Prime Office REIT-AG (PMO.DE)

September 24th Merger Vote Combined with Shareholder Activism Should Unlock Value

Prime Office REIT-AG (PMO.DE or "Prime") is an undervalued German REIT with several near-term catalysts that could unlock its true intrinsic value. With a current share price of just €2.98, Prime Office trades at a high 55.1% discount to book value ("NAV" or "net asset value") and a 22.4% discount to gross asset value ("GAV"), more than double that of comparable German commercial real estate companies. Prime Office is a busted IPO from June 2011 that owns twelve multi-story office properties in Tier-1 German cities including Munich, Stuttgart, and Frankfurt. These hard-to-replicate, well-equipped buildings house high credit quality tenants like Medtronic, Daimler-Benz, and Deutsche Telekom.

We believe the stock is overlooked by investors given the modest €150m market capitalization and a lack of bulge-bracket sellside coverage. An imminent merger with an Oaktree portfolio company has caused shareholder activists to publicly engage with management. This spirited public discussion, along with a September 24th shareholder vote on the potential Oaktree merger, should allow Prime Office to soon unlock its true value. With the potential of a sweetened Oaktree bid, a reversal of planned dilutive equity raises, and/or a possible liquidation at NAV, all of which are potential outcomes of this ongoing debate, we believe this stock offers many ways to win.

Prime Office REIT

Market Value (June 30th, 2013)		**Capitalization**	
Property Value (GAV)	847.6	Share Price (9/16/13)	€ 2.98
Add: Cash	61.9	Shares Outstanding	51.9
Less: Debt	(501.7)	Market Capitalization	154.8
Less: Net Swap Liability	(62.2)	Less: Cash	(61.9)
Add: NWC Liability	(1.1)	Add: Debt	501.7
Book Value (NAV)	344.5	Add: Net Swap Liability	62.2
Shares Outstanding	51.9	Add: NWC Liability	1.1
NAV per Share	**€ 6.63**	Enterprise Value	657.9
Current Share Price	€ 2.98	Property Value (GAV)	847.6
Discount	***(55.1%)***	*EV Discount to GAV*	*(22.4%)*

Note: By excluding the net swap liability as of June 30th, 2013 from NAV, we've assumed that the current book value is equivalent to net asset value throughout this report.

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I. Situation Overview

Over the last few months, Prime Office's share price has been continually punished by a market that loathes the uncertainty tied to an upcoming merger vote with an Oaktree portfolio company. On May 8th, 2013, Prime Office announced that it had begun initial talks to merge with OCM German Real Estate ("Acorn"), an Oaktree portfolio company with 51 German multi-tenant properties and an in-house leasing team that managed Acorn's vacancy down to 13%.

With its June 2011 broken IPO leaving Prime Office with a "REIT ratio" (book value / market value of properties) below the 45% threshold required under German REIT laws, investors initially applauded the Oaktree deal, believing that a larger, better-managed combined company could attract more institutional investors and reduce Prime's discount to NAV. Prime's shares were propelled from €3.16 to €4.25 in the week after the announcement. Prime Office shares have since declined by over 30% due to a Q2 2013 NAV write-down from €7.49 to €6.62 and a punitive exchange ratio for the Oaktree deal, which will further reduce NAV to €5.57. Management has also given their intention to complete a €125 – 175m capital raise once the deal closes. If done near the current share price of €2.98, this equity raise would be extremely dilutive to Prime/Acorn's combined NAV of €5.57. Management would utilize this capital to pay an exorbitant €18m of deal expenses, €20-25m in transfer taxes, €20m of swap breakages, and most significantly, add equity capital to Acorn's levered balance sheet.

The €125 – 175m capital raise was announced in the Q2 2012 press release, but thereafter, Prime's CEO backed down from the range on the call. He clarified the press release by stating, "We will be looking to do a capital increase, [and] keep it as small as possible." It is our opinion that management should reduce the size of the equity issuance until after the share price has recovered to at least €3.50 - 4.00, thus reducing the potential dilution. Thanks to the poor exchange ratio and the overhang of a major equity raise, it remains uncertain whether Prime Office will obtain the 75% of the shareholder vote (of those present at the annual general meeting) necessary to close the deal.

Combined Financials	Acorn	Prime Office	Combined
Net Cold Rent (annualized)	94.1	45.7	139.8
H1 2013 Rental Income	46.6	24.1	70.7
Gross Asset Value	1,393.8	847.6	2,241.4
NAV (Book Value)	402.6	344.1	746.7
Gross Yield	*6.7%*	*5.7%*	*6.3%*
Weighted Avg Lease Term	4.7 yrs	7.6 yrs	5.6 yrs
Loan-to-Value	*70.0%*	59.2%	*66.0%*
Vacancy Rate	*13.3%*	*18.9%*(1)	*16.3%*
H1 2013 FFO per Share	n.a.	(€ 0.00)	€ 0.10
NAV per Share	n.a.	€ 6.63	€ 5.57

(1) Adjusted for Q1 2014 start of Daimler AG lease in Stuttgart

While the painful exchange ratio, along with the likelihood of a dilutive equity raise, has caused many investors to abandon the stock, the benefits of the Oaktree deal are clear: i) the combined company would become the largest German REIT; ii) Oaktree's relationships with the banks should allow the combined company to refinance loans at lower rates; iii) Oaktree will add a team of full-time leasing agents, an improvement from Prime's reliance on third-party brokers and; iv) a combined €500m+ market capitalization may attract broader global research coverage. The sum of these benefits should yield a reduced Price/NAV discount. At Prime's current share price of €2.98, we calculate that the Oaktree deal offers upside of more than 35% even after accounting for a €150m dilutive equity raise at €3/share. A higher offering price and/or a decrease in the amount of new capital raised would add further upside.

The possibility of the 30%+ upside offered by the Oaktree deal is attractive on its own. And yet two alternative scenarios may be even more lucrative. Capstone Equities, a real estate public and private equity firm, issued a letter to the Board on August 22nd expressing their displeasure with the current process. Capstone conducted a bottoms-up analysis of Prime's office portfolio and concluded that the company is worth in excess of €6.00 per share. Believing the Oaktree merger ratio to be inadequate, Capstone implores the Prime Office supervisory Board to hire an investment banker to conduct a full strategic alternatives process. The entry of a motivated activist shareholder may pressure Prime's management to renegotiate the deal with Oaktree, or even better, liquidate the company near NAV. We roughly estimate that a liquidation of the portfolio yields 50-70% upside for shareholders. This assumption includes a 10% discount to the gross asset value to account for execution risks, tax leakage, and transaction costs.

Lastly, there is the very real possibility that Prime Office would continue to trade as a standalone asset. While management is encouraging shareholders to vote for the Oaktree deal, Prime Office appears cheap on a standalone basis compared to its public peers. The closest peer is Alstria REIT, a similar German CRE company with 84 properties valued at €1.6bn. Alstria trades a much lower 10.5% discount to NAV and just a 3.6% discount to gross asset value. The stock is adored by the sellside for its low leverage and a stable property portfolio generating FFO yields around 6%. Alstria shrewdly directs investors to its Net LTV (loan-to-value), rather than a Gross LTV. The former nets out cash from total debt balance. But no matter how one measures LTV, Prime Office and Alstria look remarkably similar. Alstria has a 50% Net LTV and 59.8% Gross LTV compared to only 52% and 59.2%, respectively, at Prime Office. When viewed in this light, the concern around Prime's leverage is a red herring. Moreover, Prime was able to refinance over €200m of loans during 2012, proving that German credit markets are receptive to the company. With a net loan-to-value of 52%, Prime's remaining loans appear adequately covered. We therefore believe that Prime Office standalone should trade at a 20 – 25% discount to NAV, still a discount to Alstria's 10.5%, but much lower than the other comparable company, DIC Asset AG. By either selling or leasing its vacant buildings in Frankfurt and Dusseldorf, Prime should be able to narrow the current valuation gap. At a 25% discount to NAV, Prime shares would be undervalued by 40-45% on a standalone basis. This scenario includes a €50m dilutive equity raise to account for debt service and renovation capex on the vacant buildings in Frankfurt and Dusseldorf.

Kerrisdale Valuation Scenarios

EURm	*Scenario 1* Oaktree Merger	*Scenario 2* Standalone	*Scenario 3* Liqudation
Book Value	746.7	344.1	344.1
Shares Outstanding	*133.9*	*51.9*	*51.9*
NAV per Share	€ 5.57	€ 6.63	€ 6.62
Potential Future Equity Raise			
Capital Raise	150.0[1]	50.0[2]	–
Share Price	€ 3.00	€ 3.00	–
Issued Shares	50.0	16.7	–
Adj. Shares after Dilution	*183.9*	*68.6*	*51.9*
Adj. Book Value	853.7[3]	394.1	344.1
Post-Dilution NAV per Share	€ 4.64	€ 5.74	€ 6.62
Assumed Discount to NAV	*12.5%*	*25.0%*	–
Assumed Discount to GAV	–	–	*10.0%*
Implied Valuation	€ 4.06	€ 4.31	€ 5.00
Current Share Price	€ 2.98	€ 2.98	€ 2.98
Premium to Current	***36.3%***	***44.6%***	***67.8%***
Other Potential Adjustments			
Potential H2 2013 Writedown	(39.0)	(39.0)	(39.0)
Swap Liability Gain	7.5	7.5	7.5
Net NAV Impact	(€ 0.17)	(€ 0.46)	(€ 0.61)
Downside Case Valuation	€ 3.89	€ 3.85	€ 4.39

(1) €18m of transaction costs related to the merger, 20-25m transfer tax, and €20 of swap breakage…
…the remaining €90m will be used to lower combined LTV to 55-60%
(2) €20m Euro for debt paydown and €0 - 30m for leasing-related capex
(3) Adds €150m less €25m tax + €18m transaction cost (swap breakage removes an equal liability)

Barring a second global real estate collapse, we believe that Prime Office's NAV offers substantial downside protection under any of the above scenarios. And by assuming that Prime Office will be forced to raise equity at the distressed share price of €3.00, we have made very conservative valuation assumptions. Once the uncertainty surrounding the Oaktree deal is removed and management provides further guidance around a potential equity raise, investors should become more comfortable with the investment story, thereby reducing the spread between share price and NAV. Further upside catalysts include a sweetened exchange ratio from Oaktree, a successful activist campaign leading to liquidation, and/or a competing strategic bid for the assets.

Other valuation considerations include €39m of possible H2 2013 writedowns if Prime decides to convert the €119m Frankfurt property (Westend-Ensemble) property to residential space. On the Q2 2013 call, management backed down slightly from this figure, arguing that it's only an early-stage estimate: *"we've just started...discussions with the City of Frankfurt...but we don't have a clear figure. It could be slightly less. If there's a huge demand for a residential, we may do it in a joint-venture with the developer."* Besides Frankfurt, management doesn't believe there will be any further substantial writedowns to the portfolio. Kempen, a German research firm, had modeled €80m of negative revaluation for 2013-2016, €61m of which was already recognized in Q2 2013. If a merger goes through, we suspect that Oaktree may reverse the decision to convert the Westend-Ensemble into residential property. Residential properties earn lower yields than commercial space, and a combined company with a large NOL (net operating loss) balance will be less concerned about the REIT ratio, giving it more time to seek tenants before resorting to a sale.

This hypothetical Frankfurt writedown should be partially mitigated by a positive revaluation of Prime's interest rate swaps. Prime's interest rate swaps were first put in place to protect against rising rates, but these reversed into a €62.3m liability after Germany's 10-year Bund fell below 1.2% in May 2013. This liability has now begun to swing in Prime's favor on the perceived change in the Federal Reserve's monetary policy. According to Prime's 2012 Annual Report, *"an upward shift of 25 basis points in the yield curve as of 31 December 2012 would result in a €9.7m increase in the market value of derivatives."* German Bund yields rose to a 17-month high in August on continued expansion of the German economy. By our measures, the yield on the German 10-year Bund has increased by about 15-20bps since Prime Office's June 30th swap liability mark. Using this and the guidance in the Annual report, we've calculated a positive €7.5 gain from swaps. This gain will expand if interest rates continue to rise.

Despite the many positives that the Acorn combination offers, we consider the severe dilution incurred in the deal to be cause for concern. Not only will Prime's NAV be reduced from €6.62 to €5.57 thanks to the unfavorable exchange ratio, but the addition of Acorn's 70% LTV portfolio (*see Q2 call transcript*) will also materially increase the combined company's loan-to-value. This would necessitate the €150m equity raise to reduce the LTV to the 55 – 60% range, leaving the combined company with a €4.64/share book value. The market has reacted to this potential equity raise by selling off shares in a reflexive manner, as a lower share price translates to further NAV dilution. However, this reflexivity would also work as Prime's share price rises. For example, if the €150 million capital raise is done at €4.00, the premium in Scenario 1 jumps from 36% to over 46%. A better exchange ratio, combined with a commitment by management to only execute a capital raise at a higher share price, would make us more supportive of the Oaktree deal.

II. Introduction to the Prime Office Assets

Prime Office is a German-listed REIT with twelve high-end office buildings spread throughout Germany's leading industrial cities. The portfolio is geographically diversified with a portfolio that includes a €180m, 62,000 square meter tower in Munich, a pair of Damstadt buildings fully leased to global telecommunications firms, two high-end Dusseldorf buildings, and a half dozen other high-quality properties. German commercial property not only provides a hedge against Eurozone inflation, it also generates current income on rental yields and allows investors to participate in the long-term value appreciation of limited urban land. As of June 30th, 2013, Prime Office owned 368,000 square meters of rentable space worth €847.6.

Prime Office Portfolio

Euro, millions	Mkt Value Jun 30th '13	Chg vs. Dec 2012	Net Rent	Rentable Space (m²)	% Vacancy	Lease Term
Asset Value						
Frankfurt, Ludwig-Erhard-Anlage 2-8	119.0	*(23.3%)*	0.3	35,101	*97.6%*	8.5
Darmstadt, T-Online Allee 1	170.3	*(1.3%)*	11.9	72,528	–	6.5
Essen, Alfredstrasse 236	73.1	*0.1%*	5.6	30,314	–	6.5
Darmstadt, Deutsche Telekom Allee 7	51.7	*(3.0%)*	3.4	24,686	–	6.9
Stuttgart, Daimler/Breitwiesen 5-7(1)	38.9	*(0.8%)*	1.3	25,284	*15.0%*	7.4
Nuremberg, Richard-Wagner-Platz 1	12.5	*3.8%*	1.1	6,445	–	1.7
Heilbronn, Bahnhofstrasse 1-5	29.1	*(2.7%)*	2.0	14,750	*8.6%*	4.5
Dusseldorf, Am Seestern 1	60.6	*(10.4%)*	0.7	36,110	*83.7%*	1.2
Stuttgart/Fellbach, Philipp Reis Str 2	36.6	*(6.4%)*	3.4	19,854	–	9.3
Munich, Hultschiner Str. (SZ Tower)	182.5	*(2.1%)*	10.5	62,237	–	10.3
Dusseldorf/Meerbusch, Earl Bakken	16.3	*(0.6%)*	1.3	8,038	–	6.2
Essen, Opernplatz 2	36.0	*(6.5%)*	2.5	24,531	–	9.5
Munich - Hufelandstrasse 13-15 (2)	21.0	*(13.9%)*	1.7	8,224	–	8.4
Total	**847.6**	***(6.7%)***	**45.7**	**368,102**	***18.9%***	**7.6**

(1) Vacancy falls from 61.1% to ~15% when the Daimler AG lease (signed July 31) commences in early 2014

(2) Sold for €20.5m on August 16th to improve Prime's REIT Ratio. The building housed BMW and Semcon Group

The portfolio consists of a mix of modern and historic buildings that house global companies like Hochtief, Medtronic, and Daimler-Benz. With a properly capitalized balance sheet, a prudent management team, and enough time to cure the vacant properties, this is a business that could run on auto-pilot. Global investors continue to seek safe haven assets to moderate the volatility of the global capital markets. This should ensure that German office property remains a very attractive asset class.

Darmstadt, T-Online Allee

S-Z Tower (Munich)

Note: Prime plans to sell at the end of 2013.

Frankfurt, Ludwig-Erhard

"Westend-Ensemble"

Designated as a historic building

With Prime's shares trading at just €2.98, a 35%-50%+ discount to intrinsic value, an investment opportunity exists thanks to a variety of idiosyncratic issues that have prevented Prime Office from realizing its true value.

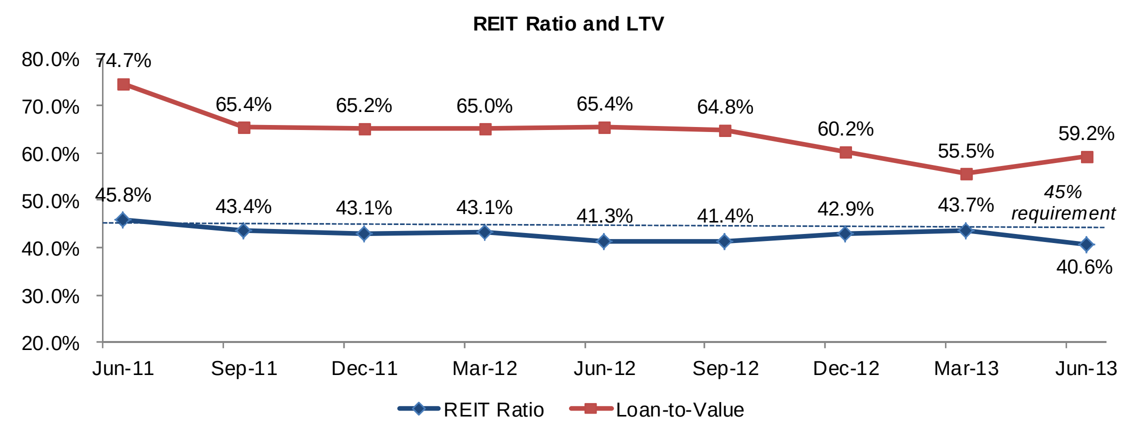
III. The Poorly Timed June 2011 Initial Public Offering

Since inception, when closed-end issuing house DCM Group AG sold shares into an unreceptive market, Prime Office has owned quality assets plagued by balance sheet issues. We actually believe that Prime's 52% Net LTV is prudent, and if anything this is an under-levered business based on market comparables. But German REIT laws require companies to maintain a 45% "G-REIT ratio," a hurdle that Prime has fallen short of because it didn't raise enough capital in its IPO. Prime's REIT ratio, calculated as book value divided by property value, is currently 40.6%. The ratio is directly impacted by the amounts raised in major share offerings, making initial IPO prices extremely important for publicly-listed German REITs.

Prime Office was founded by DCM as an amalgamation of closed-end funds in 2007 and was then taken public in June 2011. Prime's retail investor base had hoped to take Prime public even earlier, but the credit crisis prevented it until the rushed 2011 sale. Given Prime's initial book value of €8.55/share (€9.08 before swap adjustments), DCM planned to set the IPO price range at €7 - 9.50/share. This would have attracted €337m in cash and given Prime a starting REIT ratio of 58%, well above regulatory thresholds. Unfortunately, the timing of the deal could hardly have been worse. The Eurozone sovereign debt crisis broke out shortly after the deal was marketed, and the European IPO markets nearly seized up on fears of a second credit crisis. Prime Office was forced to first delay the IPO and then reduce its offering price to €6.20/share. This insufficient €214m offering ensured that Prime started its life from a position of weakness. Prime has been unable to cure its REIT ratio since.

Prime Office REIT Ratio Trend

EURm	6/30/2011	9/30/2011	12/31/2011	3/31/2012	6/30/2012	9/30/2012	12/31/2012	3/31/2013	6/30/2013
Book Value (NAV)	€ 444.0	€ 421.1	€ 418.0	€ 418.9	€ 398.1	€ 398.5	€ 389.1	€ 397.2	€ 344.1
Mkt Value of Property	970.0	970.0	970.8	971.6	963.1	963.1	907.9	908.5	847.6
REIT Ratio	*45.8%*	*43.4%*	*43.1%*	*43.1%*	*41.3%*	*41.4%*	*42.9%*	*43.7%*	*40.6%*
Debt	724.7	633.9	632.7	631.9	630.2	624.2	546.2	504.7	501.7
Loan-to-Value	*74.7%*	*65.4%*	*65.2%*	*65.0%*	*65.4%*	*64.8%*	*60.2%*	*55.5%*	*59.2%*



Worries over Prime's REIT status have caused Prime's shares to trade at a discount throughout its inglorious public market tenure. This issue has been further compounded by the loss of several major tenants, including Vodafone in its Dusseldorf property, Deutsche Post in Frankfurt, and a major tenant in Stuttgart. Since these are substantial properties, it can take time to find the right tenant and refurbish the building to suit the client's needs. On its Q2 2012 call, Prime announced significant leasing progress after Daimler-Benz signed to lease space in Stuttgart, increasing the building's occupancy rate from 40% to 85%. If it continues to correct these occupancy concerns, Prime will be well positioned as a standalone business.

IV. Vacancy Issues are Temporary

Prime Office is currently plagued by empty space in several of its largest buildings. These vacancies have reduced Funds from Operations ("FFO"), a measure of cash flow generation, and will likely prevent Prime from paying a dividend in 2013. Since expenses must still be paid on empty buildings, the lost rent from these properties falls straight to the bottom-line. Prime's largest expense is interest cost, and the business is responsible for debt service even in its empty buildings. Vacancy concerns center on three properties: Stuttgart Breitwiesen, Frankfurt Ludwig-Erhard, and Dusseldorf Am Seestern.

Encouragingly, Prime recently announced the signing of Daimler-Benz as a new tenant for Stuttgart, a step that will reduce vacancy in the building to just 15% beginning Q1 2014. Discussions remain ongoing for the Frankfurt and Dusseldorf properties. The Frankfurt building is situated in a prime downtown district, but management has yet to locate a new tenant after the 10-year Deutsche Post lease expired on December 31st, 2012. Prime's Dusseldorf Am Seestern tenant, Vodafone, constructed a purpose-built building across the street to replace its rental property. The loss of this Dusseldorf tenant in March 2013 has helped push Prime's FFO into the red. Following the loss of these two key tenants, one can see the rapid deterioration in funds from operations in the chart below. But with the Daimler lease signed for Q1 2014, Prime should begin producing positive FFO in 2014. Any positive developments on the Frankfurt and Dusseldorf properties will be viewed very favorably by the market. Once the vacant buildings find tenants, research firm Kempen & Co estimates that Prime could achieve €20-25m of annual cash flow, implying a pro-forma dividend yield of roughly 15% on Prime's current market capitalization (€155m).

Prime Office Income Statement

	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013	Q2 2013
Rental Revenue	18.2	18.4	18.1	17.7	14.5	12.0
Other Revenue	0.1	0.0	0.9	3.0	0.0	1.8
Total Revenue	**18.3**	**18.4**	**19.0**	**20.6**	**14.5**	**13.9**
Expenses for Rental Lease, Sale	(2.9)	(3.0)	(2.9)	(5.7)	(2.7)	(3.0)
Net Rental Income	**15.3**	**15.4**	**16.1**	**15.0**	**11.8**	**10.8**
Other Operating Income	0.2	0.0	0.0	0.0	0.0	0.0
Other Operating Expenses	(1.2)	(1.2)	(1.1)	(1.1)	(1.0)	(3.3)
Staff Benefits	(0.4)	(0.4)	(0.5)	(0.5)	(0.4)	(1.5)
D&A	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Losses from FV of Properties	–	(9.1)	(1.5)	(9.8)	–	(61.5)
EBIT	**13.9**	**4.7**	**12.9**	**3.6**	**10.4**	**(55.5)**
Net Operating Income	***13.9***	***13.8***	***14.5***	***13.4***	***10.4***	***6.0***
Funds From Operations						
EBIT	13.9	4.7	12.9	3.6	10.4	(55.5)
One-Time effect from Sales	–	–	–	2.5	1.4	–
Unrealized Gains on Property	–	(0.7)	–	(0.4)	0.1	(0.3)
Unrealized Losses on Property	–	9.8	0.8	10.9	(0.1)	61.8
D&A	–	0.1	–	–	–	0.1
Cash Interest Income	0.1	0.1	–	0.1	0.2	(0.1)
Cash Interest Expense	(7.2)	(7.5)	(7.8)	(12.7)	(10.8)	(7.9)
End of Period Interest Adjustment	(0.3)	(0.2)	0.2	–	0.2	0.4
Funds From Operations (FFO)	**6.5**	**6.3**	**6.1**	**4.0**	**1.4**	**(1.5)**
FFO per Share	***€ 0.12***	***€ 0.12***	***€ 0.12***	***€ 0.08***	***€ 0.03***	***(€ 0.03)***

Since most of its buildings are under long-term leases, Prime does not staff an in-house leasing team. The business relies instead on third-party brokers like C.B. Richards and Jones Lang LaSalle. Should it consummate the proposed merger with Oaktree, Prime will gain a dedicated leasing team to service existing tenants and recruit new prospects. This could jumpstart Prime's lease renewal cycle.

V. Final Valuation Considerations

Comparable Company Valuations Support our Price Targets

While there are several residential REITs in Germany, most of which trade at or above NAV (see Deutsche Annington and LEG Immobilien), Prime Office has just two comparable commercial REITs. The first is Alstria Office, a German REIT with 84 properties worth €1.6bn. Alstria maintains long-term leases, similar to Prime, and is currently the largest listed German commercial property REIT by market capitalization. Alstria has the lowest leverage in the group with a vacancy rate of just 11%, making it the most expensive stock by P/NAV and EV/GAV in the group. The second comparable is DIC Asset AG. DIC has 270 properties, 107 of which are co-investments, a 12% vacancy rate, and a balance sheet levered to 74% LTV. Given its substantial leverage, DIC Asset does not qualify for REIT status. DIC's 31% REIT equity ratio is below the 45% threshold, forcing DIC to pay a 20.5% normalized tax rate. The heavily levered balance sheet and failure to qualify as a REIT cause DIC to trade well below Alstria on an NAV and GAV basis.

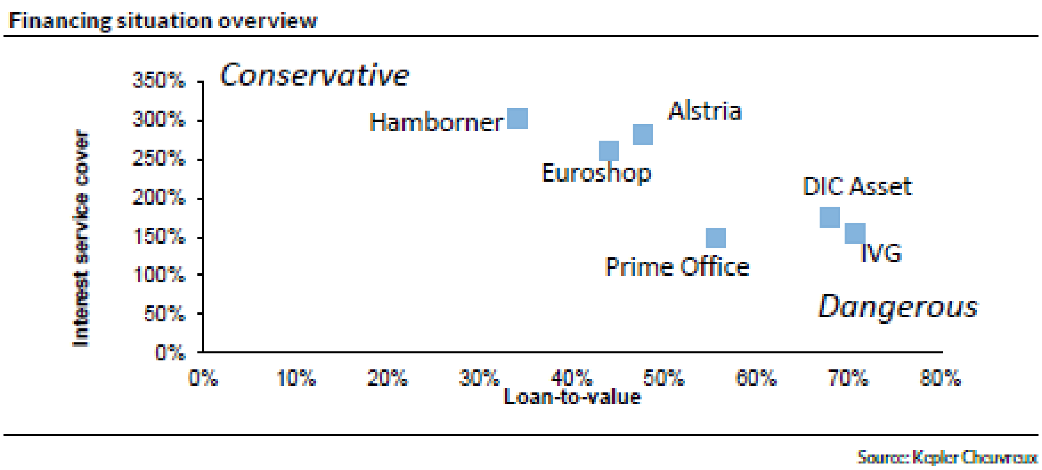
Surprisingly, Prime Office trades at an even larger discount to NAV/GAV than DIC, even though Prime's LTV is in-line with Alstria's. Since some German investors have limitations on the leverage that their portfolio companies can hold, LTV is considered important by the market. Going further, Prime will almost certainly maintain its REIT status through a modest equity or the sale of SZ Tower by year-end. Since Prime's balance sheet is not in jeopardy, we attribute the company's larger NAV discount to the uncertainty surrounding the Oaktree deal, management's poor communication around future equity raises, and Prime's temporary vacancy issues.

Selected German Commercial Property Comparables

EURm	**Price** 9/16/2013	Market Cap	Book Value	**P / NAV Discount**	Enterprise Value	GAV	**EV / GAV Discount**	**Loan-to Value**	**REIT Ratio**(3)	**13E FFO Yield**
Alstria Office	€ 9.40	742.0	828.9	***(10.5%)***	1,523.4	1,597.6	***(4.6%)***	*58.7%*(2)	*51.9%*	*6.1%*
DIC Asset AG	€ 8.13	371.7	636.5	***(41.6%)***	1,746.4	2,042.7(1)	***(14.5%)***	*70.7%*	*31.2%*	*12.4%*
Prime Office	€ 2.98	154.8	344.5	***(55.1%)***	657.9	847.6	***(22.4%)***	***59.2%***	***40.6%***	–
Prime+Acorn	€ 2.98	399.1	746.7	***(46.5%)***	*n.a.*	2,241.4	*n.a.*	***66.0%***	***33.3%***	*8.8%*

(1) Includes investments in and borrowings to associates
(2) €875.7m loans + €79.4m convertible bond dividend by gross asset value
(3) Calculated as book value dividend by gross asset value

The sellside adores Alstria, awarding it thirteen Buy recommendations, one Hold, and just two Sells. Alstria is praised as the safest investment amongst the group. But our analysis of its balance sheet indicates that Alstria has similar gearing to Prime Office. Alstria's management focuses its disclosures on "Net LTV" in their quarterly reports, a figure that nets cash from the total debt balance. Discussions around Prime Office generally center on Gross LTV. Alstria has a 50% "Net LTV" compared to only 52% at Prime Office. On a gross basis, the comparison is even closer, with Alstria at 59.8% versus 59.2% at Prime Office. However, some members of the sellside seem to confuse the two, portraying Alstria as having a lower LTV. An example of this is below.



Source: May 15th, 2013 Kepler Cheureux research report on DIC Asset AG

Admittedly, Prime Office has a tighter interest coverage ratio given its vacancy rate, though this will ease in Q1 2014 with the Daimler lease commencing in Stuttgart. Based on its modest LTV with little near-term refinancing risk, but penalizing it for a high temporary vacancy rate, we believe a standalone Prime should trade somewhere between Alstria and DIC AG.

Kerrisdale Valuation Scenarios

EURm	*Scenario 1* Oaktree Merger	*Scenario 2* Standalone	*Scenario 3* Liqudation
Book Value	746.7	344.1	344.1
Shares Outstanding	*133.9*	*51.9*	*51.9*
NAV per Share	€ 5.57	€ 6.63	€ 6.62
Potential Future Equity Raise			
Capital Raise	150.0 (1)	50.0 (2)	–
Share Price	€ 3.00	€ 3.00	–
Issued Shares	50.0	16.7	–
Adj. Shares after Dilution	*183.9*	*68.6*	*51.9*
Adj. Book Value	853.7 (3)	394.1	344.1
Post-Dilution NAV per Share	€ 4.64	€ 5.74	€ 6.62
Assumed Discount to NAV	*12.5%*	*25.0%*	*–*
Assumed Discount to GAV	*–*	*–*	*10.0%*
Implied Valuation	€ 4.06	€ 4.31	€ 5.00
Current Share Price	€ 2.98	€ 2.98	€ 2.98
Premium to Current	***36.3%***	***44.6%***	***67.8%***

(1) €18m of transaction costs related to the merger, 20-25m transfer tax, and €20 of swap breakage…
…the remaining €90m will be used to lower combined LTV to 55-60%
(2) €20m Euro for debt paydown and €0 - 30m for leasing-related capex
(3) Adds €150m less €25m tax + €18m transaction cost (swap breakage removes an equal liability)

Valuation Assumptions

<u>*Scenario 1*</u>*:* A combined Prime/Acorn with a well-capitalized 55 – 60% LTV balance sheet (post

€150 equity raise) should only trade at a modest discount to NAV. The combined company would have €2.24bn of gross asset value and €900m of tax reserve accounts, allowing them to pay dividends tax-free for the foreseeable future. This ‘synthetic REIT’ gives the combined company more flexibility on asset purchases, giving them the ability to acquire residential properties if desired. Oaktree can leverage its relationships with the banks to lower Prime’s cost of capital, and a larger market capitalization should attract bulge-bracket sellside coverage. Finally, the addition of an in-house leasing team should help expedite a vacancy rate reduction. We therefore estimate a combined company will trade at a 12.5% discount to NAV, approximately in-line with Alstria.

Scenario 2: Should shareholders vote against the Oaktree deal, the standalone Prime Office would remain well positioned. With the uncertainty of the deal removed, investors should begin to focus on Prime’s reduced LTV ratio and the new tenant in its Stuttgart property. Prime’s equity ratio could expand to 49% if it successfully sells the SZ-Tower in Munich at a slight discount (*10%*) to book value. This would satisfy the 45% REIT threshold. Our standalone valuation scenario also includes a €50m equity raise. This new capital infusion will be viewed positively by the market. The ~€30m of renovation capex would indicate that tenants are soon on the way for Frankfurt and Dusseldorf. Assuming that Prime continues to trade at a slight discount to Alstria, we’ve estimated a still substantial 25% NAV discount for standalone. Given Prime’s modest LTV and cured REIT ratio, we believe it should trade well above DIC once Prime stabilizes its leases.

Scenario 3: The liquidation scenario is the trickiest of the three. Valuation opinions from Ironsides and Capstone Equities place the liquidation value at €6 – 7.50 per share. We’ve been even more conservative than these by assuming that Prime sells its entire book at a punitive 10% discount to gross asset value. Using this assumption, a liquidation appears to have the most upside. It prevents Prime from issuing dilutive equity, not to mention affecting a NAV reducing deal with Oaktree, but comes with higher execution risks and further uncertainty around asset value. Prime recently sold its smaller Munich building for €20.5m, a negligible 2.5% discount to book, giving us comfort in our 10% GAV discount.

The German Property Market Remains Robust

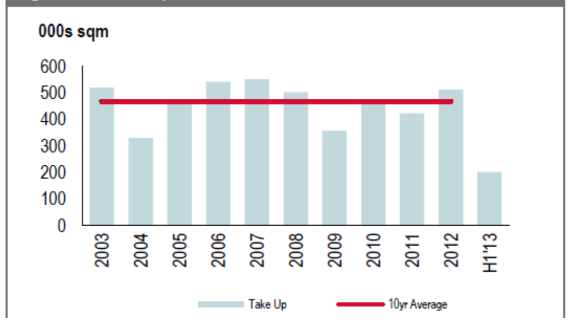
Germany’s GDP grew 0.7% in Q2 for an annualized rate of 2.9%, making it one of the fastest growing developed economies in the world. Property brokers Jones Lang LaSalle (“JLL”) and CB Richards (“CBRE”) publish quarterly reports on the German commercial real estate market, and leading indicators show continued strength. We tend to view these reports from brokers with skepticism since brokers are in the business of selling property much like Wall Street’s sell-side is in the business of selling stocks. Keeping this in mind, the raw quantitative data in these reports can be helpful. In their Q2 Germany MarketView, CBRE sees rapidly growing demand from institutional investors. Investments in German commercial property rose to €12.6bn in H1 2013, an increase of 34% from the prior year. This was the highest growth rate since the boom year of 2007. According to JLL, Germany saw the largest increase in H1 2013 transaction volumes across all of Europe. At a city-specific level, JLL has a positive twelve-month outlook for Munich and Frankfurt, and is generally positive on the overall market.

Frankfurt – JLL Q2 2013 Outlook

Summary Statistics	Q2 13	Change* Q-o-Q	Change* Y-o-Y	12 Month Outlook
Take-up (000s sqm)	134	96.9 %	5.7 %	↑
Vacancy Rate (%)	12.0	30 bps	-140 bps	↑
Prime Rent (psm)	€408	0 %	3 %	↑
	Q2 13	Change* Q-o-Q	Change* Y-o-Y	12 Month Outlook
Capital Value (psm)	€8589	0 %	4.1 %	↑
Prime Yield %	4.75	0 bps	-5 bps	→

* % Change for Prime Rents and Capital Values calculated using local currency

Figure 1: Take-up

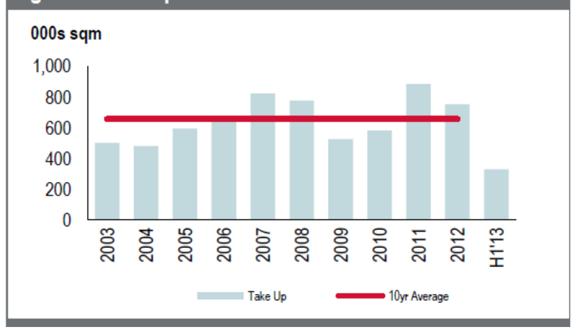


Munich – JLL Q2 2013 Outlook

Summary Statistics	Q2 13	Change* Q-o-Q	Change* Y-o-Y	12 Month Outlook
Take-up (000s sqm)	178	16.7 %	-8.5 %	→
Vacancy Rate (%)	7.9	-30 bps	-100 bps	→
Prime Rent (psm)	€372	0 %	3.3 %	↑
	Q2 13	Change* Q-o-Q	Change* Y-o-Y	12 Month Outlook
Capital Value (psm)	€8455	0 %	5.7 %	↑
Prime Yield %	4.40	0 bps	-10 bps	→

* % Change for Prime Rents and Capital Values calculated using local currency

Figure 1: Take-up

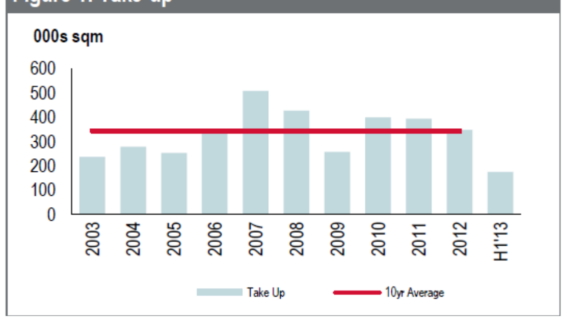


Dusseldorf – JLL Q2 2013 Outlook

Summary Statistics	Q2 13	Change* Q-o-Q	Change* Y-o-Y	12 Month Outlook
Take-up (000s sqm)	101	35.8 %	27.8 %	↓
Vacancy Rate (%)	11.5	30 bps	10 bps	→
Prime Rent (psm)	€330	5.8 %	10 %	→
	Q2 13	Change* Q-o-Q	Change* Y-o-Y	12 Month Outlook
Capital Value (psm)	€7021	5.8 %	10 %	→
Prime Yield %	4.70	0 bps	0 bps	→

* % Change for Prime Rents and Capital Values calculated using local currency

Figure 1: Take-up



Source: Jones Lang LaSalle EMEA Research [Interface]

After a slow first quarter, the Frankfurt office take-up grew by 97% in the second quarter on the back of a relocation of Commerzbank across town. JLL notes that "the availability of larger floor plates remains limited in central areas," making Prime's Westend property an attractive space. Office take-up in Dusseldorf increased by 36% sequentially, and H1 2013 leasing volume grew over H1 2012. JLL does remain cautious on transaction momentum, noting that "many tenants continue their wait-and-see approach, delaying decision making and examining any opinions carefully with regards to overall costs, location benefits and floor plate efficiency." If an eventual German recovery is anything like that recently experienced in U.S. cities such as New York, Las Vegas, and Miami, Prime Office's vacancy rates and capitalization worries should dwindle.

Several Shareholders Believe Liquidation Could Achieve €6.00 – 7.50 of value

Prime Office's largest shareholder is Ironsides Partners, a Boston-based hedge fund which has been a very vocal voice in the debate over Prime Office's future. On the Q1 2012 conference call, Ironsides revealed that it hired a third-party to complete an appraisal on the Prime properties and found that €7.50 could be returned to shareholders in a liquidation scenario. The full text from the Q1 comments from Ironsides reads, *"...I am concerned that you won't talk about the issue of dilution because for all the shareholders who have suffered due to the share price decline, the other alternative you are not discussing is just liquidating and we've had our own appraisal values on the portfolio and we think you could easily return 7.50 a share in less than a year if you just sold the properties."*

Ironsides has since backed down from pushing for liquidation and has declared their intention to vote in favor of the Oaktree deal. Ironsides may believe that the combined company NAV of €5.57 underestimates the true value of the business, and that Oaktree's management team can quickly close the share price gap to NAV. Ironsides will also participate in any proposed capital raise along with Oaktree, who has also verbally committed to a follow-on.

Capstone Equities has a similar opinion of net asset value. Their August 22nd letter to the Board states that Capstone "conducted a bottoms-up analysis of Prime's assets and concluded that they are deeply undervalued and believe the company to be worth in excess of €6.00 per share." This range was based on "due diligence [that] included several trips to Germany and conversations with brokerage firms to understand lease rates, capitalization rates, vacant building values, as well as an extensive review of comparable sales."

VI. Conclusion

We believe that shares in Prime Office provide an attractive opportunity. There are numerous near-term events that could result in a re-pricing of the stock. Oaktree may appease angry Prime shareholders by increasing the merger consideration, management of a combined Prime/Acorn may raise less dilutive equity than expected, or the merger could be voted down altogether, resulting in less dilution and a potential liquidation of Prime's asset portfolio. On account of Prime's modestly levered balance sheet at 59% loan-to-value (52% Net LTV), each of the scenarios would result in substantial value appreciation to the equity class and narrow Prime's absurdly low 0.45x price-to-book value (55% NAV discount).

Even if one believes that the June 30th, 2013 market value of Prime's assets is inflated, there is a significant margin-of-safety at the current share price. Prime would need to mark down the value of every building in its portfolio by almost 25% before Prime's NAV falls below the current share price. Weighing the substantial loss cushion against the various means available to Prime to lower its share price discount to NAV, we conclude that today is an opportune time to own Prime Office shares, no matter how the merger vote turns out on September 24th.

VII. Full Legal Disclaimer

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