

Development of the Public Real Estate Equity Investment Sector in Finland

Heidi FALKENBACH and Sami KIEHELÄ, Finland

Key words: Indirect investments, public real estate investment company, Finland

SUMMARY

The article studies the forms of investment in Finnish commercial property markets, with special emphasis to public real estate equity. The paper describes and analyses the past development of public commercial real estate equity investments in Finland and discussed its role as a market participant. Finnish legislation provides two forms of public equity investment in real estate: public real estate investment companies and real estate investment trusts. Due to taxation and operational inefficiencies, no FinnREITs have been established and in practise the public equity sector exists only in form public real estate investment companies.

The public markets for real estate equity started to develop in 1980's when the first public real estate investment company entered the stock exchange. The sector had a short period of vigour in the turn of 1990's, which ended in the severe economic crisis that hit all Finnish business sectors in 1991, cutting the sector to less than half of the earlier. In the end of 1990's Finnish property markets experienced a new wave of securitisation as new companies entered the stock exchange.

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1. INTRODUCTION

Real estate investment can be divided into different categories by their form. One of the most common divisions is the division between direct and indirect real estate investments, where direct investments refer to the acquisition and management of the actual properties. Indirect real estate investments stand for investments in a vehicle (e.g. REIT or investment company) that invests in equity or debt real estate.

A more detailed classification has been created by Hudson-Wilson et al. (2003). They divide the world of commercial real estate investment into four structures by their debt and equity as well as trading characteristics. First group of real estate investments is the private commercial real estate equity, which can be owned directly or through a vehicle. Second group, private commercial real estate debt, stands for either directly issued mortgages or commercial mortgages held through a vehicle. The third category is public real estate equity, typically in the form of real estate investment trusts (REITs) or real estate investment companies. The fourth structure commercial real estate debt that is structured as commercial mortgage-backed securities.

	Private	Public
Equity	-Direct investment -Shares in REC and MREC -Shares in unlisted instruments -real estate investment companies -funds etc.	-Shares in listed real estate investment companies (-Shares in FinnREITs)
Debt	-Mortgages held by financial institutions	

Figure 1 Commercial real estate investment markets in Finland

Figure 1 represents the forms of real estate investment available in the Finnish markets classified following model of Hudson-Wilson et al. (2003). As can be seen, the investment possibilities in Finland are still fairly limited. Private commercial real estate is organized

through direct ownership or shares in usual real estate company (REC), mutual real estate company (MREC) or an unlisted real estate investment company, or a fund. Public real estate equity is provided for in the legislation in forms of public real estate company and real estate investment trust, but in practise exists only in the form of public real estate companies. Private commercial real estate debts are mortgages held by financial institutions, but there exists no commercial mortgage-backed securities in the Finnish markets. On residential markets, the mortgage-backed security was launched in 2007.

This article focuses on the public equity sector and it's development and is organised in the following manner. Chapter 2 discusses the forms of public real estate equity investments provided for in the Finnish legislation. Chapter 3 discusses the development of the sector from 1988 to 2006 through a review of the development of the number of instruments provided in the markets as well development of the sector size. Chapter 4 provides the conclusions and discussion.

2. REGULATION OF PUBLIC EQUITY INVESTMENTS

2.1 Public real estate investment companies

Finnish public real estate investment companies (PREICs) are regulated according to the same laws as other public companies. All limited liability companies are regulated by the Finnish Companies Act (734/1978) and additionally, publicly traded companies have to comply with the Securities Market Act (495/1989). In addition, Accounting Act (1336/1997) and Accounting Ordinance (1339/1997) affect the operations of PREICs, especially in the field of distribution of dividends.

Finnish Companies Act (FCA) defines the limited liability of shareholders as well as minimum capital required for the company. Currently, a public limited liability company's minimum equity capital is set on 80 000 euros (FCA 1 §3). In addition, FCA defines the possibilities for dividend sharing. The Securities Market Act regulates the trade, marketing, issuance and trading of shares of Finnish public companies (Chapters 2 and 3). In addition, Securities Market Act has provisions on market abuse (Chapter 5) and public bidding (Chapter 6).

Accounting Act defines the rules for the appreciation of assets. Until the end of year 2004 public limited liability companies were allowed to follow the same regulation as private limited liability companies regards to appreciation of assets. In practise, this allowed PREICs to assess their real estate investments in their annual reports and financial statements into book values. In 2005, the regulation was changed, as public limited liability companies were required to follow the International Financial Reporting Standards (IFRS) (Accounting Act 7a §2). The IFRS requires PREICs to appreciate their real estate investments in market values.

Public real estate investment companies are imposed a corporate tax of 26 per cent on profits generated by the company. In addition, also shareholders are liable to pay tax for income received in form of dividends. Thereby, investments are imposed to double taxation.

For private individuals and estates 70 per cent of incomes on dividends received from a public company (incl. PREICs) is regarded as income from capital, and imposed a flat tax rate of 26 per cent. The remaining 30 per cent is non-taxable. (Income Tax Act 1535/1992, Chapter 2 § 33a).

The main principle for taxation of corporations is that dividends are non-taxable (Corporation Income Tax Act (CITA), Chapter 1 §6a). A corporation is liable of taxation for its dividend income when

- a) dividend is received from shares categorised as investment assets and the receiving corporation has less than 10 per cent ownership in the company
- b) dividends are received by a private corporation from a public corporation in which it has less than 10 per cent ownership
- c) dividend is received from a corporation whose corporate-law home is not Finland or a corporation defined in the European Community directive (90/435/ETY) on parent and affiliate companies

In these cases 25 per cent of the income is non-taxable, and 75 per cent if taxed with a tax rate of 26 per cent. (Corporation Income Tax Act (CITA Chapter 1 §6a)

2.2 Finnish real estate trusts

The first law on Finnish real estate trusts (FinnREITs) was enacted in 1997. The law regulates the activities of real estate investment trust traded in a public marketplace, i.e. stock exchange. As, according to the Real Estate Investment Trusts Act (REIT Act, 1173/1997) in it's original form, a FinnREIT can operate in a form of public limited liability company and imposed to the same legislation as PREICs. In addition, REIT Act imposes some additional regulations for the operation of FinnREIT.

The FinnREITs can practise investments in real estate and real estate securities. At least 60 per cent of assets must be invested in real estate or real estate securities within the European Economic Area (EEA). In addition, a maximum of 20 per cent of assets can be invested in construction or development activities (REITA, §15). A FinnREIT must provide public information on the value of the properties at least once a year (REITA § 17). Valuations must be provided by an external valuator (REITA §18).

The minimum equity capital of a FinnREIT is 5 million euros (REITA, §9). A FinnREIT can use leverage up an amount corresponding one third of the assets of the trust. If the rules of the trusts name special reasons for additional leverage, the trust can in these specific cases use additional leverage up to an amount that corresponds one third of the assets of the trust (REITA §16).

By this far, no FinnREITs in Plc-form have been established. The reasons are self-explanatory: FinnREITs operating in a public limited liability company as imposed to stricter regulation than the public real estate investment companies in terms of investment possibilities, leverage and provision of information, but face the same double taxation. Thus, there is no taxational or operative incentive to establish FinnREITs.

The REIT Act was amended in 2007 to enable FinnREITs to operate also as a limited partnership that offers its shares to the public. Limited partnerships are not imposed to double taxation, as the partnership itself is a non-taxable unit and shareholders only pay taxes on the dividends received from the partnership. The amendment has not led to establishments of FinnREITs in limited partnership form. Thus, shares in PREICs are the only form of public real estate equity that exists in the Finnish real estate markets and the following sections concentrate on the development of PREICs in Finland.

3. DEVELOPMENT OF THE PUBLIC REAL ESTATE EQUITY SECTOR FROM 1988 TO 2006

The development of the public commercial real estate investments is divided in 5 sections. We discuss the number and scope of public real estate investment companies (PREICs) and aim in tying the development of PREICs to the market conditions. In addition, sections 3.2 to 3.4 discuss the development of gross asset value, net asset value and market capitalisation of the public sector. Section 3.5 discusses the public real estate investment companies today.

The analysis of the development of REICs in Finland is based on the annual reports and financial statements of public real estate investment companies. Only those investment companies listed in the stock exchange's main list or OTC-list are included in the study.

The collection of data caused some hardship, as the quality of materials has varied significantly under the reference period. The significant issues to take into account when estimating the data quality are the following:

1 For clarity reasons, all figures in finnmaks have been converted into euros using the official conversation rate 1 euro = 5,94573 FIM.

2. The annual reports of companies still existing in the markets were fairly easy to obtain. However, the annual reports for companies that were delisted during the turn of 80's and 90's were not available for the researchers. The data was complemented with financial statements as balance sheets stored in the archives Finnish National Board of Patents and Registration of Trademarks

3. First real estate investment companies were listed already in the 1980's, the amount and quality of information from the first decade was, however, so varied, that for reliability reasons all data series were created only for the time period 1990-2007. In cases, when individual observations were missing within the period, the value has been estimated using the arithmetic mean of the previous and following observation. Most hardship was caused by

the SSK Suomen Säästäjien Kiinteistöt Plc (later SSK), for which information could not be collected for years 1992 to 1994.

3.1 Companies

The first real estate investment companies were established in Finland in 1985, when Helsinki Investment Trust was listed in the broker's list of Helsinki Stock Exchange. The public sector did not start to flourish, however, until 1987, when nine new real estate companies went public. At that time the Finnish real estate markets were booming: financial markets had just been liberalized and the economy in general was already overheated. Common belief among investors was, that property values could only increase and that the inflation hedging provided by real estate was unfailing (Huoneistokeskus 1992, p.2). The economic growth in services sector increased the demand for commercial premises, and vacancies very close to non-existing, leading to increasing rents and soaring property prices (Karakozova 2005, 4).

Finnish real estate investment companies had been planning going public for some time already, and Finnish actors used the earlier established Swedish real estate investment companies as model for their business in Finland (Pietilä 1989). In addition, increasing volatility in the stock markets as well as lack of long-term investment possibilities, added to the demand of real estate investments. The actual listings in stock exchange happened rapidly during the years 1987 and 1988, as 11 real estate investment companies went public, with total real estate holdings of ca. 383 million euro. Of these companies 9 were listed in the main list and 2 on the OTC-list. In 1989, one more real estate investment company entered the OTC-list (Kock 2005). In addition, construction companies participated in the real estate investment activities. Most PREICs had decided to operate in Helsinki Metropolitan area, and a few had extended their activities into other growth centres in Finland. Turun Arvokiinteistöt Plc was in these terms an exception, as it focused solely in real estate located in Turku area.

The 12 PREICs of 1980's had diversified backgrounds. Most of the companies, including Citycon Plc, Siltasaari-Invest Plc, Julius Tallberg-Kiinteistöt Plc (JTK), Interavanti Plc, Suomen Kiinteistö-investointi Plc, Suomen PörssiKiinteistöt Plc, Jämerä-Kiinteistöt Plc and Suomen Säästäjien Kiinteistöt Plc (SSK) were established during years 1987 and 1988. Formally YIT-Kiinteistöt Plc had existed as part of YIT-consortium also before 1987, but its activities started after going public in 1987. Castrum Plc had existed earlier as a development company, but changed its strategy to a real estate investment company in 1987. A year later, the company went public. Sensor Plc had been established in 1983 as an investment company, and in 1987 the company made a decision to focus solely on real estate investments. Turun Arvokiinteistöt Plc was the only PREIC that had operated actively before the listing.

The ownership structure of the PREICs was varied. Many companies, such as Castrum Plc, Jämerä-Kiinteistöt Plc, Siltasaari-Invest Plc and Suomen Kiinteistöinvestointi Plc were mainly owned by institutional investors, but also construction companies and savings banks participated in the market. YIT-Kiinteistöt Plc had a construction company as its majority owner. Suomen PörssiKiinteistöt Plc was partly owned by institutional investors, but had also

Finnish industrial companies as an owner group. SSSK Plc, Interavanti Plc and JTK Plc were mainly owned by few private investors. Of the 13 PREICs in 1989 only Suomen Kiinteistöinvestointi Plc had also significant foreign ownership.

In regards of number of companies, year 1989 was a peak year: In 1990 three PREIC's (Siltasaari-Invest Plc, Jämerä-kiinteistöt Plc and Suomen pörssikiinteistöt Plc) were merged into one PREIC, Ferenda Plc. In addition, Finanssiosakeyhtiö Sensor Plc was withdrawn from the stock exchange due to unprofitableness. In 1990 Polar Construction Corporation Plc, a public company active in both construction and investment activities, reached an agreement with Ferenda's principal shareholders to exchange their Ferenda holdings for shares in Polar Construction Corporation Plc. After the purchase the rest of Ferenda Plc shares in March 1991, Ferenda Plc was withdrawn from the stock exchange 17.4.1991 (Pörssitieto 2005).

In 1991, Finnish economy fell into a deep recession, which later deepened into a banking crisis. With the oversupply of commercial space generated during the property boom, recession led to a sharp drop in property values, rents and construction activity (Karakozova 2005, 4). Trading activity and possibilities for obtaining banking finance decreased, as interest rates and collateral requirements were updated (Huom! 1991, p.3). The economic crisis affected also the public real estate investment companies. During the recession year, the number of investment companies decreased further. In 1993 Suomen Kiinteistöinvestointi Plc was declared bankrupted and thus left the stock exchange. The majority owner of YIT-Kiinteistöt Plc, YIT Group, bought back all the shares of YIT Kiinteistöt Plc and the company was delisted.

The Finnish economy and property markets started to recover in 1994. The general economy entered a phase of steady growth, supported with the joining of European Union in 1995. In real estate markets, rent started to increase, profits recovered and vacancies decrease. For the public real estate companies, the early recovery offered no large changes. In 1998, the public sector activated again, as Sponda Plc, a real estate company owned by the state of Finland and Merita bank, was listed in the Helsinki Stock Exchange. Shortly after that, in 1999, also Technopolis Plc, a real estate investment company focusing on technology centres, entered the stock exchange.

The amount of public companies started to decrease again, as Sponda Plc bought Castrum Plc and the company was delisted. The following year, the now private real estate investment company was merged into Sponda Plc (Kock 2002).

Polar Corporation, which had bought Ferenda Plc in 1990, entered a reorganisation programme in 1993. As part of the restructuring, construction and real estate investment activities were separated as independent business functions in 1994. In 1998, Polar sold off its construction activities and limited its activities in real estate investment. During years 2003 and 2004 all shares Polar Plc was purchased by the German IVG-consortium, and the company was delisted. The latest change in the PREIC sector occurred as Turun Arvokiinteistöt Plc ended in financial distress and was delisted in 2005.

3.2 Gross asset value

Gross asset value (GAV) represents the value of assets owned by the companies. The authors faced some difficulty in defining the gross asset values of the companies: Before the introduction of IFRS-standards in 2005 Finnish PREICs were not required to report the market values of their real estate holdings in their annual reports. Thus, the availability of the market values of property holdings varied from company to company. In cases where market value was not available, book value of properties is used. Book values are calculated based on the acquisition price less the depreciation. In addition, book values can be corrected for permanent changes in value through write-ups and write-downs.

Figure 3 illustrates the development of GAV in the Finnish PREICs from 1990 to 2006. The development of GAV displays the property market cycles and changes in the market fairly well. The economic crash in 1991 can be traced, and the figure suggests that some write-downs on the property assets were done during years 1992 and 1993. If judging based on GAV, the economic through of PREIC sector continued until the end of 1997.

Year 1998 shows the beginning of new growth in the sector, with a GAV jump of almost 1 million euros. More than half of this growth can be explained by the listing of Sponda Plc, whose real estate portfolio's NAV was almost 600 million euro. In addition to Sponda Plc, and Citycon Plc increased the value of its portfolio markedly. In 1999 Technopolis Plc went public, adding 60 million euros to the public sector GAV. The sector experienced its peak in 2000, exceeding a GAV of more than 3 billions. Second peak occurred in 2006, as Sponda Plc purchased the state-owner private real estate company Kapiteeli Ltd. The total value of the transaction was 943 million euros and the estimated value of the property portfolio 1,3 billion euros.

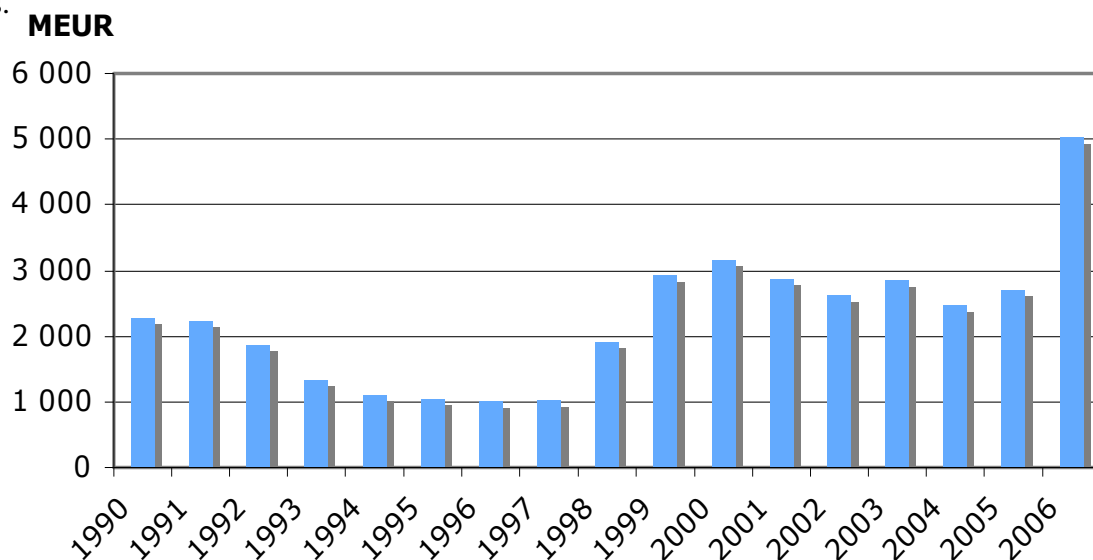


Figure 3 Development of gross asset value in the public real estate investment companies

3.3 Net asset value

Net asset value (NAV) describes the value of assets held by the companies less the liabilities. Thus, NAV can be interpreted as an indicator of sector's wealth. Figure 4 illustrates the development of the NAV of PREIC sector in Finland from 1990 to 2006. As with the calculation of net asset values, some asset values had to be calculated using book values of property portfolios.

The NAV has had a varied development. In the beginning of 1990's property values were high, an investment also highly leveraged. The write-downs during recession naturally weakened NAV, as asset values decreased and interest rates increased. Thereby, the debt to equity ratio increased from circa 50 per cent up to more than 70 per cent for years 1992 to 1995. Figure 4 suggests year 1993 to be the trough, as NAV fell down to 200 million euros. In year 1993, the PREIC sector experienced also its first, and by far the only, bankruptcy, as Suomen Kiinteistöinvestointi was officially declared bankrupted.

In terms of NAV, the recovery from the recession continued until 1998, and year 1999 was the first year, where NAV exceeded that of the pre-recession period. Again, listings Sponda Plc and Technopolis Plc affect the figures.

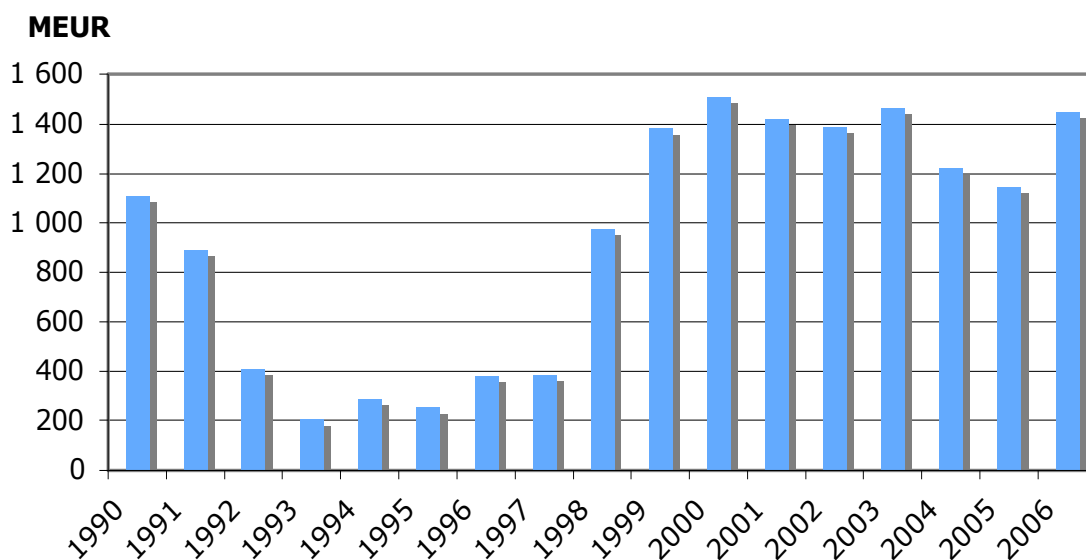


Figure 4 Development of net asset value in the public real estate investment companies

3.4 Market capitalisation and P/NAV

The figure 5 presents the development of market capitalisation and price-to-NAV figure of the Finnish public real estate investment companies from 1990 to 2006. Figures are calculated based on the market value of the share on the last day of the year multiplied by the amount of shares.

As can be seen in figure 5, also the market values of PREICs plunged during the recession, but have followed a fairly steady path since 1998. The P/NAV-ratio describes the ratio between the market capitalisation and NAV. For the 1990's P/NAV-ratio remained around 40 per cent, but showed quite much volatility. During the recession, P/NAV varied between 35 and 60 per cent. Since the beginning of the 21st century, P/NAV ratios have been increasing, and P/NAV discounts turned into P/NAV premiums in 2005.

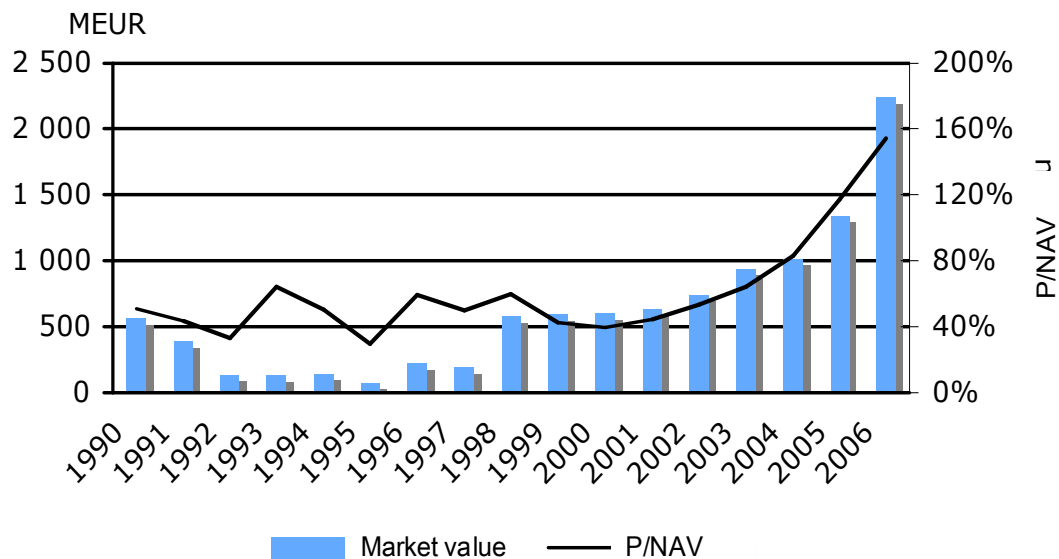


Figure 5 Market value and P/NAV-ratio of PREICs

Though the market capitalisation of public real estate investment companies has increased markedly during the past years, it still remain modest in relation to the market capitalisation of the OMX Helsinki Stock Exchange. In November 2007 PREICs represented 0,67 per cent of the total stock market capitalisation, whereas the average for Europe was 1,74 per cent (EPRA 2007). The growth of public real estate equity market capitalisation, however, has been rapid compared to the global average: According to Ibbotson Associates (2006), the global equity market capitalisation grew annually 23 per cent between 2002 and 2006, whereas in the Finnish markets the annual growth was almost 29 per cent.

3.5 PREICs today

Today, there are 6 public real estate investment companies quoted in the OMX Helsinki Stock Exchange. The existing companies differ from each other markedly in terms of size, stock trading volume and ownership structures. As shown in figure 6 two of the public real estate companies, Sponda Plc and Citycon Plc, have market capitalisations of more than 800 million euro, whereas the rest of the companies are significantly smaller. The smallest company, SSK Plc has a market capitalisation of ca 6 million euros. JTK Plc and Interavanti Plc both have a

market capitalization of less than 80 million euros, that is, less than 10 per cent of the one of Sponda Plc. The value of properties owned by the companies varies accordingly.

An interesting fact is that also the share turnover and ownership structure of the companies varies: The least traded companies Interavanti Plc, JTK Plc and SSK Plc are mainly owned by the management or by one company, and the share turnover remains below 5 per cent for all of them. For Interavanti Plc the yearly trading volume was less than 1 per cent for the year 2006. The three other companies have more diversified owner structure. The largest shareholder of Sponda Plc is the Finnish state, representing one third of the shares. Citycon Plc is mainly owned by foreign investors, Gazit Globe Plc representing almost 40 per cent of the stocks. Technopolis Plc has as its major owners foreign investors and households.

Company	Market Capitalisation (MEUR)	Value of Properties (MEUR)	Share turnover (% of number of shares)	Major owners
Sponda Plc	952	2455,1	53 %	Finnish state (34,3 %)
Citycon Plc	844,3	1447,9 (1009,7 in Finland)	31% *	Gazit Globe Ltd. (38,8 %)
Technopolis Plc	306, 7	392,2	58 % **	Foreign investors (51,2%), households (14,5 %)
Interavanti Plc	57,7	16,2	0,3 %	Management (94 %)
Julius Tallberg Kiinteistöt Plc (JTK)	66,5	129,7	3,2 % ***	Oy Julius Tallberg Ab (66,64 %)
Suomen Säästäjien Kiinteistöt Plc (SSK)	6,3	2,8	4, 0 %	OWH-Yhtiöt Oy (49,40 %)
<p>* The amount of shares was increased during 2006 from to 40 800 000 shares through stock options and a rights issue ** The amount of shares was increased during 2006 from 136 400 000 shares to 167 200 000 shares through stock options and a directed share issue *** includes only B-shares Source: Annual reports of the companies (2006)</p>				

Figure 6 Market capitalisation, real estate portfolio sizes , share turnover and major owners of public real estate investment companies

Though the portfolios held by PREICs have grown substantially during the past five years, the relative significance of the PREIC holdings in the Finnish commercial real estate markets is still fairly small. The current size of commercial real estate market is estimated to have a value of 28- 30 billion euro (KTI 2007), whereas the value of properties held by public real estate investment companies was ca. 5 billion euros. The public sector owns thus less than 20 per cent of the total commercial real estate stock. The comparative figure in U.S. was 27 per cent in 2004 (Hudson-Wilson et al. 2005), suggesting thus expansion possibilities in the Finnish public equity sector.

4. CONCLUSIONS

The forms of real estate investment in Finnish real estate markets are still fairly limited. In terms of public equity investments in commercial real estate Finnish legislation provides for two forms: public real estate investment companies and real estate investment trusts. Due to taxation and operational inefficiencies, no FinnREITs have been established, and in practise the public equity sector exists only in form of public real estate investment companies.

The public markets for real estate equity started to develop in 1980's when the first real estate investment companies entered the stock exchange. The sector experienced its short period of vigour at the turn of 1990's with 13 public real estate investment companies. In the beginning of 1990's, Finnish economy fell into a deep recession and the sector declined both in terms of number of companies as well as their asset holdings. As a result of delistings of companies and write-downs in asset values, the gross asset value of holdings decreased to less than half of the pre-recession levels, The debt to equity ratios of the companies decreased from circa 50 per cent to more than 70 per cent, representing a decline of more than 800 million euros, or 80 per cent, in net asset values. The market capitalisation decreased accordingly, but interestingly, the P/NAV-ratio, although volatile, kept its level.

The market capitalisation as well as the net and gross asset values of the sector remained below pre-recession values until 1999. The step-wise recovery of net asset values, and thus financial position of the companies, started in 1994, but the pace of recovery kept the gross and net asset values far from the pre-recession levels. The new expansion of the sector, which started in 1998, was then mainly explained by the listings of two new companies, Sponda Plc in 1998 and Citycon Plc in 1999.

Today, the public real estate equity investment companies have property holdings of ca 5 billions, corresponding less than 20 per cent of the estimated size of Finnish commercial property markets. The market capitalisation had increased rapidly since 1999, exceeding 2 billions in 2006. The appreciation of the sector as well as the current market cycle can also be detected from the development of P/NAV-ratios: Before the turn of millennium property company shares were traded with a discount of ca 50 per cent. The P/NAV-ratio started to increase in 2001, reaching a 50 per cent premium in 2006.

Despite the recent fast developments in the public real estate equity sector in Finland, the sector is still more limited than its counterparts in Europe and U.S. both in terms of property holdings as well as market capitalisation. Thus, the expansion of the sector can be expected to continue. A possible explanation for the small size of the public equity sector could be the lack of a public, tax-transparent investment vehicle (REIT), as the double-taxation imposed to PREICs decreases the attractiveness of the investment for investors, who have the possibility and means to invest in other forms of property.

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BIOGRAPHICAL NOTES

Ms. Heidi Falkenbach, M.Sc. (Tech.), Student of Economics (b. 1982)

Ms. Falkenbach works currently as a researcher in the Real Estate Research Group (REG) in Helsinki University of Technology, the focus of her study being effects of international investments on the Finnish commercial real estate market dynamics. Ms. Falkenbach completed her M.Sc. (Tech.) degree at the Department of Surveying, TKK in February 2005 and started her postgraduate studies in March 2005. She is also a M.Sc. (Econ.) student at the Turku School of Economics, where her major subject is Economics (Finance).

Mr. Sami Kiehela, Student of Technology (b. 1983)

Mr. Kiehela is an undergraduate student at the Department of Surveying in Helsinki University of Technology. Major degree of his studies is real estate investment and finance. Currently Mr. Kiehela is completing his minor subject studies in finance in Griffith University, Queensland, Australia. In addition to his on-going studies, Mr. Kiehela has worked for Newsec, one of the leading real estate advisory companies in the Nordics.

CONTACTS

Heidi Falkenbach

Real Estate Research Group (REG)

Helsinki University of Technology

P.O. Box 1200

FI-02015 TKK

Espoo

FINLAND

Tel. +358-9-451 4957

Fax +358-9-465 077

Email: heidi.falkenbach@tkk.fi