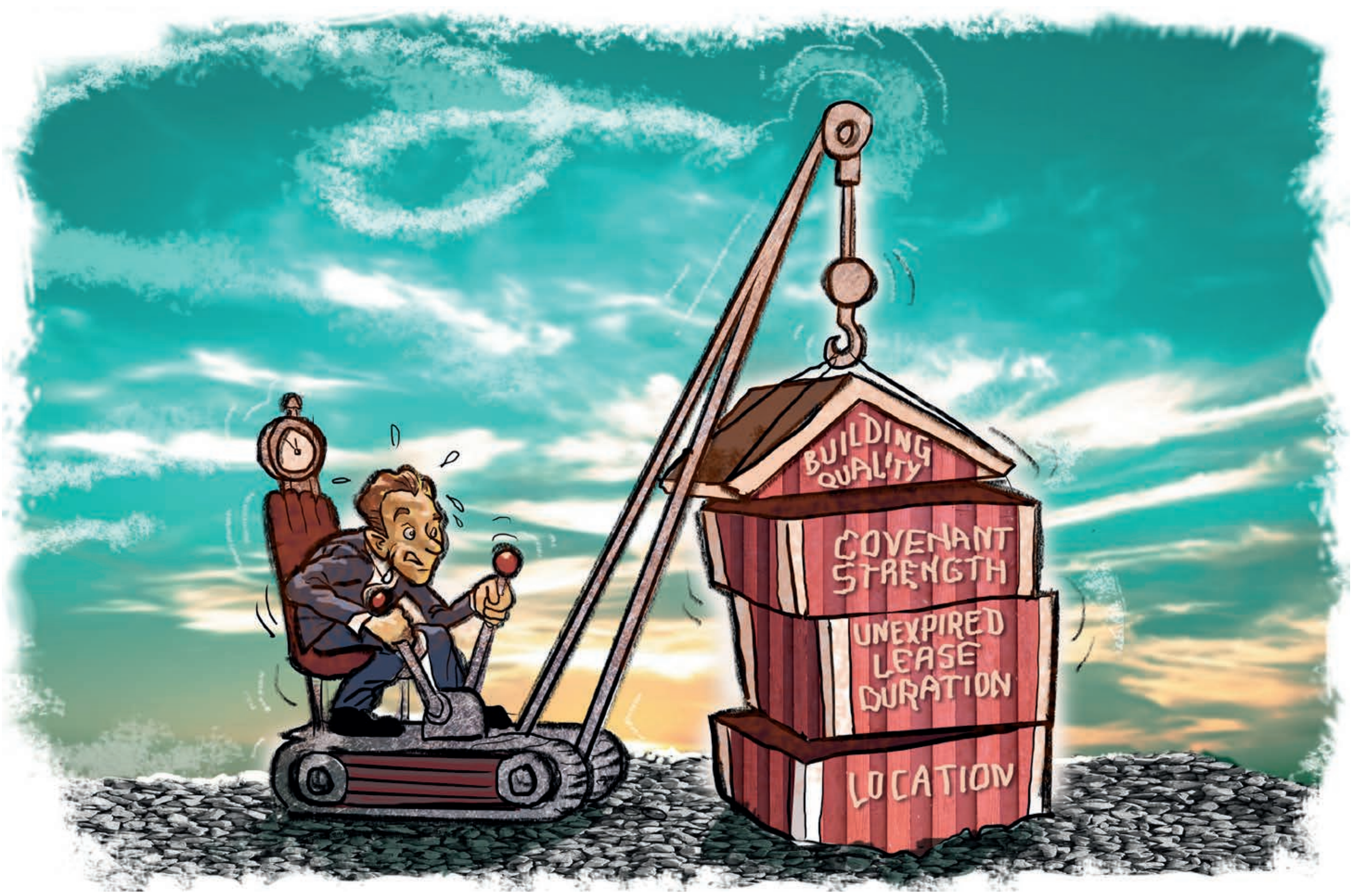
NORDIC INSIGHT

MARKET NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

DECEMBER 2016



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December 16, 2016

Dear Reader,

In this edition of Nordic Insight, we consider the components of real estate value and their implications for investment strategy by style. While the old adage of ‘location, location, location’ still holds true as a critical value driver, it is only one of four components that together constitute the concept of a ‘prime’ investment asset. These components are given different weightings through the cycle and vary with investment style.

Secondly, we explore the complexity of omnichannel retail from the perspective of the customer journey. Through this lens, it is clear that pitting online sales volumes against store sales rather misses the point; with omnichannel retailers dominating, it is the store’s overall contribution to a sale that counts, not the point of sale itself. However, we do need to understand how the role of the store is changing and extending, and both retailers and owners need to adapt their business models accordingly.

Finally, we present our view of the Kista rental market and the impact the performance of the Swedish telecom giant, Ericsson, might have on this Stockholm submarket. The outlook for Ericsson, one of the largest tenants in the Kista office market, continues to disappoint. The submarket is heavily exposed to the telecom company and, with vacancy levels already at 17%, the likelihood of an even more difficult leasing market is to be expected as layoffs are announced and implemented.

As always, we provide an update on the economy and the real estate markets in the Nordic countries.

Best regards

David C. Neil
CEO
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COMPONENTS OF VALUE DETERMINE DISTINCT INVESTMENT STYLE STRATEGIES IN SWEDEN

In an environment of sustained low bond rates, fixed-income investors have buoyed the already-strong investor appetite for prime real estate in Sweden in the search for yield. Such investors are seeking assets that closely resemble a bond structure and they therefore prize low-risk assets in terms of location and building quality that deliver a secure cashflow, effectively underwritten by the government or a multinational corporate for a defined period, usually of at least five years. Investor demand has outstripped the supply of product and compressed yields for prime assets in Stockholm's CBD to 3.75%. It has also resulted in real estate investors, including institutional investors, being somewhat priced out of the ultra prime market and being pushed up the risk curve. As they do so, different real estate investors are prioritizing the components of real estate value to best meet their investment objectives and style.

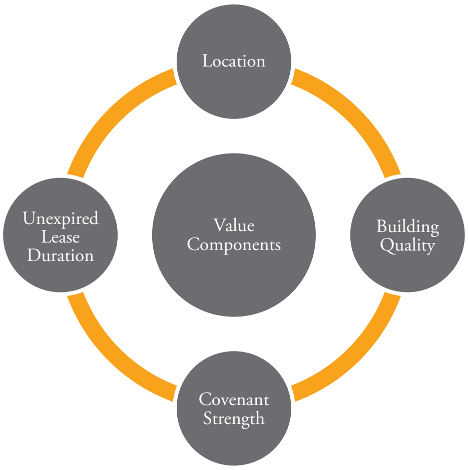
Reflecting variations in their underlying investment objectives, different types of investors place varying weights on each component of value, resulting in distinct investment strategies. Currently, this is manifest in a bifurcation of the Swedish real estate investment market. Income-focused investors are placing a higher value on longer-term income flows secured by public entities than on acquiring an asset in a Tier 1 city. Investors seeking capital growth in addition to an income return place a stronger emphasis on acquiring an asset in a strong location in a Tier 1 city.

The polarization in the locational focus embedded in these distinct income and growth investment strategies reflects differences in how these groups of investors have optimized the components of real estate value to achieve their risk-adjusted return targets. The old adage states that the three components of real estate value are location, location and location. Although a critical determinant of value, location is one of four interrelated value components. In understanding location in the context of these additional value components, the apparent divergence in the market is explained by a rational approach to minimizing risk against return objectives, rather than by a schism in how such investors are considering the performance prospects of principal and regional cities.

The Components of Real Estate Value

Real estate investments comprise four interrelated components of value: location, building quality, income security and income duration *(see Chart 1)*. From an occupier perspective, the rent a tenant is prepared to pay in an open market reflects the composite value of location and building quality, while the yield an investor is prepared to pay reflects the level of income that can be received against the risks associated with receiving that income. There is also an interplay between

Chart 1: Components of Investment Value at Asset Level



these two components, with the market often displaying a differential between the rent payable by a multinational corporate and an SME (small and medium-size enterprise) occupier for the same asset to reflect their impact on asset value.

The term "prime" is commonly used in real estate to describe the quality of an asset and, while there are some accepted norms in the market, it is awarded somewhat subjectively. It usually refers to a high-quality building, leased in the open market to a strong covenant on the longer-term lease length prevailing in that market in the best location within the area referred to, which might be a country, city or submarket. As the term "prime" can be used to describe the highest-quality asset within any geographic boundary or hierarchy, it is sometimes misinterpreted as solely reflecting location, rather than the building quality and financial attributes of the investment. This is not assisted by its use also to solely describe the quality of a location.

Location

Location is often described as "prime", "secondary" or "tertiary", with the labels being used to describe multiple hierarchies. For example, they may be employed to describe the regional hierarchy, with prime usually describing the principal city in a country, secondary the regional capitals and tertiary being used for smaller urban settlements. It is further used to classify submarkets within a city, with the CBD usually referred to as prime and other submarkets considered secondary locations. The term is also used within submarkets to describe the strength of a location within its local submarket. This results in a matrix of locational attributes that are not readily comparable between the different hierarchies. For example, the labels used to describe a prime location in a secondary submarket in the prime city cannot be directly compared to the labels employed to describe a secondary location in a prime submarket in the prime regional market city, or indeed a secondary regional market. Increasingly, the market is employing "Tier 1, 2 and 3" to describe regional locations.

Location is a major component of office value, as it provides accessibility to the marketplace in terms of clients and/or customers and impacts on the ability of the occupier to attract and retain high-caliber employees. The strongest locations are usually characterized by good public transport interchanges and other infrastructure. They are also marked by a higher density of buildings and volume of occupiers seeking to co-locate in a central marketplace.

The investor often has little influence over the quality of an asset's location, with the risk of locational obsolescence due to changing transport infrastructure that adds to the viability of new or competing locations being beyond the investor's control. Equally, other factors such as technological change can impact on the relative importance of location versus building quality in terms of occupational priorities. Historically, the prime CBD markets in cities are less exposed to locational obsolescence due to their scale and the evolution of transport infrastructure that has continued to evolve to serve them. This lower exposure makes them attractive to income-focused investors.

Building Quality

Building quality is an important component of value. While it is also described as "prime, secondary and tertiary", the terms "grade (or class) A, B and C" are now commonly employed to categorize and distinguish building quality assessments. Factors used to determine building quality gradings include design, quality and modernity of construction, space efficiency, sustainability and natural light ratios. Building quality is not static, but evolves over time with changing occupier requirements and innovation in design and building materials. This exposes assets to obsolescence and value depreciation, which, in turn, can provide investors focused on growth an opportunity to create value through refurbishment and redevelopment strategies that restore an asset's building quality grading.

From an occupier perspective, location and building quality comprise the key characteristics that determine the rental value they are prepared to pay for an asset. The utility value will vary between different occupiers and in a competitive market occupiers will trade-off location and building quality against occupation costs. Assets that have the strongest attributes will command the highest rents and in a weak market tend to benefit from stronger demand fundamentals as occupiers trade-up the quality of space achievable at their given utility of rent. In recent years, the escalation of rental levels and the scarcity of modern, large floorplate space within the CBD has resulted in a number of occupiers relocating to new premises in adjacent submarkets as they prioritize space efficiencies over location.

The locational and physical attributes underpinning occupier demand – and, in turn, rental levels – also impact on the financial characteristics associated with an asset. The covenant strength of the occupier translates into a credit rating for the income stream, while the unexpired lease term determines the duration of the income that is secured by the lease.

Covenant Strength

The credit quality of an occupier impacts on the probability of a tenant defaulting during the course of a lease. Public sector entities are considered to be a low risk as they are unlikely to default or fail to fulfill lease covenants. Similarly, multinationals are considered unlikely to default on their obligations under the lease, even if they cease to occupy the premises. SMEs are generally considered to have a higher probability of default and therefore represent a higher risk to the security of income.

Unexpired Lease Term

The unexpired lease term represents the period that the occupier is contracted to pay rent. The longer the lease, the more secure the certain income stream. Upon lease expiry the occupier might renew or may vacate, exposing the investor to potential void periods and costs of re-letting. Rents are also subject to the property cycle and therefore there is also a risk that current market rents, even if higher than the rent passing under the lease, may not prevail at lease expiry. This reversionary period following lease expiry is therefore usually attributed a higher risk weighting than the term of the lease.

Given that occupier demand is highest for assets with the strongest locational and physical attributes, owners are able to negotiate stronger lease terms including rent and duration. Equally, the occupying businesses able to derive a high utility value from occupying such assets tend to be strong covenants relative to those trading-off an asset's attributes.

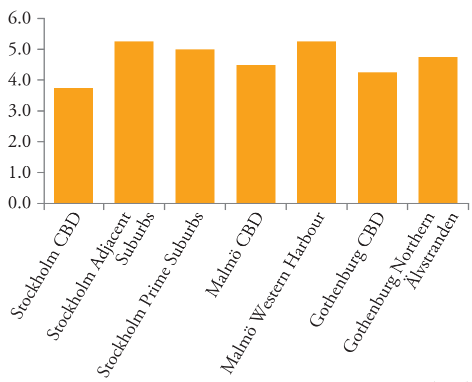
Value Components and Investment Strategy

Prime assets represent the strongest location and building quality attributes, which also reinforce the high quality of the financial characteristics that determine the security of the cashflow associated with prime investments. Thus, a modern office property in Stockholm's prime CBD market leased for a 10-year term to the government represents a low-risk asset with a certain income and, as such, closely resembles a bond. Given the 3.0% to 3.5% spread that such a prime asset would deliver over government bonds, it is perhaps unsurprising that fixed-income investors in search of yield are demonstrating a strong appetite for such product.

Real estate investors with higher return targets are pushed up the risk curve and must prioritize an asset's locational and building quality attributes against their impact on income security. Investors must decide whether they are prepared to lower locational attributes, building quality or income security. The pricing of different combinations of risk attributes is illustrated in a recent report exploring the potential to benchmark investment quality . Using published data, the yields associated with different combinations of risk attributes associated with location/building quality, lease length and covenant strength for UK regional and suburban office markets are used to demonstrate that different combinations of risks can be priced similarly *(see Table 1)*. The combination of risks that best match an investor's objectives will be selected and these will vary between income- and growth-focused investors.

Income-focused investors are more likely to compromise on location, while seeking to protect, if not strengthen, income security. In the current market, this has resulted in institutional investors seeking high-quality assets in the prime markets of Tier 2 regional cities in Sweden, with a stronger emphasis on securing assets with income streams underwritten by public entities. They are rewarded for the higher locational risk by a 50 bps spread with similar investments in Stockholm's prime CBD market *(see Chart 2)*. Alternatively, investors seeking capital growth are searching out investments in Stockholm's prime suburbs. Prime assets in these locations offer a spread of 125 bps over the prime CBD market or a prime asset, reflecting the lower income security associated with a multinational or national corporate and the perceived locational risk.

Chart 2: Prime Yield by City and Submarket, H1 2016 (%)



Source: JLL (2016)

Table 1: Regional and Suburban Office Capitalization Rates by Property Quality, Tenant and Lease Term (%)

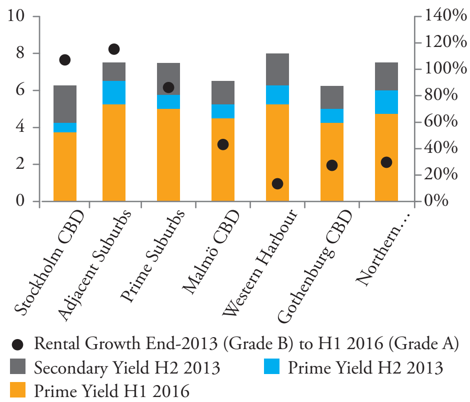
		Small Cos and Private Individuals			National and Strong Regional Business			Prime Occupier		
	Headline Rent	Lease Term			Lease Term			Lease Term		
		1	10	25	1	10	25	1	10	25
Prime	£30.00	9.25	8.25	7.50	9.00	6.50	6.00	8.75	5.75	5.00
Secondary	£22.00	11.50	9.75	9.00	11.25	8.75	7.25	9.75	7.50	6.25
Tertiary	£14.00	14.00	12.00	11.00	13.50	10.00	9.00	13.00	9.00	7.75

Sources: IPF (January 2016); Lambert Smith Hampton (April 2015)

Taking an additional risk on building quality and/or income security will increase the spread by a further 175 to 250 bps, depending on the asset. This provides investors seeking to deliver capital growth the opportunity to deliver their target risk-adjusted returns from actively managing such assets and restoring the building quality and, in turn, the income profile of an asset back to prime within the submarket.

As discussed previously, investors are not usually able to influence the location of an asset, with value-added opportunities related to location being centered on infrastructure developments improving a location's perceived quality. However, investors can improve building quality through refurbishment and redevelopment and, in turn, this improves income security by attracting tenants that are able to derive a higher utility value from the asset and pay a higher rental level. In turn, these occupiers will be of a higher credit quality and competition will enable a longer lease duration. Investors focused on capital growth will employ strategies in the markets that deliver the strongest risk-adjusted returns, net of construction costs and the required risk premium associated with the risk of market timing and implementation of the strategy *(see Chart 3)*. Given the high yield spread between Grade A and Grade B assets and the higher rental growth achieved in Stockholm's prime suburbs in comparison to Sweden's regional markets, supported by stronger underlying occupier demand, their focus on these submarkets rather than Tier 2 cities is also rational. To undertake this activity on a secondary asset in a Tier 2 city would increase the composite risk, but offer a lower return, given the lower rental growth experienced in the markets, reducing rental uplift and the lower potential for yield compression.

Chart 3: Example of Rental Uplift and Yield Change Achieved on Refurbishment Strategy End-2013 to H1 2016 (%)



Sources: Genesta (2016); JLL (2016); JLL (2013)

The polarization between the acquisition strategies of different sets of investors may be identifiable by location, but upon closer examination reflects their consideration of the four components of value in the prevailing economic environment. Institutional investors are prioritizing income security over location. Those seeking to deliver capital growth through restoring asset quality and, in turn, income security are prioritizing location over building quality. They are focusing on the markets that benefit from the strongest underlying demand, as evidenced in rental growth, and deliver the strongest risk-adjusted returns.

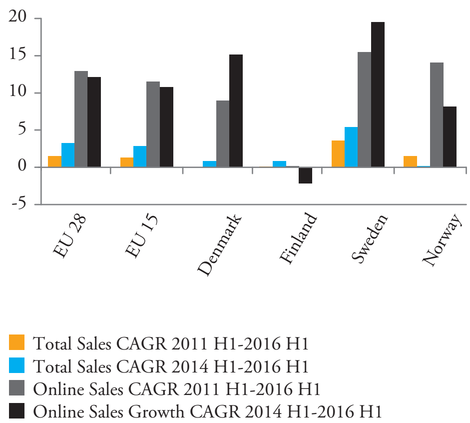
THE MULTIDIMENSIONAL ROLE OF STORES WITHIN OMNICHANNEL RETAIL

The growth of online retail sales in the Nordics and elsewhere is often compared to total retail sales and accompanied by media articles hyping up the death of the traditional retail store. While providing easy headlines, such analysis represents a rather simplistic understanding of the size and growth of online sales, the evolution of consumer purchasing behavior and the integration of technology with retailer business models. With the exception of Internet marketplace giants (most notably, Amazon and ebay), the strongest online retailers are established High Street store brands that are able to capitalize on their trusted brand value, store networks and distribution capabilities in order to better serve their customers. The customer base is not binary; customers browse and transact across multiple channels, changing their behavior with mood and shopping mode. Success in this omnichannel world requires retailers to integrate their physical and online operations to serve one customer. Within the omnichannel retail hierarchy, the role of the store is extended, rather than diminished. However, it also makes capturing the value of a store more complex.

Online Sales Growth in the Nordics

Given high cultural engagement with technology in the Nordics, it is perhaps unsurprising that the region has experienced strong online sales growth, well above the European average *(see Chart 1)*. While total sales have also experienced

Chart 1: Total Sales and Online Sales Growth (CAGR) 2011 H1-2016 H1 and 2014 H1-2016 H1 (%)

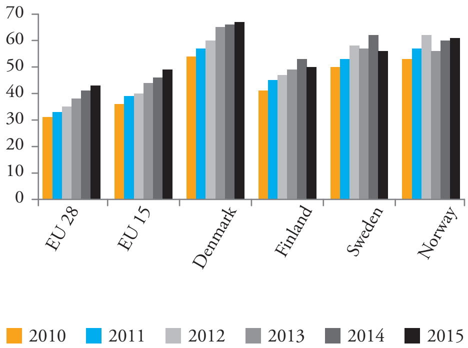


Source: Eurostat (2016). Data points taken as 3-month average

positive growth, it has been outpaced by the rate of growth in online sales, with the exception of Finland. However, the rate of growth appears to be slowing in many markets, while in Sweden higher growth rates also reflect buoyant levels of consumption. The trend of deceleration is also evident in the growth momentum across countries in the number of individuals making a purchase online in the last three months, with the exception of Denmark, which may reflect the wider retail recovery there *(see Chart 2)*. This suggests that the share of online sales to total sales is beginning to plateau.

When considering online sales data it is also important to understand what the data represents. The retail sales category is a broad umbrella and encompasses many sales and services that would not usually

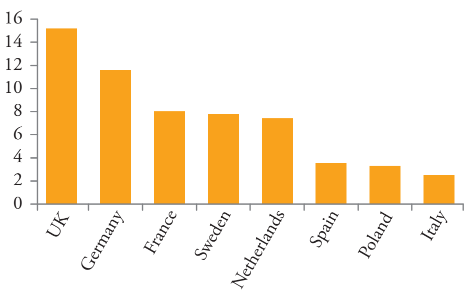
Chart 2: Transacted Online in Previous 3 months, 2010-2015



Sources: Eurostat (2016); ibuy survey

feature in the tenant mix of shopping centers and that might be characterized by a high online sales component; for example, betting shops, ticketing, insurance, etc. The Centre for Retail Research has compiled survey-based data that quantifies online retail sales across 11 countries, including Sweden, and uses a narrow definition of retail sales that better reflects retail activities within shopping centers *(see Chart 3)*.[1] However, it is worth noting that this data excludes food and beverage (F&B) services, which cannot be digitized, and that this estimate of the online share of total sales occurring in retail destinations may be overstated. Using this narrower definition of retail, Sweden's online share of retail sales is 7.8%, significantly lower than the UK and Germany.

Chart 3: Online Share of Retail Trade, 2015 (%)



Source: Centre for Retail Research (2016)

Moreover, in an omnichannel world considering the number and volume of transactions online against store sales is an oversimplification of customer buying behavior. Measuring online transactions merely records the point of sale, not the customer journey.

Changing Customer Behavior

The point of sale (POS) is one of many steps in a purchase decision. Consumers browse online and shop instore and *vice versa*. Indeed, the ability to undertake price comparisons, read reviews and solicit feedback from peer networks has arguably been one of the most important impacts of the Internet on retail, especially on pricing margins. The rapid growth of smartphones, tablets and the emergence of the Internet of Things (IoT) have further blurred retail boundaries, with consumers able to shop instore and online simultaneously. Research in the US and UK markets suggests that over 50% of instore sales are web influenced, with consumers browsing and researching products and peer reviews prior and during a store visit.[2] Equally, online sales are influenced by the physical store as part of the pre-purchase journey, fulfillment or post-purchase experience. This holds true for even the most digitally active consumers, with 60% of the most active online consumers reporting that the store influences their online purchase activity.[3] Focusing on the final POS is misleading, as it masks the more complex customer journey underlying it, involving a symbiotic relationship between online and physical retail.

Consumer buying behavior is both complex and dynamic, varying between consumers and, for any one consumer, changing with the shopping mode and mood for any one purchase. Fulfillment of the product is also variable and may be received immediately instore, collected from store or delivered to home or an alternative address or collection point. The blurring of retail boundaries has put the consumers firmly in control of where, when and how they consume. For retailers,

[1] Centre for Retail Research (2016), "Online Retailing: Britain, Europe, US and Canada," http://www.retailresearch.org/onlineretailing.php.

[2] Javelin, "Organisational Structure: Transforming the Structure of your Organisation for True Omni-Channel Retail," 2014; McKinsey, "Making Stores Matter in a Multi-Channel World: Perspective on Retail and Consumer Goods," Summer 2014, http://www.mckinsey.com.

[3] UPS/ ComScore(2015), Pulse of the Online Shopper, Europe Report

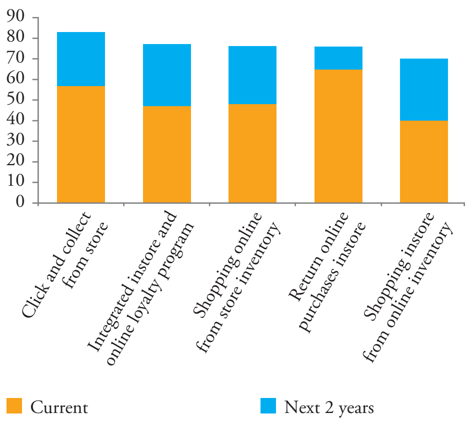
their overriding objective remains delivering the right product, at the right time, at the right price, in the right place, in the right way. However, in extending time and place, omnichannel adds new layers of complexity to the task. Customers expect a "one-customer, one-company" service, a demand that is beyond many retailers' current capabilities. Most retailers are restructuring their business models away from multichannel operations to refocus on omnichannel consumers.

Retailers Transforming from Multi- to Omnichannel Business Models

For omnichannel retailers, what matters is that the sale happens – not where it occurs – and that customers' experiences are positive, engendering brand loyalty. Increasingly, customers are expecting to continue any one shopping journey in any place, whether online or instore, without having to re-trace steps. Retailers are restructuring their business operations to meet these consumer demands and to capitalize on technological change. Developing the ability to identify and understand individual customers across channels requires the integration of all operations, systems and applications. This includes sales and marketing, customer insight, stock management, and distribution and accounting systems. Indeed, with only 19% of the top 250 global retailers indicating that they are able to deliver a profitable online strategy, a more holistic approach is viewed as pivotal to unlocking value.[4]

Given the high costs associated with fulfillment as well as returns associated with online transactions, merging distribution and stock management operations has also been a priority for the majority of retailers. Integrating inventory management alongside distribution may unlock profitability.[5] For many retailers, establishing a system that ensures that the retailer knows the location of all of its products on a real-time basis is something they must get right. The ability to deliver a product that is supposed to be in inventory to a customer, whether at home, instore, instore for pick-up, or at other distribution points, must be achieved as promised and in a timely manner. Moreover, less than two years ago only 24% and 29% of retailers had systems that worked well for click-and-collect and returns, respectively, despite the store being employed commonly as a fulfillment and returns centre for online transactions *(see Chart 4)*. This is because of the legacy of multichannel strategies that used separate central warehouses and inventory management systems that required an item to be delivered to store regardless of whether it was in stock. Greater integration will enable click-and-collect items to be picked from store, providing a cost advantage.

Chart 4: Cross-channel Capabilities (%)



Source: EbeltoftGroup (2014)

In addition to organizational transformation, the evolving omnichannel retail model also has significant impacts upon store portfolio optimization and the role of the store itself.

Impact on Store Portfolios

As omnichannel retail continues to evolve, the structure of the retail landscape will adapt and respond. The extension and greater complexity of consumer journeys characterizing omnichannel shopping behavior has increased rather than diminished the role of physical stores.

[4] PWC/JDA, "Global Retail and Consumer Goods CEO Survey: The Omni-Channel Fulfillment Imperative," December 2014, http://www.jda.com

[5] Boston Retail Partners, December 2014

Most retailers suggest that the physical store is the cornerstone of their overall omnichannel retail operation.[6] The value to the business is now considerably more complex than a mere POS. Strong synergies between sales channels have been evidenced by increased online sales in markets where the retailer opens a store.[7] Achieving the sale in the most appropriate way is what matters and requires a dynamic approach to store portfolio optimization.

The size of appropriate store portfolios will vary according to the scale of the market, retail category and pricing strategy. For example, discount retailers operate on thin margins and often do not provide an online offer and still rely solely on store networks for market penetration. Luxury and aspirational retailers may seek to constrain store portfolios to help protect and extend the scarcity or "wow" value associated with the brand. Online activity is employed to extend the reach of flagship and major stores.

Most other retailers still require a large store portfolio, but the portfolio is often segmented into a hierarchy, with each tier having a clearly defined remit.[8] This may comprise a tier of flagship stores in major destinations that have a dual remit of sales and building brand value through engaging customers meaningfully in the brand experience, showcasing products and staging promotions. Long valued by luxury fashion retailers, the flagship store is now also viewed by even mid-market retailers as a key to branding and showcasing products. Such stores are an important driver of sales across the wider store hierarchy and also online. As a result, there is very high demand for stores in Tier 1 locations. A second, larger tier of stores in strong, but lower cost locations might have a greater emphasis on sales and stronger profitability, while a third tier of stores in local and accessible retail locations might have a strong secondary remit to sales of brand awareness, convenience, customer service and fulfillment.

The growth of the retailer's digital platform is changing the store's contribution to the value chain. The store is now one of a number of sales platforms through which the retailer can engage, entice and transact with consumers.[9] This makes it more difficult to find an accurate proxy for assessing store value.

Assessing the Contribution of the Store to the Retail Value Chain

The fundamentals underlying the rental value of a store have not changed; it continues to represent the potential operational value of a store in an open market, itself a reflection of the value of the customer opportunity and the capacity for a given store to build brand value and generate sales within the catchment area. Historically, stores sales turnover is often employed to measure store performance during the course of a lease, providing owners the opportunity to participate in growth in the value of a store. However, while the multidimensional role of the store is not new, sales no longer represent a perfect proxy for the value of a store to its sales performance. This is because all the sales it influences no longer have to be transacted there, but that does not necessarily diminish the role that the store plays in generating sales. Indeed, its role in building brand value through customer engagement and service delivery has increased.[10]

Research undertaken by the ICSC examining the impact of omnichannel strategies on lease models indicates that the development of new approaches to capturing store value remains a work in progress.[11] Where leases include a performance element based on a percentage of turnover, the treatment of click-and-collect sales and returns is a particular area of contention between retailers and

[6] ICSC (2015), Exploring New Lease Models in an Omni-Channel World, September

[7] Bank of America Merrill Lynch, "Consumer & Retail Conference" (Bloomberg Transcript), Macy's presentation, 11 March 2014, p. 6; Accenture, "Trading Spaces: Changing the Way Retailers Think about Stores," 2012; Javelin Group, "How Many Stores Will We Really Need? U.K. Non-Food Retailing in 2020"; Retail Think Tank, "How is the Internet Changing Retail?"; KPMG/Synovate Retail Think Tank, "White Paper #16," KPMG/Ipsos 2010

[8] ICSC (2015), Exploring New Lease Models in an Omni-Channel World, September

[9] Ebeltoft Group (2014), Global Cross Channel Retailing Report

[10] Billingsly, A and O'Roarty, B (2016), "Liberation of Time and Place for the Consumer: Recent Omni-Channel Trends," Retail Property Insights, ICSC

[11] ICSC (2015), Exploring New Lease Models in an Omni-Channel World, September

owners. The former argue that, at present, there is no cost saving for fulfillment from click-and-collect options and that the owner is already benefiting from additional sales generated from the footfall traffic it generates. Owners contend that the contribution of the store to the retailer's ability to fulfill online customer orders should be recognized. In respect of online returns to store, both parties agreed that they should not be deducted from store sales; however, many store systems do not differentiate between returns of sales generated instore and online.

Store turnover also fails to capture the contribution of the store to online sales that may have been influenced by a pre-purchase store visit that enabled the retailer to engage the consumer and showcase the merchandise. Similarly, the "halo" affect of the store in the catchment area on brand awareness and online sales is not accounted for in the performance element of the lease, although it is implicitly reflected in the base rent. Indeed, research demonstrates that there is a symbiosis between having a physical presence in the locality and higher online sales generation. Understanding the size of total sales across the catchment area is crucial to assessing the value of the store *(see Chart 5)*. Of course, additional costs associated with operating a digitized platform in terms of logistics, stock management marketing, etc, also need to be taken into account. Retailers are developing integrated customer insight systems to generate this knowledge, but are unlikely to share sensitive trading information beyond the store with owners.

Chart 5: Contribution of the Store to Omni-Channel Retail Models

Although new lease agreements represent the market value of a store, new metrics that better measure store performance in the omnichannel era are required to establish the rent at lease renewal. Some owners are abandoning turnover rental elements of rent agreements in favor of the simplicity of fixed rents. However, this reduces the alignment of interest between owners and retailers. New performance metrics are being developed for asset management performance of shopping centers, including conversion rates, basket size and measuring peel-off rates between different retailers. While it may be too early to include them in lease agreements, given their longer-term nature, this is an area that is expected to yield new solutions for capturing the value of a store.

ERICSSON'S TROUBLES MEAN WEAK OUTLOOK FOR KISTA

Against the backdrop of a comparatively weak local rental market and a considerable volume of unused building rights, the aggressive pricing of the Kista market during 2015 and the beginning of 2016 seems overdone. Indeed, albeit that concrete evidence so far is limited, the market has likely already undergone a correction. Not only is it no longer reasonable to expect rental growth, the recent setbacks for Ericsson, to which the office market is heavily exposed, would point to further increases in vacancy levels, and a slight decrease in rents.

The Kista office market consists of approximately 850,000 m^2 of office space located in the Kista district in the municipality of Stockholm, some 15 km to the north of central Stockholm. Situated along the E4 motorway, north of where you would typically see the worst traffic congestion, the area enjoys good access to Arlanda Airport. Kista is Europe's leading information and communication technology (ICT) cluster and home to more than 1,400 companies; and at least 300 are ICT companies. A large number of major IT companies have made Kista the location of their Swedish or global headquarters. Such major tenants include Ericsson, Tele2 and Microsoft.

Ericsson has had a tough time of late, seeing a considerable drop in both turnover and margins. Full-year 2016 the share price was down 35% and over five years to end-2016 it was down 27%. In a 16 December 2016 article, the *Financial Times* did not pull any punches, saying that it amounted to another spectacular fall from grace for a major Nordic technology firm, and compared the fate of the company to that of Finnish Nokia.[1] In view of comments from other experts and analysts, the FT's comments must be seen as more critical than most. The poor performance led to the ousting of then CEO Hans Vestberg in July 2016.

The poor performance has resulted in layoffs. On 4 October 2016, Ericsson announced that it would make 3,000 employees in Sweden redundant and gave them notices of termination. Of these, about 1,000 were in production, 800 in R&D and 1,200 in administration and sales. Later in October, it gave notice to a further 1,900 employees, of which 1,450 were in Stockholm. The bulk of these terminated Stockholm employees reside in Kista. This means that Ericsson has laid off a staff force that is the equivalent of 1.5-2.0 average size office buildings and that the firm's need for space is likely to go down.

This lower demand from Ericsson adds to an already challenging vacancy situation. Vacancy levels had already reached 17% in fall 2016.[2]

Lower demand is met by a steady stream of new supply. Unlike the other top established office markets in Stockholm, the Kista office market is not filled in and has ample room to grow. Slightly more than 20,000 m^2 of office space has been added each year since 2010, which is high compared to other office locations in Stockholm.[3]

This will create a market condition where it is likely that we will see falling rents during this year. Grade A properties will see the bulk of new leases, leaving owners of Grade B-D properties to fight hard for tenants. Several properties traded at record yields in 2015. It is unlikely we will come close to these levels during the year to come. ■

[1] The full article is available on the FT's webpage https://www.ft.com/content/662059fa-c77f-11e6-9043-7e34c07b46ef

[2] JLL Nordic City Report, Autumn 2016

[3] Savills Market Report Kista, Q1 2016

SWEDEN

Economic growth in Sweden remains buoyant, with GDP expected to grow by up to 3.7% in 2016[1] *(see Chart 1)*. While the range in forecasts suggests some uncertainty, there is consensus that growth will continue to be well above the European average. The economy has been sustained by domestic demand from the public and private sectors, with the long-awaited pick-up in export demand for investment goods held back by a stagnating global economy. This is expected to persist over 2017 and 2018, with reduced impetus for domestic demand slowing GDP growth to a respectable 2.8% and 2.3%, respectively. Over a longer-term horizon, Sweden is well poised to benefit from an eventual uptick in global demand given the health of government finances and a strong but competitive labor force.[2]

Strong population growth in metropolitan areas underlies a number of factors that have driven domestic demand over 2016 and that will continue to drive growth in 2017. The rapid pace of urbanization coupled with increased immigration has led to a housing shortage. As a result, residential development activity has accelerated, although the pace of development is lower than demand growth indicates.[3] Nevertheless, housing investment has increased sharply and accounts for a large component of growth in investment spending *(see Chart 2)*. Being labor- and resource-intensive, construction activity also has a large multiplier effect on the economy, with studies indicating that every unit of capital invested generates productivity of some 2.84 units.[4] Immigration and refugee resettlement programs have also been a driver of public spending. The number of new arrivals has decreased sharply and will reduce spending going forward. However, coupled with urbanization, there will be a continuing need for increased investment in social infrastructure and services. Indeed, this will be essential to reducing polarization in the labor market and ensuring its expansion.

Employment growth is expected to increase by 1.7% during 2016 and unemployment is trending downward[5] *(see Chart 3)*. However, unemployment among foreign-born jobseekers, especially those born outside Europe, is high. This reflects the low educational attainment level of many migrants and the need for education and skills training in order to integrate them into the labor force. As well as benefiting social cohesion, this will reduce the structural unemployment level and expand the labor pool at a time when resource utilization has increased sharply and employers are indicating matching problems.

In addition to public spending, private consumption remains an important driver of the economy. Low interest rates have proved an important fiscal stimulus for households, coupled with modest wage increases and low inflation *(see Chart 4)*. Private consumption growth is expected to rise to 3.1% in 2016, softening to 2.8% in 2017 and 2.5% in 2018 *(see Chart 5)*, but remains a major component of GDP. Although housing investment has seen household debt levels increase, savings rates have continued to climb higher and provide a cushion to any pricing correction in the housing market *(see Chart 6)*. Given the forecasts of a continued housing shortage and expectations of a continued low interest rate environment into the medium term, the biggest risk to house price inflation is the prospect of caps on mortgage debt-to-income ratios.[6] This

[1] SEB (2016), Nordic Outlook, August

[2] Swedbank (2016), Economic Outlook, 26 August

[3] Danske Bank (2016), Nordic Outlook, September

[4] APL, CREFC, INREV and ZIA (2016), Commercial Real Estate Debt in the Real Economy

[5] SEB (2016), Nordic Outlook, August

[6] Swedbank (2016), Economic Outlook, 26 August

would primarily impact the owner-occupied apartment market in Stockholm.

From a domestic stance, the strength of the economy suggests that the Riksbank could unwind fiscal stimulus, but the international perspective makes this difficult. Following Brexit, the Bank of England expanded quantitative easing and the ECB is also extending its expansionary policy. While the Fed is expected to adopt a more unilateral approach to the degree and timing of interest rate rises under a Trump presidency, monetary policy is expected to remain expansionary. Indeed, given the importance of the United Kingdom and United States as trading partners to Sweden, both of these unexpected political outcomes represent a degree of risk and uncertainty for the export-led economy of Sweden. Although the inflation outlook improved in H1 2016, it has since subsided. The Riksbank continues to prioritize inflation and was expected to lower the repo rate by 10 bps to -0.6% at its December meeting in an effort to reverse the downward trend,[7] although it instead opted to keep the rate unchanged at -0.5%.

Chart 1: GDP Growth, Sweden 2012-2018f (%)

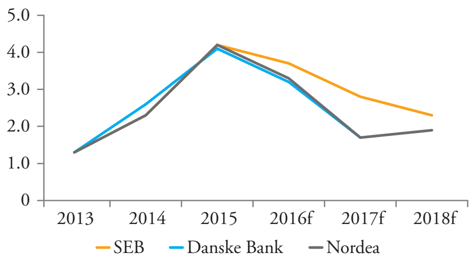


Chart 2: Fixed Investment, Sweden 2013-2018f (SEK)

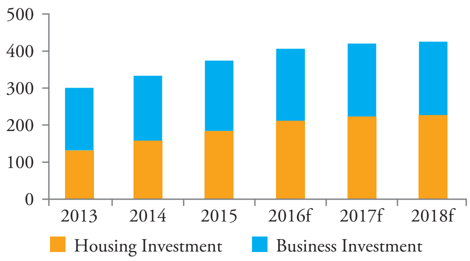


Chart 3: Employment ('000) and Unemployment Rate (%), Sweden (Jan 2013-Oct 2016)

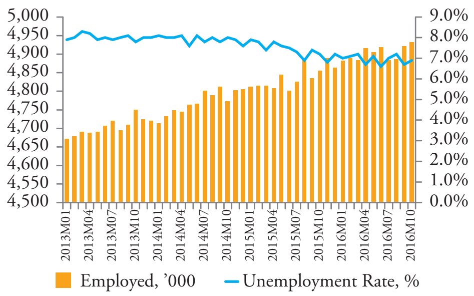


Chart 4: Interest Rate Payments as % of Net Disposable Income 2013-2016

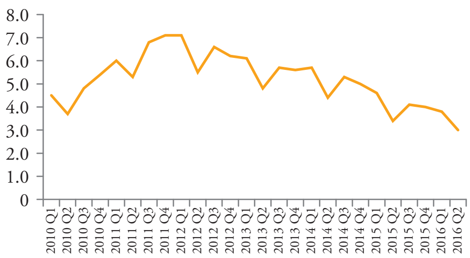


Chart 5: Private Consumption Growth, Sweden 2012-2017f (%)

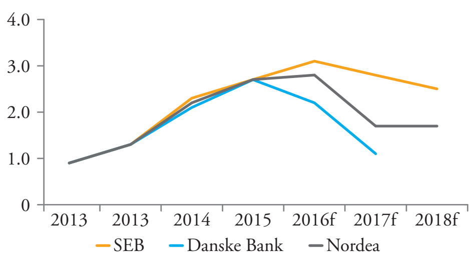
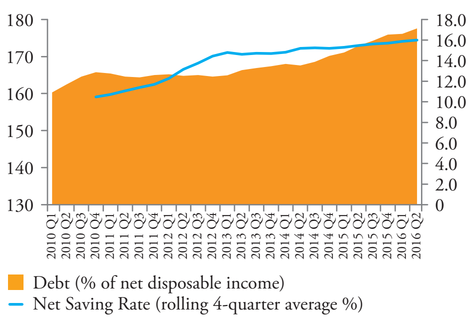


Chart 6: Household Debt (% of Income, LHS) and Savings Ratio (%)



Sources: SEB, August 2016; Danske Bank, September 2016;Nordea Bank, September 2016; Labour Force Survey; Statistics Sweden, 2016

[7] Nordea (2016); Majors and Scandies (2016); Central Bank and rates forecasts, 11 November

FINLAND

Revised figures indicate that the Finnish economy moved out of recession in 2015, growing by 0.2% following three years of contraction *(see Chart 1)*. Over 2016, the recovery has continued steadily, but the pace of growth remains slow. There is broad consensus that GDP growth will deliver growth of at least 0.7% for 2016, underpinned by a recovery in domestic demand.[1] The Finnish export market continues to face a number of impediments that are dragging on growth, but the outlook looks more positive for 2017 and exports will lend support to GDP growth delivering a more convincing recovery rate of 1%.

The export market has survived a perfect storm of structural and cyclical change. Consumer appetite for smartphones and the rise of digital media ultimately resulted in the demise of Nokia and, at the same time, the publishing industry began a sharp reduction in demand for Finland's staple export: paper. Economically destructive at any time, the structural events occurred at the onset of the global financial crisis, which further reduced demand for other investment goods. Moreover, the GFC sharply reduced investment capital, risk appetite, business and consumer confidence. Positively, the economy benefited from the strength and stability of government, financial institutions, corporates and household finances, but Finland's capacity to restructure exports was hindered by the deterioration in competitiveness that had resulted from the earlier boom. The economy is still subject to a number of headwinds, including the slow recovery in global demand for investment goods and the contraction in demand from Russia, a key trading partner. However, these headwinds are beginning to subside as a result of restructuring and innovation in the paper industry, the success of the competitiveness pact between the government and labor market organizations and the emergence of Russia from recession. At 0.5%, export growth is expected to remain subdued over 2016 and, given stronger imports, to drag on growth *(see Chart 2)*. However, the recovery of the Russian economy and the long-awaited recovery in global demand for investment goods is expected to support stronger growth of 2.5% in 2017, while improved competitiveness in Finland absolutely and relatively will begin to have a visible impact from 2018.[2]

Given the economic weakness in recent years, domestic demand has proved resilient and delivered growth well above expectations. Low interest rates and weak inflation have lent support to private consumption and ensured that the impact of wage freezes that form part of the competitiveness pact on purchasing power is limited. Private consumption growth of between 0.5% to 1% per year is expected over the next three years *(see Chart 3)*. Although this suggests that growth is slowing, private consumption levels outstripped expectations in 2015 and were also boosted by a number of spending incentives during the year. Over 2016, consumer confidence has increased, partly as a result of an improving labor market *(see Chart 4)*. September data indicates that unemployment continued to trend downward over Q3 2016, falling by 80 bps since September 2015, to 7.6% *(see Chart 5)*.[3] This is faster than anticipated by forecasts. Although the number of inactive persons increased marginally over the same period, the active population grew faster, increasing to 69.2% of the population. The fall in unemployment is largely accounted for by employment growth, with 7,000 new jobs

[1] Danske Bank (2016), Nordic Outlook, September; SEB (2016), Nordic Outlook, August; Nordea (2016), Nordic Outlook, September

[2] Danske Bank (2016), Nordic Outlook, September

[3] Statistics Finland (2016)

created year on year by September 2016.[4] In contrast to previous turning points in the market, the labor market is being driven by an upswing in the construction industry rather than by a resurgence of export demand.

The government remains focused on structural reforms that will support sustainable, long-term growth and restructure public sector financing, reducing public spending by EUR 10 billion by 2020. However, following the agreement of the competitiveness pact, which includes a wage freeze, lower public holiday pay, increased working hours and a transfer of social security payments, there are no major cuts planned over 2016.[5] Indeed, recognizing the importance of domestic demand the government is introducing tax measures that will help to soften the impact of the pact on disposable incomes.

Reducing public debt remains difficult given the weak economic environment. Although public debt remains conservative in comparison to other European countries *(see Chart 6)*, it has risen sharply since 2008. Nevertheless, coupled with sluggish growth, the debt ratio leaves the economy without a small cushion should a new crisis arise. This prompted rating agencies to downgrade the economy to AA+. This has had little impact on Finland's borrowing costs, although the spread with German bonds has increased.

Chart 1: GDP Growth, Finland 2012-2018f (%)

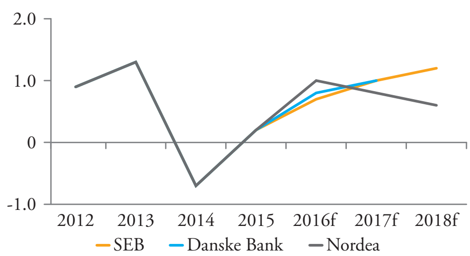


Chart 2: Export Growth 2014-2018f, Finland (%)

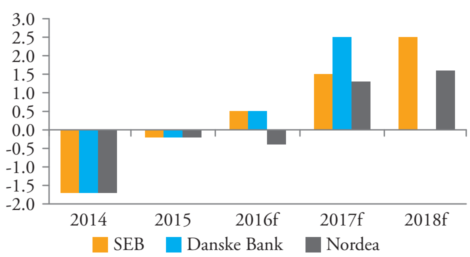


Chart 3: Private Consumption Growth 2014-2018f, Finland (%)

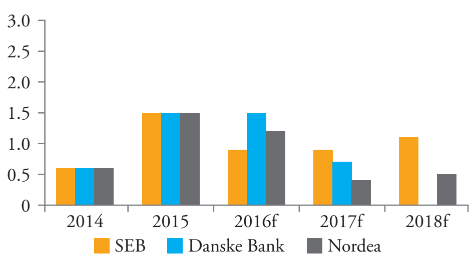


Chart 4: Consumer Confidence Indicator Jan 2013-Oct 2016

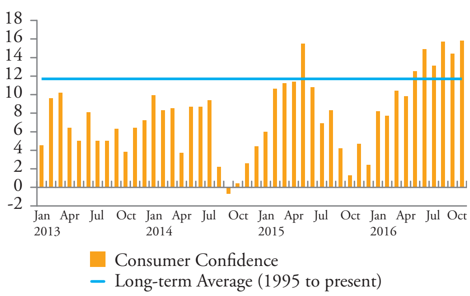


Chart 5: Employment ('000) and Unemployment Rate (%), Finland (2010 Q1-2016 Q3)

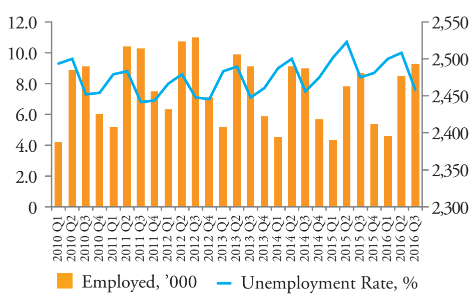
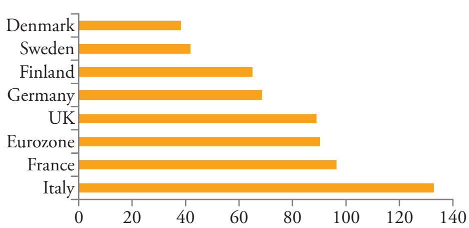


Chart 6: Government Debt at 2016f (% of GDP)



Sources: Danske Bank, September 2016; SEB, August 2016;Nordea, September 2016; Statistics Finland, 2016; Labour Force Survey, Statistics Finland, 2016

4 Statistics Finland (2016)

5 Danske Bank (2016), Nordic Outlook, September

DENMARK

Over the past three years, Denmark's economic recovery has developed at a very gradual pace *(see Chart 1)*. Following a slowdown in H2 2015, economic growth prospects declined, with growth for the year materializing at a disappointing 1%. Over Q1 2016 growth recovered, expanding by 0.7% quarter on quarter, but slowed over Q2 to 0.4%.[1] Falling consumer and business confidence suggest that spending plans may be deferred amid growing uncertainty. Indeed, although private consumption has been an important component of economic growth, consumers have continued to spend below potential over the recovery. The economic revival has been most evident in employment data, but the boom in job growth is not fully reflected in spending patterns. GDP growth is expected to remain broadly stable over 2016, accelerating to 2.3% in both 2017 and 2018 *(see Chart 2)*.

Indeed, employment growth accelerated over H1 2016, but stalled in July due to public sector lay-offs *(see Chart 3)*. Despite an expanding labor supply from young workers, especially students, entering the workforce and increasing immigration, unemployment is also trending downward.[2] However, there is some evidence of matching issues between available labor and jobs, particularly in the construction and service sectors.

Despite private consumption being lower than its potential, it is a key driver of growth and expanded by 0.7% over H1 2016. However, like GDP, the pace of growth slowed over Q2 and indicators suggest a weak Q3. Consumer confidence dropped to a three-year low in October as consumers considered their current finances to have deteriorated, although they remained upbeat about future prospects.[3] Yet, low inflation, real wage growth, low interest rates and the wealth effects of rising house prices are boosting purchasing power. The lower sentiment is expected to result in consumers delaying big ticket item purchases in 2016, leading to a widening in the range of growth forecasts from 1.6% to 2.4% for the year *(see Chart 4)*.[4]

Similarly, business confidence has declined in recent months as Brexit, together with wider external influences, negatively impacted on sentiment *(see Chart 5)*. In part, this is the impact of Brexit, which has increased risk and uncertainty for manufacturing exporters. The United Kingdom is an important trading partner and, while there has been no contagion of the slowdown in the British economy for Europe, the EUR has appreciated against the GBP, making exports potentially less competitive. Investment spending plans have been deferred, but not revised.

Confidence fell across all manufacturing categories. However, the sentiment reflects increased uncertainty rather than hard data. Exports experienced modest growth over H1 2016 and key export markets, including Sweden, are growing. Indeed, over Q3 2016 capacity utilization increased to its highest level since the GFC and business investment spending is expected to expand by 1.9% in 2016, increasing to 3.2% and 4.0% in 2017 and 2018, respectively.[5] Such investment is required to boost productivity and, in turn, corporate profits. The government's 2025 plan to restructure the economy includes the objective of increased productivity and this is being stimulated through tax incentives on spending.

[1] Statistics Denmark (2016)

[2] Danske Bank (2016), Nordic Outlook, September

[3] Statistics Denmark (2016)

[4] Danske Bank (2016), Nordic Outlook, September; SEB (2016), Nordic Outlook, August; Nordea (2016), Nordic Outlook, September

[5] SEB (2016), Nordic Outlook, August; Nordea (2016), Nordic Outlook, September

Although export growth remains modest, goods exports continue to generate a large trade surplus as goods imports have declined. In part, this actually reflects the low rate of business investment. The expected pick-up in business investment will lower the trade surplus in tandem with the drag of weak service exports *(see Chart 6)*.

Chart 1: Index of Real GDP Growth, Quarterly 2013 Q1-2016 Q2

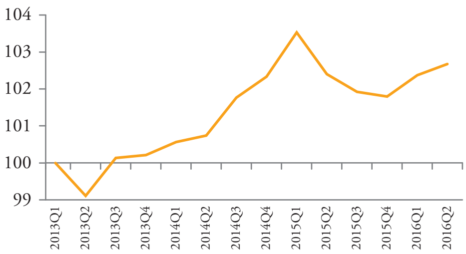


Chart 2: GDP Growth 2013-2018f, Denmark (%)

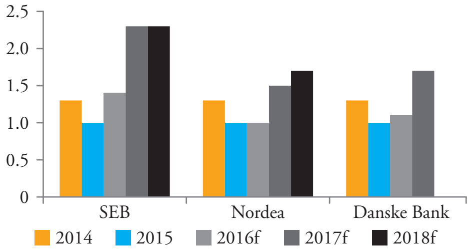


Chart 3: Employment ('000) and Unemployment Rate (%), Denmark (2010 Q1-2016 Q3)

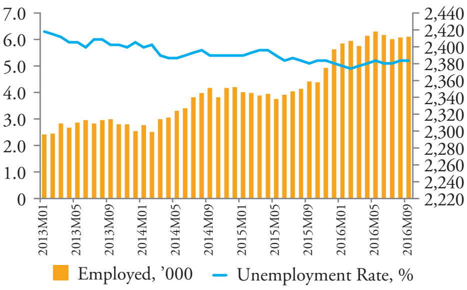


Chart 4: Private Consumption Growth 2014-2018f, Denmark (%)

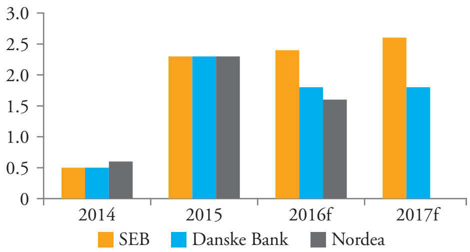


Chart 5: Business Confidence Indicator (Manufacturing), Denmark (Jan 2013-Oct 2016)

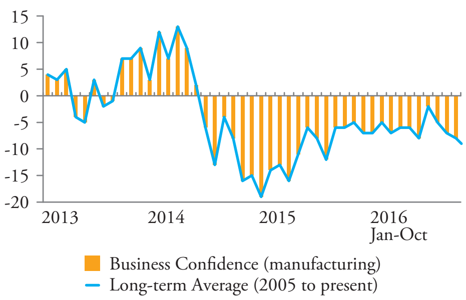
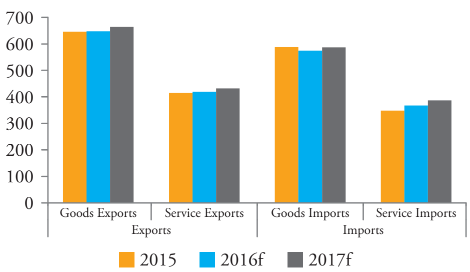


Chart 6: Export and Import Growth 2015-2017f (DKK billion)



Sources: Statistics Denmark, 2016; SEB, August 2016; Danske Bank, September 2016; Nordea, September 2016; Labour Force Survey; Statistics Denmark, 2016

NORWAY

Supported by expansionary fiscal policy and more durable than expected mainland sectors, the Norwegian economy is withstanding the downturn in its oil sector considerably better than expected. Indeed, non-oil sectors appear expansionary. There are also signals that the oil sector and slowdown in related industries is stabilizing. Mainland GDP growth is forecast to grow by around 0.9% to 1% in 2016, increasing to 1.8% in 2017 and 2.1% in 2018 *(see Chart 1)*.[1] Indeed, somewhat unusually, mainland GDP is forecast to increase at a faster rate than the whole economy in 2017 and 2018, reflecting the continued drag of reduced capital spending in the oil sector.

The impact of the contraction in the oil sector on the mainland economy has been less severe and more concentrated than expected. Although there is broad consensus that the decline in capital spending in the oil sector is slowing, it will continue to drag on growth in the short term, before turning positive in 2018 *(see Chart 2)*. The price of oil has also stabilized and is expected to recover to USD 70 per barrel by 2018.[2] The impact on oil-related manufacturing has been severe, but is beginning to bottom out. However, the non–oil-related economy has been sustained by a low interest rate environment, a weaker NOK and an expansionary fiscal policy, which have helped to offset the negative drag of the oil sector on the mainland economy. Of course, this polarization in economic performance is reflected in regional productivity, with oil-dependent counties experiencing recessionary conditions in comparison to other areas, including Oslo, where growth is accelerating.

Over the past two years, domestic demand has been an important driver of performance, but private consumption is weakening due to a number of factors. While supporting exports, the devaluation of the NOK resulted in imported inflation, which increased to 3.5% in H1 2016. This has eroded purchasing power, although spending on services has helped to compensate for a slowdown in goods consumption *(see Chart 3)*. Inflation is expected to ease in 2017 once price rises are washed through the annualized data. Employment growth also slowed, but again there is evidence of polarization. Oil-related industries are continuing to downsize, albeit at a slower rate, while the number of vacancies for non–oil-related industry is rising. Unemployment is expected to peak at 3.5% (Norwegian Labor and Welfare Administration)/4.8% (Labor Force Survey) during 2016, with employment growth expanding with the uptick in the economy over 2016 and 2017 *(see Chart 4)*.[3] As a result, private consumption is expected to slow to 1.6% in 2016 before accelerating to 2.0% and 2.7% in 2017 and 2018, respectively *(see Chart 5)*. In contrast, government spending has risen over 2016 and is expected to have expanded by 2.5% over 2016. In addition, business investment spending is rising more quickly than anticipated, reflecting growing confidence in economic prospects.[4]

Housing investment and construction continue to expand and lend support to growth. Population growth and the low interest rate environment have resulted in a sharp increase in housing demand and a surge in price growth in the large urban centers. By September, new housing starts increased by 15% and a similar increase in construction activity also character-

[1] SEB (2016), Nordic Outlook, August; Danske Bank (2016), Nordic Outlook, September

[2] SEB (2016), Nordic Outlook, August

[3] Danske Bank (2016), Nordic Outlook, September; SEB (2016), Nordic Outlook, August

[4] Nordea (2016), Norway GDP: Low Mainland Growth, 15 November

izes the commercial sector. Although the Financial Supervisory Authority has proposed a series of measures to ensure more prudent lending behavior, low interest rates, population growth and the strengthening economy will underpin the market.

Indeed, fiscal policy has been an important driver of growth, accounting for 1.1% of mainland GDP in 2016.[5] Following a rate cut of 25 bps in March, Norges Bank has left the policy interest rate unchanged at 0.5% in subsequent meetings. While Norges Bank has indicated that there is some room for a further rate cut and there is some market uncertainty, a cut is not widely anticipated given the positive signals surrounding the economy and an inflationary housing market *(see Chart 6)*. A further rate cut is only expected if the NOK appreciates sharply. Equally, safeguarding against appreciation of the NOK greatly reduces the prospect of a rate hike until the ECB moves, which isn't expected until late 2017 at the earliest.[6]

Chart 1: GDP Growth 2013-2018f, Norway (%)

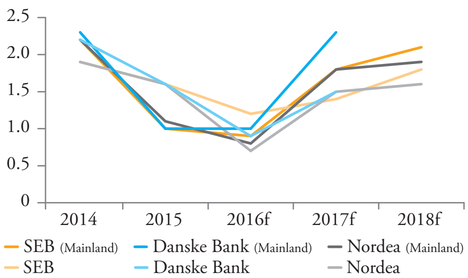


Chart 2: Gross Fixed Capital Investment by Industry and Sector (% change year on year) 2010 Q1-2016 Q3, Norway (%)

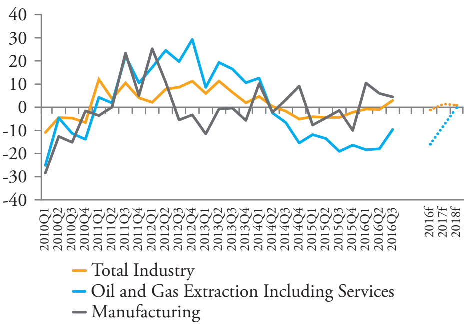


Chart 3: Index of Household Consumption Expenditure Growth (quarter on quarter) by Category, 2010 Q1-2016 Q3

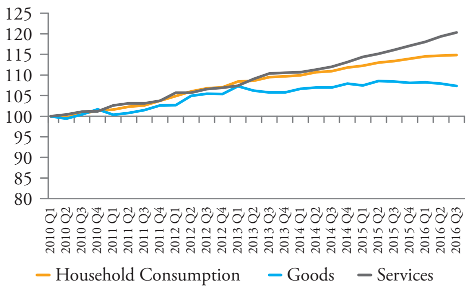


Chart 4: Employment ('000) and Unemployment (%), Norway 2010 Q1-2016 Q3

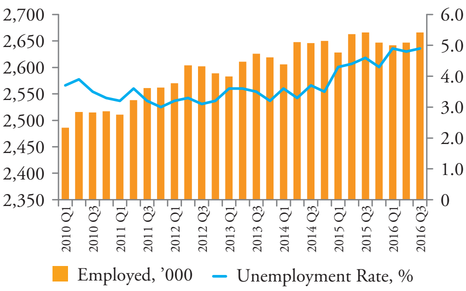


Chart 5: Private Consumption Growth, Norway 2013-2018f (%)

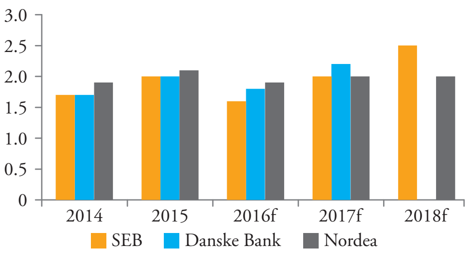
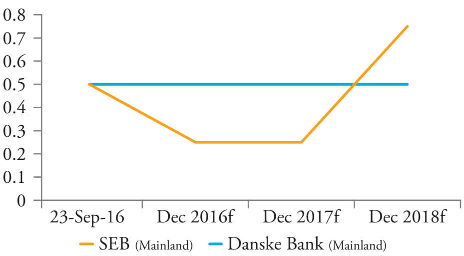


Chart 6: Repo Rate Movement Sept 2016-Dec 2018f, Norway (%)



Sources: SEB, August 2016; Danske Bank, September 2016;Nordea Bank, September 2016; Statistics Norway, November 2016; Nordea, 2016, forecast for Total Industry is 'All Fixed Investment' in Economy; Statistics Norway, November 2016

[5] SEB (2016), Nordic Outlook, August

[6] Nordea (2016); Majors and Scandies (2016); Central Bank and rates forecasts, 11 November

NORDIC REAL ESTATE MARKETS

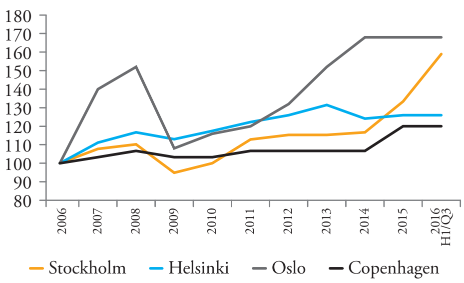
Investment volumes in the Nordic real estate markets experienced a record high in the first three quarters of 2016, buoyed by large portfolio deals in Sweden, Denmark and Finland. Indeed, investor demand is outstripping supply and the volumes would have been higher in all markets if the product availability had been less curtailed. The strength of investor demand, coupled with existing pricing and market uncertainty in global financial markets, is resulting in divergent investor strategies. Longer-term investors are prioritizing secure cashflow over location, while value-add investors are prioritizing location. In contrast to investor activity, differences in economic fundamentals continue to explain variances in occupier market performance across the Nordics. In some markets, a dislocation between occupier and investment market performance is apparent when considered solely by real estate fundamentals, but is rational when prime real estate is compared to wider fixed income products across the financial markets.

1.0 Occupier market fundamentals
1.1 Office Market

Stockholm

The Stockholm real estate market continues to benefit from both demand- and supply-side characteristics that are supportive of rental growth. Since the beginning of 2016, prime rents have increased by 19.2% to SEK 6,200 per m² in Q3, building upon strong growth of 16% in 2015 *(see Chart 1)*.[1] While the pace of growth appears to be moderating, there are a number of ex-

Chart 1: Prime Rental Growth Index by Market, 2006-2016 H1/Q3



Source: Genesta, 2016

amples of lease agreements reaching more than SEK 7,000 per m². Given supportive demand fundamentals, low availability and modest supply levels, prime rental growth in the CBD continued into the fourth quarter. Moreover, large occupiers seeking modern, efficient, yet affordable premises will continue to re-focus on the rest of the inner city and prime submarkets offering good and improving transport links. These office markets have also experienced good rental growth due to strengthening demand and low space availability for high-quality assets. Since end-2014, prime rents in the suburbs close to the CBD and to Solna and Sundbyberg have increased by SEK 400 per m² to end–Q2 2016, representing growth of 16.7% and 18.2%, respectively. At the same time, leasing incentives, including rent-free periods, have been greatly re-

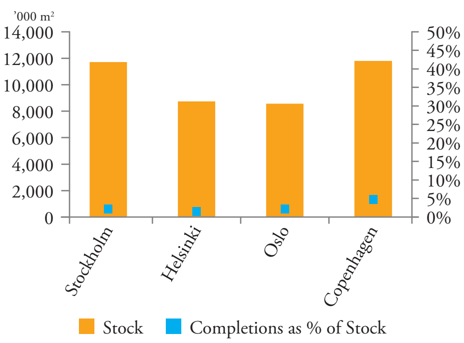
[1] JLL (2016), Property Clock, Q3; JLL (2016), Nordic City Report. Autumn; JLL (2015), Nordic City Report, Spring

duced, with a further positive impact on the net effective rent.

Although the rate of take-up slowed over H1 2016, at 248,000 m², it remains expansionary.[2] Occupier demand for modern premises remains strong and, given low availability within the CBD, companies with large space needs continue to consolidate their portfolios in new premises in submarkets beyond the CBD that benefit from good transport links. Further infrastructure developments in Stockholm, including new transport links and the growth of new residential areas close to prime suburbs, will continue to influence changes in the relative attractiveness of locations beyond the CBD.

The supply pipeline remains modest. Between 2016 and end-2018, 265,000 m² of space is scheduled for completion, representing 2.1% of existing office stock *(see Chart 2)*. Of this, 29% is located within the CBD, the rest in the inner city

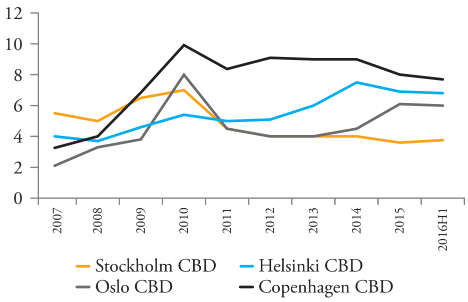
Chart 2: Total Stock End-2015 and Completions to End-2018 as a % of Stock



Sources: Genesta, 2016; JLL, 2016; NewSec, 2016

and adjacent suburbs, which account for 50% of Stockholm's total office stock.[3] Most of these projects are fully let upon completion, with 65% of space in the total pipeline already pre-leased. In addition, the strong demand for residential units is resulting in older, less efficient office stock undergoing a change of use. With 35% of existing planned supply to 2018 being delivered in 2016, rising to 53% for the central markets, the vacancy rate softened slightly across all submarkets in H1 2016 *(see Chart 3)*. Given the rapid absorption of space, the strength of demand and low levels of speculative supply, the vacancy rate is expected to remain historically low in the CBD and to reduce further elsewhere.

Chart 3: Vacancy Rates by City 2007-2016 H1 (%)



Sources: Genesta, 2016; JLL, 2016; CBRE, 2016

The strength of market fundamentals is expected to drive further rental growth in the short term. Interesting opportunities are expected to arise as occupier demand begins to respond to changes in infrastructure, including transport links and the shifting urban landscape, particularly the growth of new residential areas in the Solna and Sundbyberg areas.

Helsinki

Although there are signals that the Finnish economy has reached a turning point, it is too early to be manifest in occupier demand. During H1 2016, the Helsinki Metropolitan Area (HMA) vacancy rate reached 13.5%.[4] Although the supply pipeline is very low, it still exceeds occupier demand, which continues to contract its space needs, with a continued emphasis on modern, efficient premises. This mismatch between occupier requirements and available space is resulting in new construction. Although the supply pipeline is very low and non-speculative, the net effect is an increase in market availability. The conversion of older office stock to residential or other change of use lends support, especially in central markets,

[2] JLL (2016), Nordic City Report, Autumn

[3] OpCit and NewSec (2016), Nordic Property Outlook, Autumn

[4] Catella (2016), Catella Market Indicator, Finland, Autumn

but is not sufficient to compensate for additional stock.

Demand remains skewed to the strongest locations including the CBD, adjacent central submarket, Ruoholahti, Keilaniemi and the Pasila-Vallila-Kalasatama area.[5] Given occupiers' emphasis on space efficiency, quality of space is a clear demarcation of the market and is reflected in rental levels. Demand for good-quality space in strong, well-connected locations has remained stable over the year. However, the prevalence of lease incentive packages, amounting to the equivalent of six months rent-free, represents as much as 10% of the income secured under the life of a five-year lease.[6] Affordability is also an important driver of demand. The Central submarket benefits from its adjacency to the CBD, higher availability of modern premises and good affordability relatively, with rents for Grade A space in the Central submarket being 24% lower than prime rents in the CBD.[7] These characteristics have helped to steady demand and the Central submarket continues to experience the lowest vacancy rate in the HMA, which fell marginally over H1 2016 to 8.3%. In contrast, vacancy in the CBD is higher at 12.4%, despite falling by 120 bps over 2016. It is worth noting that the CBD is relatively small in terms of stock (4,190,000 m^2) in comparison to the Central submarket (1,771,000 m^2), and in volume terms its vacancy is approximately a third of that in the Central submarket. To some extent, the higher vacancy rate in the CBD also reflects the higher proportion of space in historical buildings in need of refurbishment. The availability of modern premises is scarce and it is noteworthy that newly-refurbished space within the CBD returning to the market is leading to an upward momentum in asking rents.

The polarization in market demand by submarket is now clearly evident in vacancy rates. With the exception of the Central submarket, which is well below the HMA average, the other favored submarkets have moderately lower than average vacancy rates. In contrast, the least favored markets, including Espoo, Leppavaara and Aviapolis, have considerably higher than average vacancy rates. However, the vacancy rate is more reflective of the proportion of outdated stock and/or the concentration of the former occupier base in technology than the location itself. Indeed, Aviapolis continues to benefit from strong transport connections, including its adjacency to the airport, while newly-developed space in Leppavaara has leased successfully.

The market is expected to strengthen very gradually as the economy continues its slow recovery. The low level of supply will have a more tangible impact on rental support as demand begins to increase and take-up finally exceeds even relatively minor net additions to space. However, given the volume of vacant space, there will be a very light upward pressure on rents in the best locations. Occupier demand is expected to have a gradual reawakening and space efficiency will remain a priority in the near term.

Copenhagen

Economic growth coupled with increasing urbanization and occupiers' desire for adjacency between work and where employees live is accelerating occupier demand for modern premises in prime locations. This has assisted in lowering vacancy levels to 9.4% for the Greater Copenhagen region and to 7.7% across the prime central markets.[8] The flexibility and high-quality space available in new multi-use schemes is a preferred option for SMEs and this is adding to the polarization in the performance of prime and secondary locations, and Grade A and B assets. Grade A assets in the Old and New CBD can command up to DKK 1,800 per m^2, while Grade B rents fall between DKK 1,050 and DKK 1,200 per m^2.[9]

[5] JLL (2016), Nordic City Report, Autumn

[6] Ibid

[7] Catella (2016), Catella Market Indicator, Finland, Autumn

[8] JLL (2016), Copenhagen City Profile

[9] JLL (2016), Nordic City Report, Autumn

Secondary markets are less favored by SMEs as clustering of economic sectors has become a characteristic of the Central market and there is also a perception that secondary locations may limit potential recruitment and retention of high-quality labor. However, availability of prime, Grade A space is low and this should result in a reawakening of demand for secondary space. However, high vacancy in such stock suggests that this will remain a tenant's market and lease incentive packages representing 5% to 10% of the income over the term of the lease will continue to feature.[10] However, the trend for older premises being converted into residential is continuing and this will assist in reducing vacant secondary stock.[11]

Despite the strength of occupier demand, prime rents have remained stable over 2016 to end-Q3, although the scarcity of modern premises has resulted in the gap between average and prime rents narrowing. In contrast to Stockholm and Helsinki, the supply pipeline has increased sharply, with 260,000 m^2 of space delivered in the Greater Copenhagen area in 2016, nearly half of which is in the Central submarkets. A further 300,000 m^2 is in the pipeline to end-2018.[12] Although space in the pipeline is predominantly non-speculative, net absorption rates are low. In addition, banks are continuing to restructure and refocus on core activities and this is expected to result in redundant space re-entering the market.

Given the supply response, rental levels are expected to remain relatively stable over the near term. The strength of occupier demand and the non-speculative nature of new supply will reduce the risk of rising vacancy. Indeed, the scarcity of prime product in the prime markets is expected to gradually assist in the recovery of secondary markets.

Oslo

Occupier activity revived over H2 2015 and strengthened further during H2 2016. Take-up increased to 344,000 m^2, some 24% higher than for the same period in 2015.[13] This was partly driven by an increase in the number of large space lettings, which had previously reduced in the wake of the slowdown in the oil industry. To some extent, the increase in the number of large space requirements is predictable as it follows a number of scheduled large lease expiries. Further large lease requirements are anticipated, with the volume of requirements tripling to 193,000 m^2 in comparison to the same period last year. These include a number of large space requirements from public entities. The availability of large space offerings is low, with only five premises offering space in excess of 10,000 m^2 available.[14] Coupled with a modest and predominantly non-speculative supply pipeline, competition for such space is expected to intensify. This will impact on vacancy, with these large units representing 16% of total vacancy.

The resurgence of occupier demand and low levels of new supply has resulted in further declines to the total office vacancy rate for Oslo, which fell by 50 bps to 7.6% over H1 2016.[15] There is considerable variation in the performance of occupier submarkets across Oslo. Occupier demand is strongest for the CBD and Central submarkets, which are also characterized by the lowest vacancy rates (6.0% and 3.4%, respectively). Although the Western corridor has experienced more volatility in occupier markets owing to its greater exposure to the oil industry, the vacancy rate fell by 250 bps to 10.2% during H2 2016 following the lease of a large space holding at Fornebu. As in other markets in the region, vacancy is concentrated in Grade B space and some 38% of vacant space has a unit size of less than 2,000 m^2.[16]

[10] JLL (2016), Copenhagen City Profile

[11] NewSec (2016), Nordic Property Outlook, Autumn

[12] JLL (2016), Nordic City Report, Autumn

[13] CBRE (2016), Norway Property Market Update, H1

[14] JLL (2016), Nordic City Report, Autumn

[15] CBRE (2016), Norway Property Market Update, H1

[16] CBRE (2016), Norway Property Market Update, H1

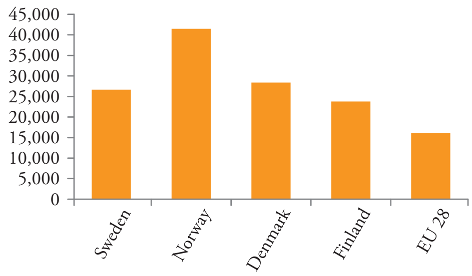
Prime rents have remained stable over 2016, but the strength of demand for modern premises in prime locations is expected to result in an upward pressure on prime rents across the central submarkets. The resilience of the mainland economy, urbanization trends and the recovery of the wider economy are expected to result in continued employment growth and demand for good-quality office space.[17] As the oil industry continues to readjust to market conditions, modest rental declines in the Western corridor market are anticipated, but vacancy is expected to reduce further.

1.2 Retail Market

The Nordic retail markets continue to benefit from strong underlying drivers of performance. While all the markets offer good fundamentals, the relative strength and characteristics of the retail market opportunity differ across the countries. The retail sector is driven by the interaction of multifaceted demand-side factors. These include consumer wealth and its growth expectations, consumption culture and retailer demand, and supply-side variables including availability of retail space and the growth of alternative modes of consumption, including online and the growth of non-food sales in supermarkets and other outlets.

While there are differences in wealth indicators across the Nordic markets, such as disposable income *per capita*, consumer affluence is significantly higher than the EU average in every market *(see Chart 4)*. This represents a significant market opportunity for retailers, particularly as retailer representation by multinational retailers in the region's major cities has been relatively low in comparison to other markets comparable in size, but with lower wealth indicators. Until recently, such retailers focused on countries with large populations and a corresponding high number of retail locations that offered economies of scale to distribution and other overheads associated with market

Chart 4: Median Net Disposable Income *per capita*, 2015 (EUR)



Source: Eurostat, 2016

entry. The relatively smaller scale of the Nordic countries, their geographic dislocation from mainland Europe and currency risk deterred many retailers from prioritizing these markets. In addition, the strength of local and regional retail operators in the discount and mid-market comparison retail segment reduced the market opportunity for cross-border retailers unable to compete on price or product quality.

The interaction of a number of structural and cyclical influences has led to retailers re-evaluating the region and prioritizing it within their expansion strategies. First, rapid urbanization in tandem with the growth of omnichannel retail strategies has transformed the dimensions of retailers' portfolio strategies. The capital cities of the Nordic market represent four of the five fastest-growing cities in Europe.[18] Omnichannel retailers are focused on employing online marketing to generate geographic reach beyond third tier markets and on consolidating the number of stores in large retail locations. Urbanization lends further support to this strategy, with higher proportions of target customers in the same locality. Profitability is no longer solely tied to store penetration. As a result, retailers have shifted from country-led to city-led strategies, greatly reducing the importance of country size. Critically, the store portfolio is considered as a number of different tiers that have a distinct purpose in the consumer journey.

[17] NewSec (2016), Nordic Property Outlook, Autumn

[18] Stockholm Chamber of Commerce (2016), October

Second, in the post-crisis era, many countries have seen disposable income levels deteriorate or, at best, stagnate. This has made the consumer opportunity in the Nordic region somewhat compelling. However, there are differences in the degree to which this is impacting upon the different markets and, of course, how more cyclical economic drivers are influencing retail market prospects.

The retail market in Sweden represents the strongest opportunity for retailers due to a combination of both structural and cyclical drivers. First, Sweden is the region's largest country by population and GDP. Its capital city, Stockholm, also functions as the business capital for the Nordic region and presently it is Europe's fastest-growing city. The city represents the highest and fastest-growing total volume of spending in the region and its regional headquarter role makes it a natural point of entry for many cross-border retailers. In recent years, economic growth has been strong relative to the EU average and persistent. In addition, fiscal policy has been expansionary and consumers have benefited from lower taxes and other windfall gains in addition to stronger employment growth, real wage increases and low interest rates. Retail spending growth has been strong and is expected to remain broadly stable during 2016, moderating slightly over 2017 as household spending adjusts to the introduction of amortization requirements for mortgage payments and the gradual raising of interest rates.

These attractive consumer fundamentals have attracted developers and investors as well as retailers. Indeed, multinational shopping center developers can also play a persuasive role in attracting cross-border retailers to a market due to their own marketing efforts and the long-standing relationship that they have with many leading retail brands. Sweden has experienced strong supply growth through new shopping center developments as well as the refurbishment and extension of existing schemes. The supply pipeline remains strong, with approximately 350,000 m^2 of new and refurbished space in the pipeline. This will dampen rental growth in the most saturated markets, but retail space in prime High Streets and shopping centers will continue to experience strong demand and relatively strong rates of rental growth.

Despite the recessionary economic conditions experienced in Finland until 2016, household consumption levels remain above the EU average. In Helsinki, strong population growth is compensating for weakening disposable incomes and prime rents have remained broadly stable. The availability of good-quality units in the CBD remains low, with vacancy concentrated in smaller units in weak locations. The bankruptcy of Antilla, which operates 31 department stores across the Nordics, will release space to the market and increase vacancy in the short term, although this presents a strong opportunity to reconfigure well-located stores into modern, large retail units for which there is strong retailer demand.

Helsinki has the lowest international retailer representation of the four Nordic capitals. It is also the lowest priority for retailers expanding into the region due to the smaller size of the economy and its relatively weaker prospects compared with the other Nordic markets. Nevertheless, cross-border retailer activity is expanding, albeit at a slower rate. As the economy recovers, prime rents are expected to come under modest upward pressure, but elsewhere new supply is anticipated to absorb retail spending growth.

Norway has the second largest economy in the region and the highest wealth indicators on a *per capita* basis. This consumer affluence attracts luxury brands to Oslo's prime High Street, Karl Johans Gate, and the strength of demand has seen an expansion of the retail core into adjacent streets. Equally, there is increasing demand for the mid-market Bogstadveien High Street retail area, where expansion from international retailers is also supporting market dynamics. This positive impetus is expected to continue, with international retailer representation still low relative to market size and affluence.

The continuing recovery of the Danish economy is evident in rising employment and household wealth indicators. Despite the recovery of household wealth and high savings, consumers remain somewhat prudent in their spending, although retail sales growth is positive, if weak.

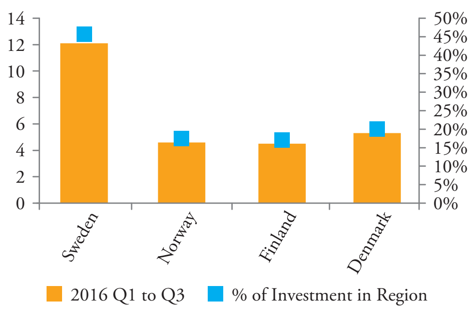
Owing to its geographic adjacency to mainland Europe, Copenhagen is an important point of access for retailers seeking to expand in the region. While low relative to other comparable cities, it has the second-highest international retailer representation of the Nordic markets. Retailer demand for units in the prime High Streets, including Strøget and Købmagergade, is strong and, like Oslo, is leading to an expansion of the core retail location into adjacent streets. Indeed, secondary locations as well as prime shopping centers are experiencing increasing demand from international retailers entering the market. Given the strong demand and limited new supply, there is upward pressure on rents, which increased by 2.8% year-on-year to the end of H2.

2.0 Investment Market

2.1 Investment Volumes

The Nordic region remains a preferred destination for investment capital from domestic, intra-regional and international investors. Institutional investors seeking fixed income style returns have been up-weighting to real estate, which offers attractive yields relative to low and negative yields from bonds and other fixed income investments. Within the real estate universe, portfolio managers continue to up-weight allocations to the Nordic region, given its stronger relative risk-adjusted returns. In short, the region is getting an even larger slice of an expanding pie, which explains why another new record investment volume was reached in H1 2016. In H1 2016, EUR 18.6 billion of real estate was transacted across the region and while activity slowed over Q3, at EUR 26.5 billion for the year to date, volumes remain on a par with 2015 *(see Chart 5)*.[19] The slowdown in activity is driven by a lack of product availability rather than by any easing of investor appetite. It also may reflect a tightening of lending criteria.

Chart 5: Investment Volumes by Market Q1-Q3 2016 (EUR million)



Sources: Genesta, 2016; CBRE, 2016

Sweden continues to account for the largest proportion of investment, accounting for 46% of Nordic investment over 2016 to end-Q3. Although investment volumes in the region have been high in recent years, the year-to-date volume of EUR 12.1 billion is some 44% higher than the previous record investment level reached in 2014.[20] Portfolio transactions continue to dominate, accounting for almost 60% of investment by value at end-Q3. In H1, the Castellum portfolio transaction skewed activity to the office sector, although residential portfolios were also a significant aspect of the market. In Q3, residential dominated while the sale of Starwood's retail portfolio bolstered the retail sector's

[19] CBRE (2016), Nordic Investment, MarketView, Q2; CBRE (2016), Nordic Investment, MarketView, Q3

[20] CBRE (2016), Nordic Investment, MarketView, Q2; CBRE (2016), Nordic Investment, MarketView, Q3

share of activity. The greater emphasis on residential and portfolio transactions is resulting in a wider distribution of activity beyond the three major cities. This also follows a divergence of investor strategies depending on risk appetite. Core, income return focused investors are prioritizing income security over location as they move a little up the risk curve in search of yield. This is manifest in a search for good-quality assets secured on longer leases to low-risk, often public sector, tenants in secondary cities. For value-add investors focused on restoring income security through refurbishment programs and leasing strategies, a strong location is an important balance to risk.

Denmark and Finland account for 20% and 17.4%, respectively, of activity in the region and investment volumes reached also represent record levels of market activity. Like Sweden, these markets have also been bolstered by growing numbers of large portfolio sales. Although the office sector accounts for the largest share of activity, the residential sector has increased its share of Nordic investment to approximately 30% in 2016 to end-Q3. Its share of activity is particularly high in Denmark, where the residential sector accounted for 49% of activity to Q3 2016. Investors are attracted to the strong underlying fundamentals of stable cashflow generating assets in a region where strong levels of urbanization and population growth across major cities have resulted in a housing shortage.[21]

The strength of investment activity in Finland is perhaps surprising, given weak occupier fundamentals. The transaction volume reached EUR 4.5 billion by Q3 2016, putting the market on track to reach a record investment level in 2016. Investors are attracted by the relatively strong underlying fundamentals of the residential and retail sectors, which account for a high proportion of activity. In addition, yields for prime, income secure assets offer a premium in comparison to other markets with stable financial economies.

Investment volumes in Norway account for 22% of the activity and represent a decline following an exceptionally strong H2 2015. Investor appetite remains strong, particularly from cross-border investors seeking high-quality assets, but the availability of such product is low. While there have been a number of large transactions, there has been a sharp fall in deal size, with the majority of investments being for assets of less than EUR 60 million.

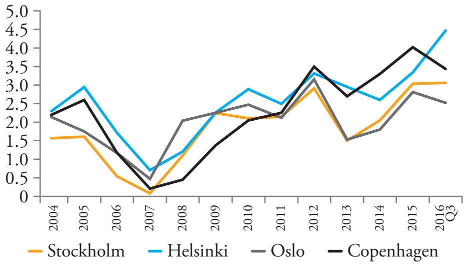
2.2 Pricing

The very high volume of capital targeting the real estate sector continues to put pressure on pricing partly because there is a lack of suitable alternative investments. With bond rates falling between 0% and 1% across the Nordics, real estate provides a much required income yield to institutional investors. These low-risk investors are seeking prime, income secure assets that behave similarly to bonds, offering stable and predictable cashflow. Investor demand has outstripped supply, compressing cap rates. While prime yields are at all-time lows in some markets, the wide spread with bond rates reflects investor discipline and perhaps the higher marginal cost of debt relative to pre-crisis rates *(see Chart 6 and Chart 7)*.

Clearly, the relativity of secure real estate and other fixed income instruments is driving pricing in the prime market. Through this lens, pricing is rational. The right to a longer-term cashflow agreed in a lease to a public entity or multinational corporation is so secure that its risk is only marginally impacted by real estate market prospects. The residual value is protected by the strength of the location and its proportion of value decreases inversely with lease length. Real estate prospects are of greater importance when pricing reflects a capital growth requirement.

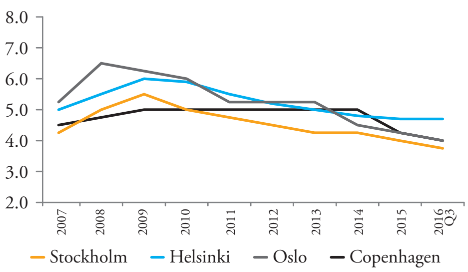
[21] NewSec (2016), Nordic Property Outlook, Autumn

Chart 6: Bond Yield Spread 2004-2015 H1 (%)



Sources: Genesta (2016); Danske Bank, October 2016

Chart 7: Prime Office Yield Movement 2000-2016 Q3 (%)

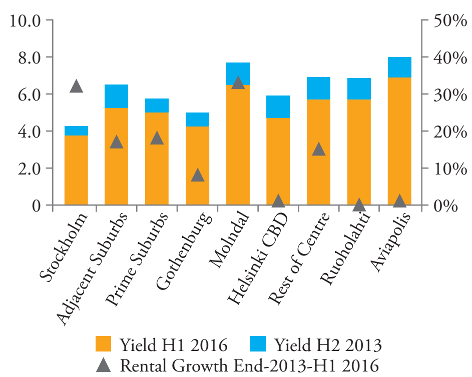


Source: Genesta, 2016

Moving gradually up the risk curve, real estate changes its financial characteristics. Many factors impact upon the security of income that reduce real estate's fixed income characteristics, including shorter leases, good but less secure tenants and building quality. The strength of real estate prospects affects the degree of risk exposure. For example, real estate prospects determine the probability of re-letting an asset at an acceptable rent in the open market. Fixed income style investors are narrowly focused on secure cashflow. As a result, there is reduced pressure from the increased weight of capital from such investors beyond prime assets. However, from a real estate perspective, the yield movement and spreads between markets is not explained by differences in real estate fundamentals. For example, since H1 2014 the spread between prime office yields in Stockholm and other Nordic cities has narrowed, while the difference in rental performance prospects has widened. Indeed, over the same period prime office rental growth of 32% has been achieved in Stockholm compared with broadly stable prime rents in Copenhagen and Helsinki.[22]

Differences in real estate fundamentals are more evident in the pricing of prime and secondary assets, and to a lesser extent between prime and secondary markets within and between countries. For example, the CBD, adjacent suburbs and prime suburbs markets in Stockholm have all achieved prime rental growth of 32%, 17% and 18%, respectively, between Q4 2013 and end–Q2 2016.[23] In contrast, prime rents in corresponding submarkets in Helsinki have remained largely static, with the exception of the Central suburb (excluding CBD). The yield spread between the CBD submarkets in the two cities has narrowed by 70 bps over the same period, while the spread between Stockholm CBD and its prime suburbs has narrowed by only 40 bps *(see Chart 8)*. However, the comparative yield spread in Helsinki has widened by 5 bps. These yields reflect well-leased, Grade A assets in each submarket. The yield spread between Grade A and Grade B assets is larger and much wider in non-prime locations with weak real estate fundamentals.

Chart 8: Yield Movement and Rental Growth by Selected Markets End-2013-2016 H2 (%)



Source: Genesta, 2016

[22] JLL (2014), Nordic City Report, Spring; JLL (2016), Nordic City Report, Autumn

[23] Catella (2014), Property Market Trends, Spring; Catella (2016), Market Indicator, Finland, Autumn; JLL (2014), Nordic City Report, Spring; JLL (2016), Nordic City Report, Autumn

NORDIC INSIGHT

MARKET NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

GENESTA PROPERTY NORDIC

Genesta Property Nordic is a fund and investment manager that specializes in commercial real estate in the four Nordic countries. We invest in office, retail and logistics assets and have offices in Stockholm, Helsinki, Copenhagen and Luxembourg.

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