# NORDIC INSIGHT

SPECIAL REPORT
FINLAND
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# A RECOVERY FOR THE FINNISH ECONOMY?

## -The Case for Real Estate Investing in Finland


GENESTA

## 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, Oslo, Copenhagen and Luxembourg. Genesta's assets under management total more than EUR 800 million and 500,000 m2 of space.

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# Executive Summary

Although investor intentions surveys since the onset of the financial crisis have indicated strong investor appetite for Finnish real estate, investment volumes remain subdued. This reflects the heightened risk aversion of investors, manifest in a narrow focus on income-secure assets within the prime CBD. Despite strong pricing in the CBD, domestic institutional owners have been unwilling to sell prime assets and this has resulted in low market liquidity. Excess demand for finite product has compressed prime yields to levels last achieved at the previous market peak. Yields for good quality assets in strong non-prime locations remain elevated. The yield spread between income-secure assets within the prime CBD and in the prime submarket is at an historic high. This research demonstrates that exploitation of mispricing in good quality real estate in strong submarkets is expected to outperform on a risk-adjusted basis due to the following factors:

- Although economic output deteriorated over 2012 and in H1 2013, this export-led market is expected to be an early beneficiary of the global economic recovery, given the diversity of its key export partners and the concentration of investment goods within its export mix. Importantly, the stability of the economy and its low exposure to debt across all economic sectors ensures that economic growth is accretive. Comparative analysis of the structure, stability and prospects of the Finnish economy relative to other eurozone countries indicates that growth expectations are not merely stronger and more sustained, but more certain. Low fiscal debt and modest total government debt will enable a more expansionary fiscal policy to dominate once the recovery gains traction, stimulating economic growth.

- Real estate investment risks are comparatively low in this open, transparent market. In particular, the banking sector is well capitalized and existing loan books have a low exposure to non-performing or out-of-the-money real estate assets. This removes the risk of market destabilization from a flood of non-performing asset sales present in other markets.

- Real estate prospects are modest in the near term as the economic slowdown has resulted in a softening of occupier demand. However, given the high concentration of investment goods within Finnish exports and the economic strength and/or recovery of many of its key export partners (Sweden, Germany, the UK and the US) occupier activity is expected to recover sharply from 2015 as pent-up investment spending is released. Strengthening real estate fundamentals will be supported by the very low supply pipeline.

- The yield spread between prime CBD and prime submarkets is historically wide at 100 to 150 bps for income-secure assets in even the strongest submarkets. This is indicative of a market dislocation and affords the opportunity to exploit a significant pricing arbitrage opportunity.

- This market dislocation is even more pronounced for good quality assets/well located assets with weak leasing profiles. Such assets incur a penalty of 150 to 200 bps, resulting in a spread with prime assets within the CBD of between 250 to 350 bps. Given the low supply pipeline and path to global economic recovery, the central risk of market timing inherent in the execution of tenant engineering/asset repositioning value-added strategies is greatly diminished. This represents a strong opportunity to create value by restoring secondary yielding assets in strong locations back to prime, while incurring limited additional risk.

# 1. Introduction

Real estate investors have pursued procyclical, risk-averse strategies since the onset of the financial crisis in 2008. This has resulted in strong yield compression on income-secure assets in prime locations across perceived safe-haven markets, including Helsinki. However, the adoption of such strategies tend to secure risk minimization rather than risk optimization; that is, stronger risk-adjusted returns may be derived from alternative investing strategies. Indeed, the concentration of investment activity on the narrow prime segment of the market has resulted in a pricing dislocation in many safe-haven markets. While prime yields have fallen to levels achieved at the previous market peak, yields for good quality assets in non-prime locations remain elevated. This suggests the potential for market mispricing.

This paper considers the prospects and pricing of the Finnish real estate market in the context of wider economic considerations and comparative to alternative European markets. First, the paper considers the structure, stability and growth expectations of the Finnish economy. In particular, the analysis considers the factors that have resulted in Finland being identified as a safe-haven market, the timing and pace of economic growth, as well as risks to the recovery. Subsequently, the paper considers the performance and prospects for the office market in the context of economic and real estate investment risks. The analysis explores real estate pricing across submarkets within the Helsinki market, and between Helsinki and other European markets. This enables the potential investment opportunity set to be identified.

# 2. Economic Weakness is Encased in a Strong Suit

The Finnish economy is somewhat paradoxical; economic productivity is not expected to recover to its pre-crisis level until 2016 and yet Finland continues to be considered as an economic safe haven. This seeming enigma is, of course, entirely rational. The underlying drivers of Finland's economic weakness stem from structural and cyclical dynamics within its export market. In particular, the demise of its leading industry, Nokia, and the high concentration of its export market in investment goods. Although the global financial crisis has exacerbated the downswing in demand for investment goods, Finland's economic weakness does not stem from the underlying driver of the financial crisis itself, namely exposure to debt. Indeed, the structure and stability of the Finnish economy are major strengths and underpin its identification as a safe-haven market. Moreover, it provides for a potential economic bounce once global demand resumes.

## 2.1 Stability of the Finnish Economy

The Finnish economy remains the only eurozone economy except Germany to have maintained its AAA rating since the downturn across all three principal rating agencies. This is despite the economy being pulled back into recession as the euro crisis reawakened in late 2011 and into the summer of 2012. This confidence in the stability of the economy stems from the credibility of its balance sheet across all sectors of the economy.

The global financial crisis emanated from a debt bubble and the challenge of deleveraging continues to present the greatest underlying risk to a sustained recovery in the eurozone. The solvency of the Finnish economy relative to its eurozone peers is its greatest strength and is evident across all economic sectors. As elsewhere, weak economic growth has resulted in rising public sector debt. However, estimated at 58% at end-2013, public sector debt is comparatively low relative to all other eurozone countries; for example, Germany has a debt ratio of 80.3% and France 93.5% ***(see Chart 1).*** Moreover, current revisions to the national accounts of EU member states will see R&D expenditure accounted for as investment spending. This will positively impact on Finnish GDP and is expected to reduce the debt ratio by approximately 3%. Equally, fiscal debt is under control, with the government maintaining a tight budgetary policy ***(see Chart 2).*** This has led to the introduction of austerity measures that are split between increased taxation and spending cuts, which are estimated to deliver net savings of over EUR 5 billion from 2013 to 2015 and to lower the budget deficit from 2.5% to sub 2% over the same period. Relative to other eurozone economies, the austerity measures are modest. Moreover, the low level of debt to GDP provides some headroom for enacting stimulus measures should further shocks to the global economy transpire. The decision to implement austerity measures reflects the government's focus on maintaining its AAA credit rating and continuing to benefit from investor confidence and a low risk premium. The spread between Finnish and German bonds over the course of 2013 fluctuated between 20 and 30 bps. Importantly, the relative solvency of public finances means that the capacity for public spending and stimulus measures will resume when the economy shifts from recovery to growth from H2 2015. This is in stark contrast to more indebted countries, where the requirement to reduce debt will act as a drag on economic growth.

Since the announcement of the ECB's Draghi Plan, which effectively positioned the ECB as a lender of last resort for the eurozone, financial market volatility has abated. However, the solvency of financial institutions remains central to economic risk and to economic growth. Finnish financial institutions had a relatively low exposure to debt as a percentage of GDP at the peak of the market and, importantly, held a very low exposure to the high- risk sovereign debt of the peripheral economies. Nevertheless, in the heightened uncertainty that ensued post-crisis, credit availability constricted as banks refocused on derisking balance sheets and, from 2011, on preparing to meet the requirements of new global banking regulations. In particular, these included the increased capital adequacy requirements of Basel III. Alongside their Nordic peers, the lower exposure to debt and non-performing loans enabled Finnish banks to restructure balance sheets relatively quickly. By the end of 2012, Nordic banks dominated the small minority of European institutions estimated to have completed the balance sheet restructuring required to meet the capital adequacy requirements of Basel III ***(see Chart 3).*** This was greatly facilitated by their relatively low exposure to bad debt, notably the risk of sovereign debt default.

As a result, credit availability increased during 2013 across the Nordic region, including Finland. In addition to increasing competition amongst banks to provide real estate finance, small- and medium-sized enterprises are benefiting from the higher availability of capital. This represents an important economic stimulus that will accelerate as the recovery strengthens and as pent-up investment spending resumes. With the exception of Germany, credit availability remains very constricted in most other eurozone countries for even viable businesses and continues to impede economic growth.

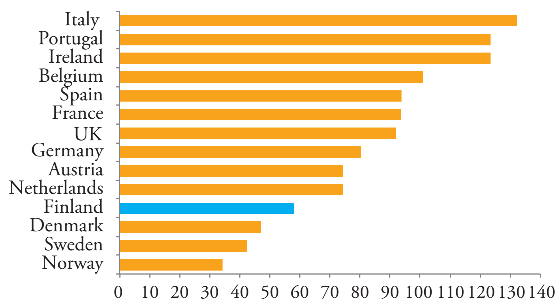
Although the weak economic conditions will constrain spending growth, the relative solvency of households will assist in stabilizing consumption levels in the near term. While savings ratios are currently low, Finnish households are relatively unindebted relative to other European markets *(see Chart 4).* The absence of a pre-crisis housing market bubble has left households unscathed by the negative wealth effect of a housing market crash as occurred in Ireland, Spain, the Netherlands and the UK *(see Chart 5).* Indeed, post-crisis Finnish house prices have risen in line with incomes, creating a sustainable positive wealth effect. Although the market has softened due to falling confidence amid rising unemployment and stagnating incomes, underlying demand against the low level of new supply is expected to result in market stabilization. Given the relatively low levels of household debt, consumption growth is expected to provide an important contribution to economic growth as the recovery strengthens and shift toward growth by the end of 2015. This contrasts with markets including Spain, Ireland, the Netherlands and the UK where pressure to deleverage public finances is combined with high ratios of household debt.

## 2.2 Structure of and Prospects for the Finnish Economy

Positively, Finland is an export-led economy. Its current malaise stems from structural difficulties within its important ICT and forestry sectors as well as from the high concentration of investment goods within its export market. In different ways, both sectors have been affected by the growth of smartphones and tablet devices. Nokia failed to gain sufficient market share and new technologies have structurally changed the publishing industries, resulting in lower demand for high quality paper products. Nokia's mobile phone production represented a large share of Finland's ICT sector and at its peak represented 4% of Finland's GDP between 2000 and 2007 and accounted for a third of research and development spending in Finland. Since 2007, its loss of market share and subsequent closure of Nokia's mobile phone manufacturing plants resulted in a fall in the value of goods exports by 2.6% *(see Chart 6).* Quarterly data indicates a slow improvement in exports from mid-year 2013. In July to September 2013, the volume of goods exports rose by 1.5%, although the value of goods declined over the same period. Industrial production of electronics goods declined by almost 10% year on year in November 2013 and the manufacture of machinery was down by 14.5%. Other important sectors such as forestry and paper products did not sustain their recovery over Q3 2013, with data for November 2013 indicating a modest decline in production on an annual basis. However, following a decline in H1 2013, investment goods rebounded in H2 and by November 2013 stood 3% higher than the previous year. While the timing of recovery is later and softer than anticipated, the upward trend is already evident.

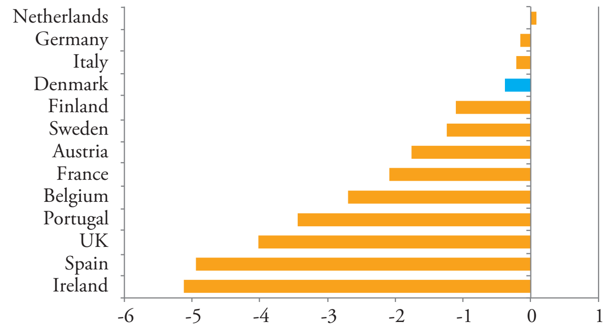
With economic productivity already reflecting the decline of Nokia, its subsequent sale of its mobile phone division to Microsoft may have a positive impact on the economy for a number of reasons. First, Microsoft is expected to retain value-added activities, notably R&D activity, within

Chart 1: Government Debt at end 2013f as a % of GDP



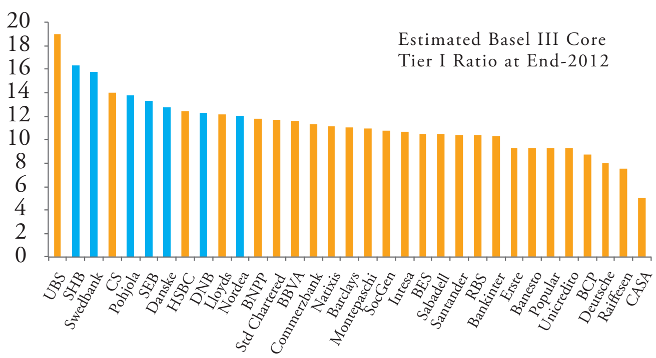

Source: IMF, October 2013

Chart 2: Structural Fiscal Balance as % GDP end 2013f (General Government)



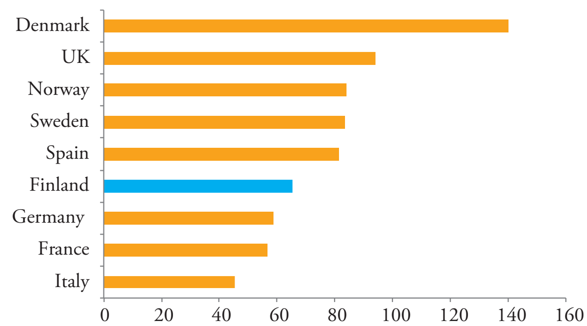

Source: IMF, October 2013

Chart 3: Nordic Banks Are Well Capitalized to Meet Basel III Tier 1 Requirements



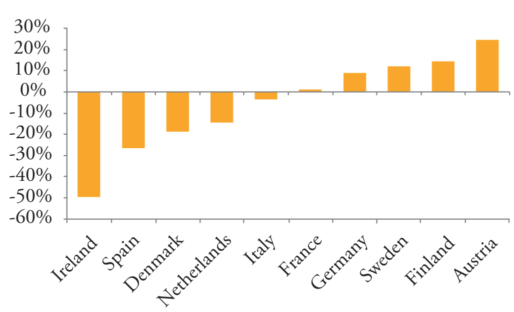

Source: J P Morgan Equity Research

Chart 4: Household Debt by European Country as a % of GDP



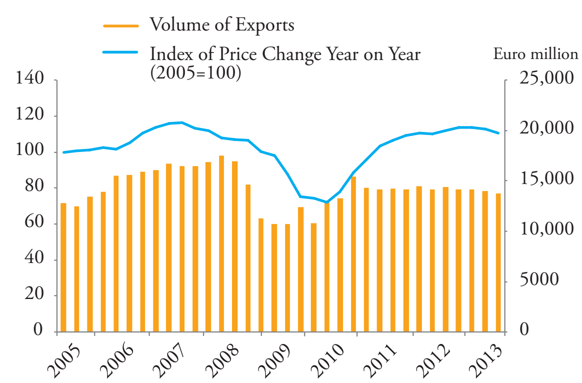

Source: Eurostat, 2013 (loans and securities other than shares)

Chart 5: House Price Growth end 2007 to end 2012




Source: Hypostat, 2013; Genesta, 2013

Chart 6: Volume and Value of Exports, Finland 2005 to 2013




Source: Eurostat, 2013; Nordea Markets, December 2013 their operations in Finland. Given the global war for talent within the technology sector, the acquisition of Nokia partly represents the acquisition of a highly skilled talent pool, knowledge base and expertise. The growth of Nokia established the region as a major European technology center. Second, the EUR 5 billion proceeds of the sale will enable Nokia to invest and expand its remaining telecoms networks division, providing a boost to investment spending. Third, former Nokia electronic and software engineers have been establishing embryonic start-ups such as Rovio and Supercell, particularly in growth sectors such as gaming and mobile app development.

Given the high concentration of the export market in investment goods, the slow recovery in global demand has impeded Finland's recovery. While the market emerged from technical recession in H1 2013, growth over Q3 2013 failed to gain traction and initial data suggests that growth stagnated through the final quarter of the year. This resulted in further job losses and, given the weakness of new manufacturing orders, unemployment is expected to rise during H1 2014 before employment growth resumes thereafter. This has resulted in forecasts for GDP growth being revised downward to -1.0% for 2013 and to 0.8% for 2014, with the recovery expected to gain traction from H2 2014, strengthening to 2.0% by end-2015 ***(see Chart 7).***

The recovery of the Finnish economy is reliant on export growth in investment goods. Given the low level of investment spending since the onset of the financial crisis, export- led economies are expected to become beneficiaries of the wider global economic recovery. While the EU returned to positive GDP growth of 0.3% over Q2 2013, it followed six quarters of contraction. The prolonged recession within the EU and the more recent slowdown in Russia have resulted in sustained low demand for Finnish exports, exacerbated by the strengthening RUB/EUR exchange rate. However, economic activity is strengthening in Finland's other major export markets, including the US, the UK, Sweden and Germany. Although global trading activity has surprised on the downside given the strength of leading indicators, pent-up investment demand is expected to be released in H2 2014 and 2015. While the lag will drag on Finnish growth in the short term, the timing is somewhat beneficial. Given stronger wage growth since the crisis, the competitiveness of Finnish manufacturing has deteriorated relative to Germany. Recognizing the importance of export growth to the wider economic recovery, labor unions within this consensus economy have agreed to very low wage growth to end-2015. In addition, the Government lowered corporation tax by 4.5% to 20% at the beginning of this year. This should assist in restoring competitiveness and enabling Finland to gain a sufficient market share of investment spending. Export growth is forecast at 3% in 2014, with growth accelerating into the medium term as domestic demand recovers ***(see Chart 8).***

## 2.3 Risks to the Economic Outlook

There are a number of underlying risks to the momentum of growth that must be considered. These include external and internal factors that would impact on the economy.

*European Recovery Postponed*

As a small, open export-led economy, Finland remains vulnerable to shocks in the wider economy and the timing of any recovery is dependent on import growth from its major trading partners. While the implementation of the Draghi Plan and the effective creation of the ECB as lender of last resort have significantly reduced uncertainty and financial market volatility, the sovereign debt issue itself is not yet resolved. Any resurgence of the risk of sovereign default will halt the path to recovery. While harmonization of the banking sector is progressing slowly, the credit market remains fragmented, resulting in divergent access to, and cost of, borrowing facilities. This is acting as a major impediment to the recovery of peripheral economies. In addition, the earlier normalization of central bank monetary policies in the US and associated interest rate hikes may impact on growth depending on how financial markets react. In particular, it may impact on consumption, investment spending, credit markets and government finances, which would negatively impact on Finnish exports. Such downside risks are counterbalanced by an upside risk that the contagious effects of the US recovery for Europe may prove to be stronger than assumed in forecasts.

*The Housing Market*

Nominal house prices have risen 14.3% since 2007, prompting some commentators to be concerned about the risk of a housing bubble. However, house price growth has risen in line with earnings. While austerity measures and falling employment levels will put some pressure on household income over the short term, this is cushioned by exceptionally low interest rates. Given the low level of construction activity and supply shortage in growth centers, market prices are expected to broadly stabilize. A housing market crash could only be precipitated by a sharp rise in interest rates in the short term or a prolonged market downturn, resulting in sharper falls in employment levels.

Household debt as measured as a percentage of GDP remains low at 65% relative to other eurozone markets and to its Nordic peers, with debt principally amortized. This provides a cushion against interest rate shocks and the negative wealth effect of any price falls. However, the household savings rate is low and presents a minor risk should an interest rate shock occur, because interest rates are usually tied to Euribor.

# 3. Real Estate Prospects and Pricing

Real estate investors have pursued procyclical, risk-averse strategies since the onset of the financial crisis in 2008. This has resulted in strong yield compression on income-secure assets in prime locations across perceived safe-haven markets, including Helsinki. However, beyond this narrow segment of the market, yields for good quality assets in non-prime locations remain elevated. This presents a strong arbitrage opportunity when considered against the comparative risk and prospects within the Helsinki market and against other European markets.

## 3.1 Investment Market Risk

The size of the investable real estate investment market in Finland is estimated at EUR 45.7 billion. The market is highly mature, transparent and is dominated by domestic institutional investors who account for approximately 35% of holdings. Non-listed real estate funds and direct holdings by international investors account for a further 34% and a further 27% is accounted for by both listed and non-listed property companies ***(see Chart 9).***

Prior to the financial crisis, real estate investment market risks were considered across a number of simple metrics, namely market size, transparency and liquidity. However, the legacy of the financial crisis has demonstrated the complexity of the globalization of financial markets and its associated risks. While reference to market size as a basis for the neutral portfolio remains important, a legacy of the downturn has been a reassessment of investment market risks. A debt-fuelled real estate bubble of some EUR 2 trillion was at the heart of the global financial crisis and the process of deleveraging the sector brings additional risk.

Since the downturn, investment allocations to Europe have favored perceived safe-haven markets that have been subject to a stronger and increasing proportionate share of capital at the expense of southern peripheral markets. In recent years, Europe's core economies (Germany, France and the UK) and the Nordics have accounted for around 85% of capital invested, yet represent 57% of European GDP. In contrast, the peripheral economies, including Italy, Spain, Greece, Portugal and Ireland, account for less than 7% of invested capital, yet represent 23% of European GDP ***(see Chart 10).***

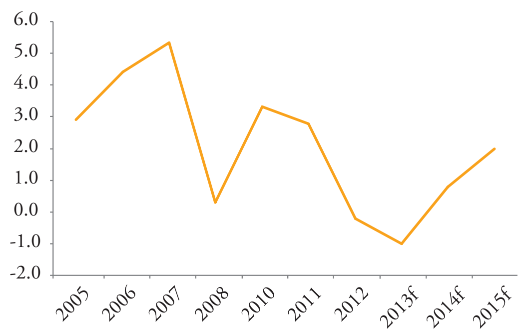
Within the Nordics, Sweden accounts for the largest share of investment in part due to its market size, but also due to its more favorable economic prospects. Relatively, investment volumes in Finland have remained subdued since the crisis, despite investor intentions surveys indicating an increase in allocations to the market, especially from 2010 to 2012 ***(see Chart 11).*** Domestic institutional investors holding such assets have been unwilling to sell despite yield compression.

This reflects the narrow focus of excess capital on good quality, income-secure assets within the prime CBD that have a finite supply. While investment volumes are subdued relative to historic trends, the recovery of activity contrasts with the inertia that has characterized southern peripheral markets, driven by low investor appetite. Being within the eurozone, Finland also benefits from increasing demand from real estate investors seeking exposure to the Nordic region, but limited to investing in euro-denominated markets. Such investors recognize the comparative strength, stability and prospects of the economy and real estate market relative to other eurozone countries. In southern Europe, investment volumes showed early signs of revival in 2013. However, investment volumes remain very low relatively. For example, at EUR 0.85 billion, real estate investment in Italy over Q3 2013 increased by 145%, yet represents less than half the EUR 1.9 billion invested in the smaller economy of Sweden, where volume growth was broadly stable.

Looking forward, a number of large Finnish institutional investors have announced their intention to increase investments in non-domestic real estate. It remains to be seen if this will have a positive impact on Finland's real estate liquidity. It is uncertain whether the reweighting of portfolios will be achieved through increasing total real estate allocations or if it will require divestment in domestic holdings, which would improve liquidity.

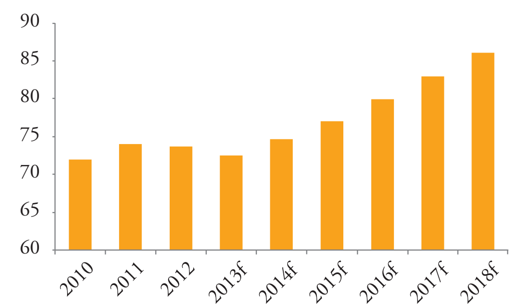
The low level of distressed assets has also reduced market liquidity relative to other markets. In the wake of the financial crisis and the downturn in real estate, a debt funding gap emerged affecting circa 45% of real estate loans in Europe. This reflected the equity gap created as real estate values declined as well as the downward revisions to loan-to-value thresholds upon renewal. Like investors, lenders prefer low-risk assets in low-risk markets. As a result, refinancing has been a growing issue for the vintage of high-risk debt maturing over the next four years. Indeed, the need to bolster solvency to meet the requirements of Basel III has rapidly increased the pressure to restructure bank balance sheets and remove out-of-the-money assets to assist balance sheet repair. For markets with a large exposure to such legacy loans, the risk of market destabilization from a market flood of asset disposals by banks, or by those purchasing loan books, is growing. However, Finland has a very low exposure to the presence of a debt funding gap absolutely and relatively, suggesting a low risk of market destabilization ***(see Chart 12).*** Thus, there is also

Chart 7: GDP Growth Finland 2005 to 2015f (%)



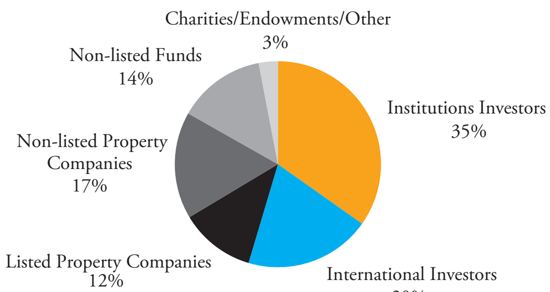

Source: Eurostat, 2013; Nordea Markets, December 2013

Chart 8: Volume of Finnish Exports 2010 to 2018f (€ billion)



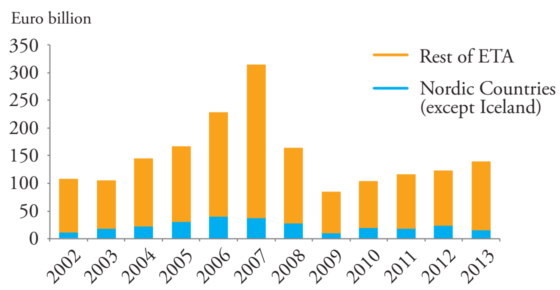

Source: IMF, October 2013; Genesta, 2013

Chart 9: Structure of Finnish Real Estate Investment Market



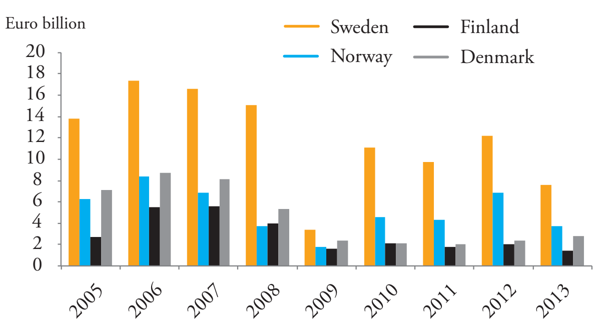

Source: KTI, 2013

Chart 10: Investment Volumes by Nordic Market and Rest of ETA (Europen Trading Area)



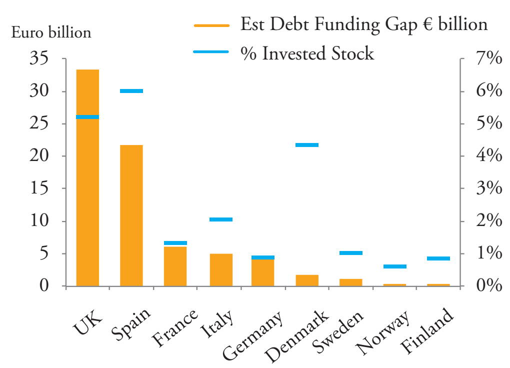

Source: RCA (2013); JLL (2013); Newsec (2013)

Chart 11: Investment Volumes by Country 2004 to 2013 Q3




Source: Newsec, 2013; CBRE, 2013; DTZ, 2013

Chart 12: Estimated Debt Funding Gap Relative to Market Size




Source: DTZ

significant interest from distressed opportunity investors in the disposal of non-performing assets by banks within the market.

## 3.2 Prospects for the Office Market

Mirroring the investment market, the occupier market has been polarized. Occupier demand within the prime CBD segment remains robust despite the weak economic environment. This reflects the limited availability of suitable product within the market and resulted in rental growth of 2-3% over 2013. Indeed, prime rents have increased by more than 12-13% since the previous market peak in 2008. Rental growth has also characterized good quality assets in prime submarkets, with rental levels some 24% higher than in 2008 in the central area and a more modest 2% higher in the prime submarket. This compares favorably with other safe-haven markets. Prime rental growth in Stockholm, Munich and Paris since the market trough is 10%, 8.5% and 11%, respectively. In Spain and Italy, prime rents continued to decline over 2013 and are now some 40% and 14.5% below their previous market peak ***(see Chart 13).*** Looking forward, prime rents are not expected to rise during 2014 as near-term growth was already captured in 2013 and occupier demand will remain subdued during the year. However, modest rates of growth are expected in the medium term as economic activity strengthens over 2015. Despite the weak outlook in the near term, rental growth expectations for Helsinki compare favorably with other European markets on an annualized basis over three-year and five-year forecast periods ***(see Chart 14).***

The stronger rental performance of the Central submarket is reflected in a comparison of vacancy rates. Vacancy rates within the CBD and within the prime suburbs have shifted upward to 7.9% and 11.75%, respectively, while the vacancy rate in the Central submarket has fallen to a low level of 4.4% ***(see Chart 15).*** Vacancy in non-prime suburbs that are not well located is considerably higher. Moreover, vacancy and achievable rental levels are highly variable with asset quality. It is noteworthy that 90% of vacancy is accounted for by ageing assets, in excess of ten years old. This polarization has been exacerbated by a modest supply pipeline since the downturn. Although this has been dominated by non-speculative construction, occupier demand was not sufficient to deliver net absorption. Rather, occupiers took the opportunity to trade up to modern, efficient space that offered better value for money, releasing vacated space back to the market. Looking forward, the supply pipeline is now muted and will assist in eroding the vacancy rate and stabilizing rental levels for good quality assets in the near term. Rental growth is expected to resume in the medium term as economic activity accelerates in 2015. In contrast, rents for ageing assets will be subject to downward pressure given increased availability and softening occupier demand.

## 3.3 Mispricing Provides Strong Countercyclical Investing Opportunities

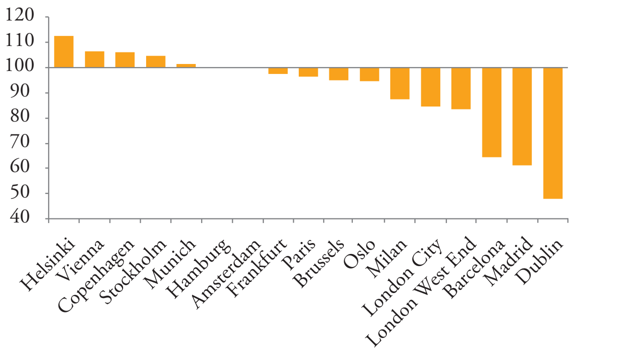
Investor demand has been narrowly focused on income-secure assets in the prime locations since the onset of the downturn. This has resulted in strong prime yield compression in the Helsinki market, which has continued over 2012 and 2013. At 5.0%, prime yields have reached the level achieved at the previous market peak, although rental growth expectations are considerably more modest. In part, this reflects the low risk appetite of investors and the value placed on certainty of income. It also reflects the presence of low bond yields. The yield spread between bond rates and prime office yields remains high relative to historic trends and comparative to other markets within the region ***(see Chart 16).*** However, it is widely acknowledged that bond rates are artificially low due to the requirement for accommodating monetary policy to ease financial market turmoil. Secondly, risk aversion across the financial markets has seen increased appetite for safe-haven market government bonds, which pushed bond rates to unsustainably low levels in the Nordics, Germany and the UK. However, as market uncertainty has reduced fixed income investors have increased their risk appetite and bond rates have begun their broadly expected upward trajectory, eroding spreads with real estate. This upward trend in bond yields is expected to continue as markets revert to trend rates in anticipation of normalization of policy rates. The wide spread present in Helsinki will provide a cushion against rising bond rates, although given modest rental growth expectations the absence of capital growth will result in low returns. Prime yields in Stockholm and Oslo will be subject to some upward pressure due to the much narrower spread with the risk-free rate, which given modest rental growth expectations may result in negative returns for prime assets within the CBD.

In contrast to the CBD, yields for good quality assets in strong non-prime locations in the Central and prime suburb submarkets remain elevated at 6% and 6.5%, representing a spread with the CBD of 100 and 150 bps respectively ***(see Chart 17).*** Equally, analysis of the pricing differential between submarkets demonstrates that the yield spread is at an historic high. Although occupier demand is stronger within the prime area, there is sufficient demand for good quality assets in the central and prime suburbs. This is reflected in the low vacancy rate within the Central submarket and while vacancy is high across suburban locations it is concentrated on ageing assets and poorly-located business parks. While occupier demand is expected to soften in the near term, it will strengthen sharply from 2015 as strengthening export demand restores economic activity, confidence and releases pent-up investment demand. To this end, the yield spread between the prime CBD and prime assets in income-secure, good quality assets in other submarkets represents a market dislocation within the market and relative to wider opportunities in alternative markets. For example, while there is evidence of such a market dislocation between the prime CBD and prime suburb submarkets in Stockholm, at 75 bps the yield spread is much lower. Moreover, despite the fragility of the economic prospects of the southern peripheral economies as reflected in higher bond rates and weaker real estate fundamentals as reflected in vacancy and rental levels, prime yields in Madrid and Milan are 50 bps lower than for a prime asset in a good quality submarket in Helsinki ***(see Chart 18).*** This emanates from the narrow focus of investor appetite since the onset of the financial crisis and represents a significant countercyclical investment opportunity to exploit mispricing.

The spread between prime and secondary cap rates is substantially higher for assets in strong locations with weak leasing profiles that could be readily restored with appropriate value-added asset management strategies. Assets subject to some income impairment or requiring refurbishment incur a penalty of approximately 150 to 200 bps over an income-secure asset in the same location. While some assets are functionally obsolete, selective opportunities persist to refurbish and upgrade ageing assets and/or to improve the income profile of assets through professional asset management. Current pricing provides up to a 300 to 350 bps yield premium to compensate for the income risk incurred in repositioning otherwise good quality assets in strong non-prime locations. The risk is greatly reduced by market timing, which affords the opportunity to undertake such value-added strategies countercyclically, acquiring the asset and executing the asset strategy in the early phase of economic recovery. The associated risk is greatly reduced by the low supply pipeline and the presence of market mispricing.

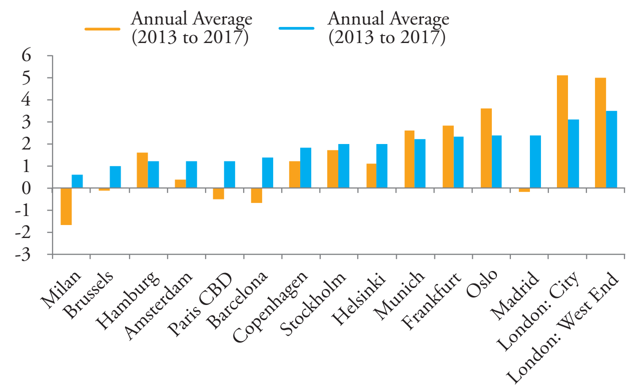
In the current risk-averse market, two principal asset management strategies may be deployed – tenant engineering and asset repositioning. Both strategies are focused on rebuilding the leasing profile of an asset (including lease length, rental terms and the tenant's covenant strength) and, in turn, the generation of capital appreciation as the income yield shifts inward to reflect the asset's restored risk profile. The two strategies differ in their risk components. Tenant engineering is a cyclical play that exploits the latent value of a moderate to good quality, multi-tenanted asset in a strong location, but that suffers from vacancy and/or a weak leasing profile. The emphasis is on derisking the lease profile and involves a rolling program of tenant improvements as the short lease ends that characterize such assets expire. Subsequently, stronger market conditions enable longer new or renewed leases to be secured, at higher rents, often to lower risk tenant covenants. While the execution of a rolling program of tenant improvements reduces income return in the short term, the staged program insulates against the degree of income risk exposure at any one

Chart 13: Prime Rent as % Previous Market Peak at Q3 2013



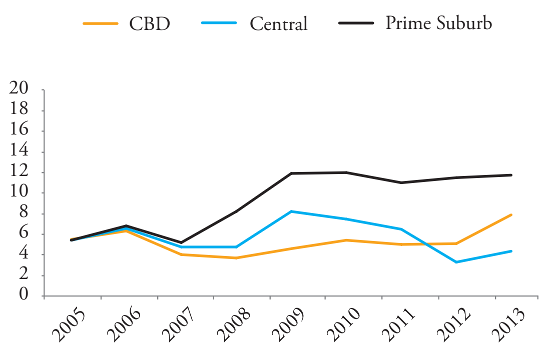

Source: Genesta, 2013; CBRE, 2013; Newsec 2013

Chart 14: 3 versus 5 Year Annualized Rental Growth Projections (%)



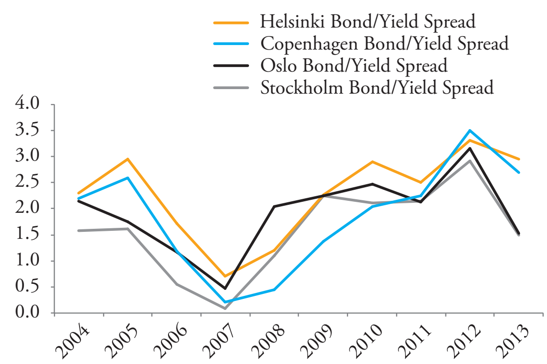

Source: Genesta, 2013; IPF, October 2013

Chart 15: Helsinki Vacancy Rates by Submarket 2007 to 2013 (%)



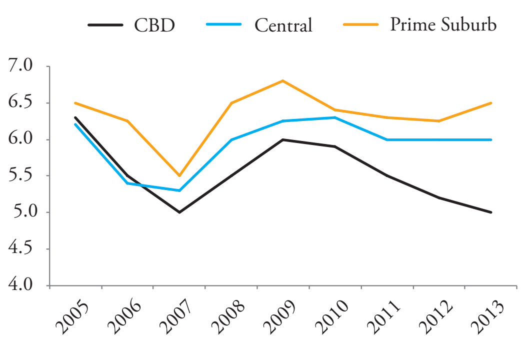

Source: Genesta, 2013

Chart 16: Bond Yield Spread 2004 to 2013 (%)



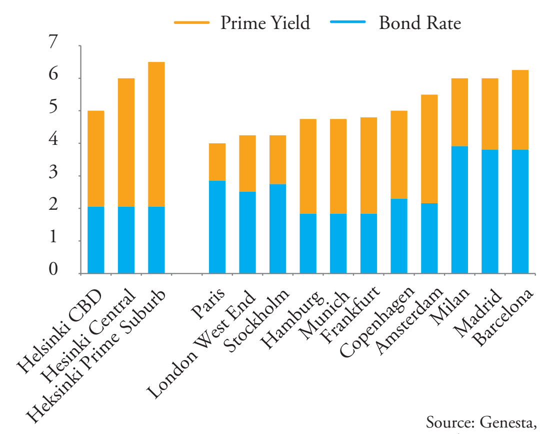

Source: Genesta, Dec 2013; Danske Research, Dec 2013

Chart 17: Prime Yields by Helsinki Submarket (%)




Source: Genesta, 2013

Chart 18: Comparison of Prime Yield/Government Bond Rate Spread by Helsinki Submarkets and Selected European Markets (%)




Source: Genesta, 2013; Bloomberg, 2014; CBRE, Q3 2013 period of time. Derisking the asset by restructuring the quality and profile of income restores the asset's investment characteristics to those of a core institutional investment.

Asset repositioning is focused on transforming the quality of assets in strong locations. It may involve redevelopment and/or a significant structural and technical retrofit rather than a simple rolling refurbishment program more usually associated with tenant engineering strategies. Given the higher exposure to building quality risk, preleasing is employed to ensure that leasing risk is low. By dramatically improving the grade and functionality of the building, it is possible to secure significantly better quality tenants at higher rental levels on longer lease terms. Again, the asset is restored to institutional investment quality in both its fabric and leasing profile, commanding a lower yield. This strategy is also highly relevant for shopping center assets that are well located but failing to attract market share due to a weak leasing profile and/or outdated configuration of public spaces, store size and layout. It is highly applicable in micro locations where competing schemes are limited yet consumer profiles strong.

## 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, Oslo, Copenhagen and Luxembourg. Genesta's assets under management total more than EUR 800 million and 500,000 m2 of space.

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