NLI Research Institute August 10, 2016

Real Estate Analysis Report

Japanese Property Market Quarterly Review, Second Quarter 2016

~While Housing Starts Robust, Office and Retail Rents Peak Out~

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Summary

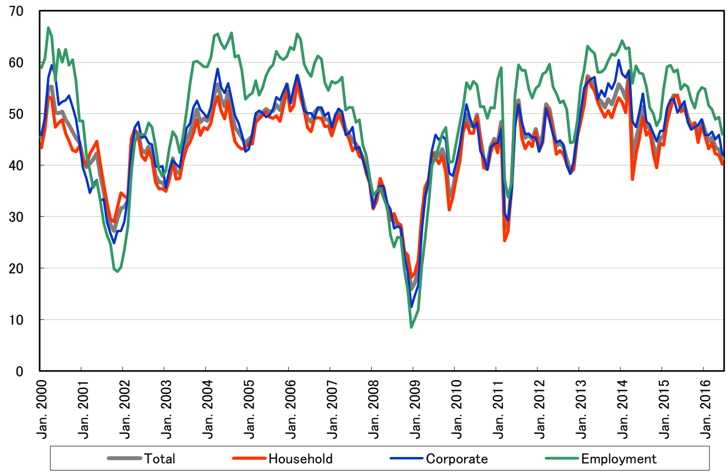
- Several negatives such as the earthquake in Kumamoto, Brexit, the appreciation of the yen and the equity market decline based on the global economic uncertainty have hung over in the second quarter. The government decided to reschedule the next consumption tax rate hike from April 2017 to October 2019. Thus, the anticipated tax hike related rush demand in 2016 and the counteractive slowdown in 2017 have disappeared.
- Housing starts have been increasing as land owners build flats to save on inheritance taxes. The number of condominium units sold in the Tokyo metropolitan area shrank to the lowest level in 24 years and inventories have been accumulated, while the luxury category has still sold well.
- Following limited office demand in 2015, large amounts of office spaces were newly occupied in 2016, though shrinking again in June. While the vacancy rates of Tokyo grade-A offices have improved, the rents have apparently lost steam declining by 6.9% q-o-q. The vacancy rates can improve further with limited supply in 2017 however large new supply is anticipated afterward.
- Duty free sales, which have declined by 15% y-o-y, can no longer drive department store sales, as Chinese tourists are buying less big ticket items than before, affected by the appreciation of the yen and the reviewed Chinese tariffs for individual imports. Though foreign visitors still increased by 19% y-o-y in the second quarter, the total number of overnight stays in Japan declined by 2.5%, affected by Japanese tourists' preference for going overseas.
- The TSE REIT index declined by 2.8% in the second quarter due to Brexit, yet still rose by 5.5% in the first half, outperforming TOPIX which declined by 19.5%. The negative interest rate policy can lead to incremental values of the J-REIT portfolios. However, property incomes have to grow for sustainable value enhancement.

1. Economic Conditions

Diffusion Indexes of the Economy Watchers Survey by the cabinet office declined to the worst level in the second quarter since the inception of Abe Cabinet (Chart-1), affected by several negatives such as the earthquake in Kumamoto, Brexit, the appreciation of the yen and the equity market decline based on global economic uncertainty. Private consumption has not strongly recovered since the consumption tax rate hike in April 2014.

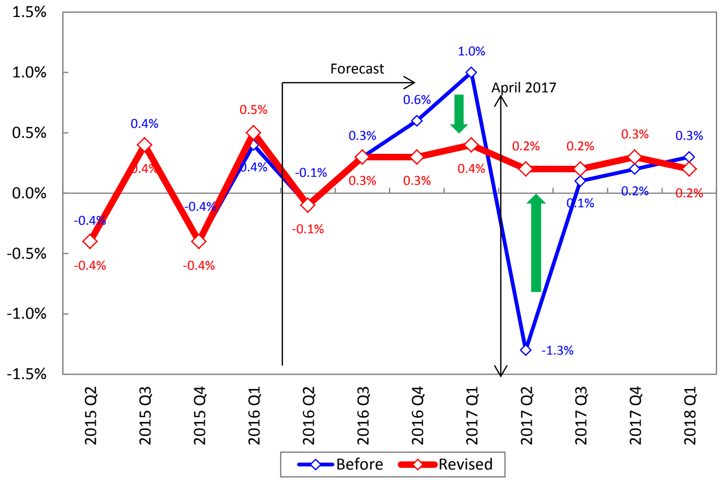
On June 1, the government decided to reschedule the next consumption tax rate hike from 8% to 10% again from April 2017 to October 2019. Considering the disappearance of the anticipated tax hike related rush demand in 2016 and the counteractive slowdown in 2017, NLI Research Institute revised its real GDP growth forecast from +0.9% to +0.6% for 2016 and from 0.0% to +1.1% for 2017 (Chart-2).

Chart-1 Economy Watchers Survey



Source: Cabinet Office, Government of Japan

Chart-2 Japan GDP Growth Rates

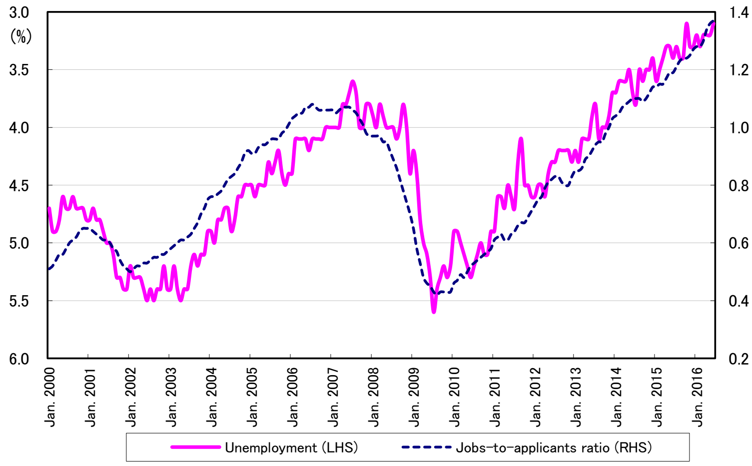


Source: Economic and Social Research Institute, Cabinet Office, Government of Japan "Quarterly Estimate of GDP" NLI Research Institute "Weekly Economist Letter" June, 2016.

2. Eased Labor Shortage and High Construction Costs

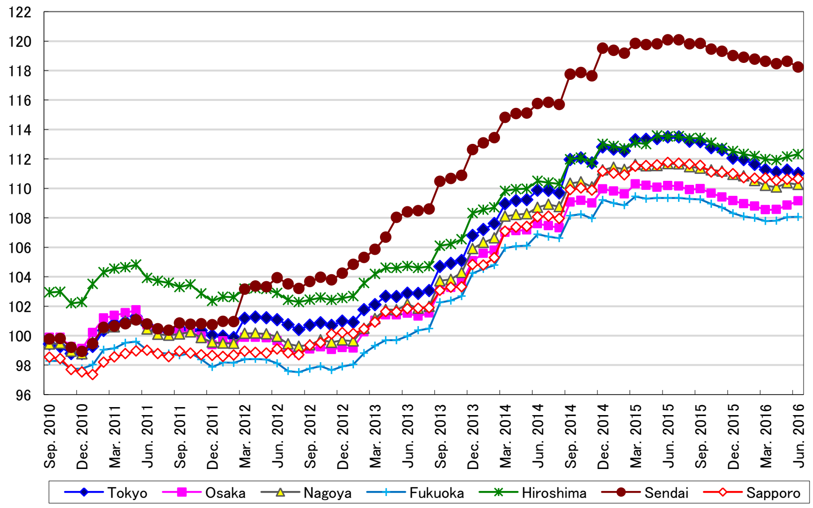
The unemployment rate and the jobs-to-applications ratio have been improving (Chart-3). However, labor shortages have somewhat eased based on higher wages, and construction costs have apparently peaked out (Chart-4). According to Keidanren, wages for construction workers rose noticeably by 3.2% y-o-y this spring compared with those in other industries rising by around 2%.

Chart-3 Unemployment rate and Jobs-to-Applications Ratio



Source; MIC "Employment Report", MHLW "Job introduction」

Chart-4 Construction Cost Index



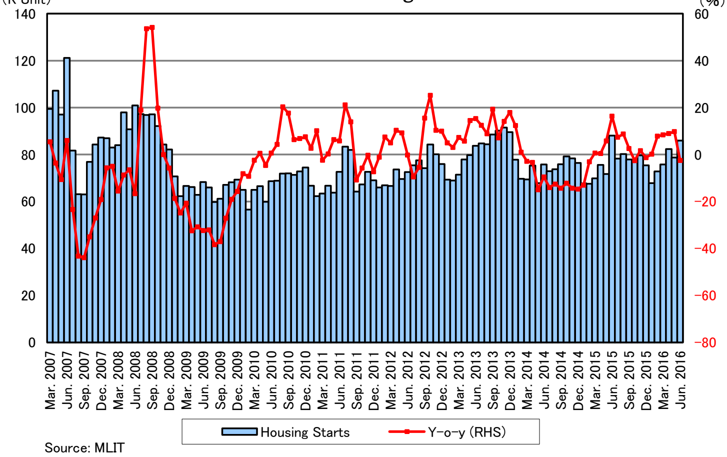
Source: Construction Research Institute

3. Housing Market

Housing starts have been increasing in 2016 (Chart-5) as land owners build flats to save on inheritance taxes. Housing starts did not shrink in June even after the decision to reschedule the next consumption tax rate hike, suggesting that the strong housing starts in 2016 had not been mainly attributed to the rush demand before the tax rate hike.

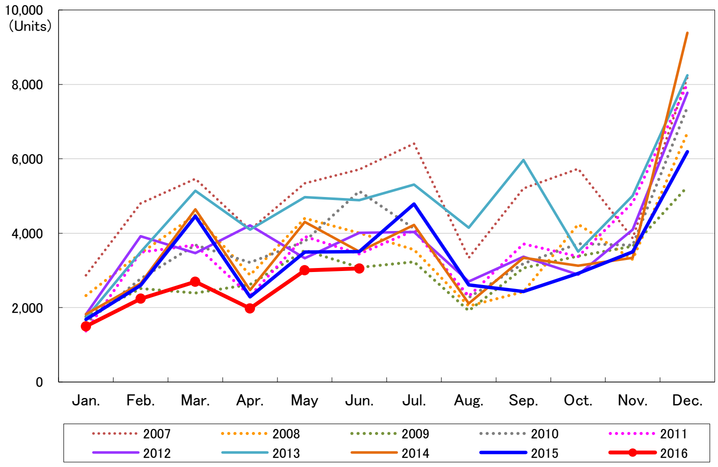
However, the number of new condominium units sold in the Tokyo metropolitan area has been stagnant (Chart-6), shrinking by 19.8% y-o-y in the first half, posting the lowest number in 24 years. It seems rising prices have brought low close rates and high inventories (Chart-7). However, the luxury category has still sold well with high close rates.

Chart-5 Housing Starts



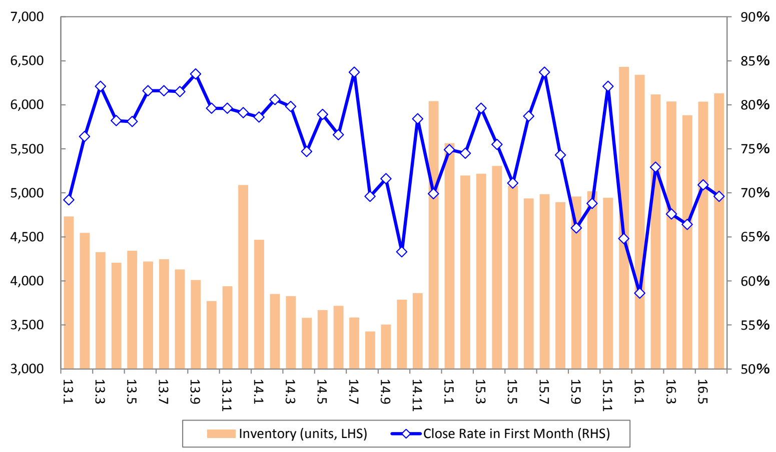
Source: MLIT

Chart-6 New Condominium Units Sold in the Tokyo Metropolitan Area



Sourc: Real Estate Economic Research Institute

Chart-7 New Condominium Units Inventory and Close Rates in the Tokyo Metropolitan Area



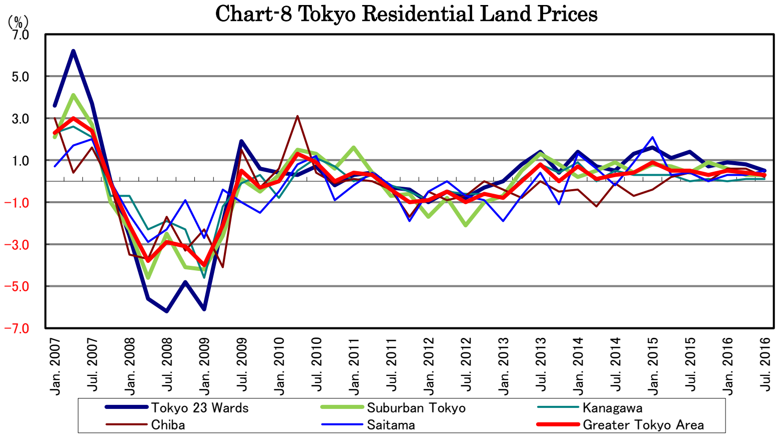
Source: Real Estate Economc Institute

4. Land Prices

According to “Rosenka” published by National Tax Authority on July 1, the average national land price rose for the first time in eight years by 0.2% y-o-y. 14 prefectures out of 47 posted land price appreciations topped by Osaka appreciating by 22.1% y-o-y and followed by Tokyo, Nagoya, Sapporo, Sendai, Kanazawa, Hiroshima and Fukuoka, each appreciating by more than 10% y-o-y.

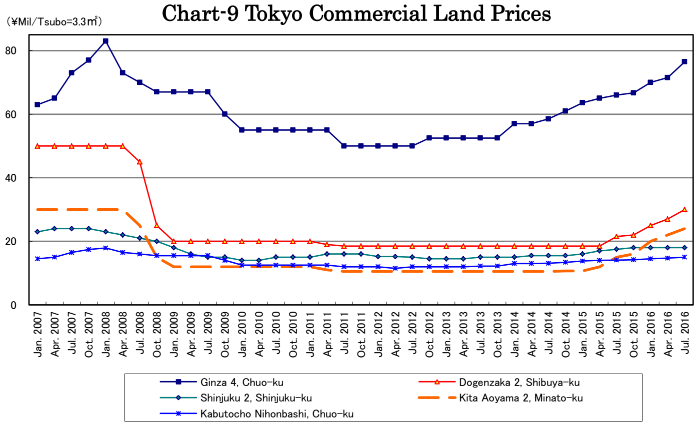
According to Nomura Real Estate Urban-net, residential land prices in the Tokyo metropolitan area rose for the eleventh consecutive quarter since January 2014 (Chart-8). Commercial land prices in the center of Tokyo appreciated significantly such as for Kita Aoyama, Shibuya and Ginza, growing by 60.0%, 39.5% and 15.9% y-o-y respectively (Chart-9).

Chart-8 Tokyo Residential Land Prices



Source: Nomura Real Estate Urban Net

Chart-9 Tokyo Commercial Land Prices



Source: Nomura Real Estate Urban Net

5. Sub-sectors

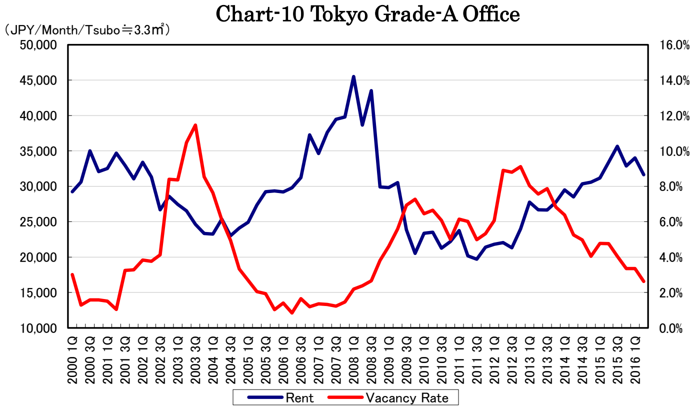
1) Office

Large buildings in the Tokyo CBD such as JR Shinjuku Miraina Tower, Sumitomo Fudosan Shinjuku Garden Tower, Otemachi Financial City Grand Cube and Tokyo Garden Terrace were completed in the first half of 2016 with occupancy rates of each exceeding 80%.

The vacancy rates of Tokyo grade-A[1] and grade-B offices improved to 2.6% and 2.5% respectively in the second quarter (Chart-10, 11). Moreover, not only high grade buildings but also small buildings have seen occupancy rate improvements.

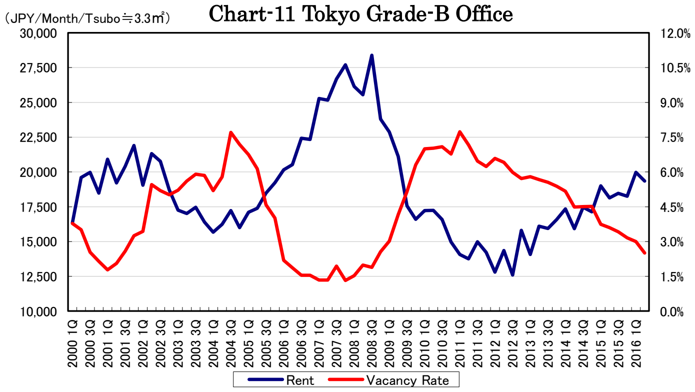
On the contrary to occupancy improvement, the rents of Tokyo grade-A and grade-B offices declined by 6.9% and 3.1% q-o-q respectively (Chart-10, 11). Several negative factors such as the earthquake in Kumamoto, the appreciation of the yen, the equity market decline, stagnant consumption and the scarce office demand following the large supply in the first quarter have apparently affected office rents.

Chart-10 Tokyo Grade-A Office



Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

Chart-11 Tokyo Grade-B Office



Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

Following limited office demand in 2015, large amounts of office spaces were newly occupied in 2016 (Chart-12). However, demand shrank again in June with limited new office spaces available.

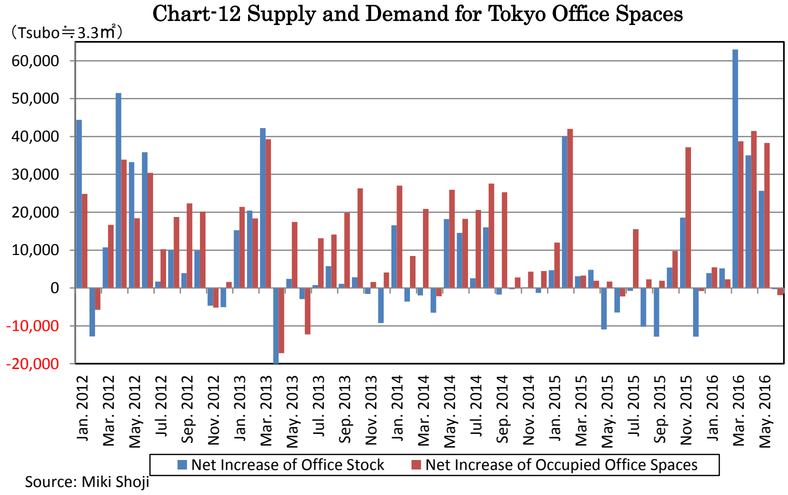
According to Mori Building, office supply in Tokyo will be nearly as small in 2017 as that in 2013. Thus, it looks like office occupancy rates will continue to improve until 2018, when large new supply is anticipated. However, it should be noted with caution that most large

[1] Sanko Estate chooses high grade buildings individually on its guidelines such as gfa of more than 33,000m², main floor sizes of more than 990 m², building age of 15 years or less and so on.

affluent tenants have already settled and office space per person has been shrinking.

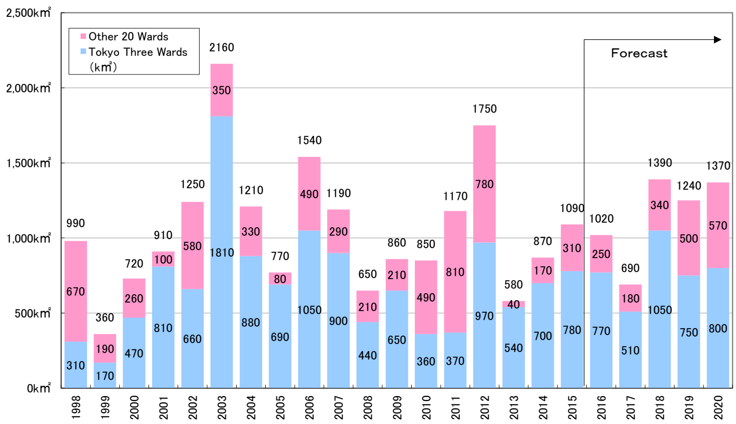
Other than Tokyo, office vacancy rates in major cities have been improving (Chart-14) and moderate new office supply is scheduled in coming years.

Chart-12 Supply and Demand for Tokyo Office Spaces



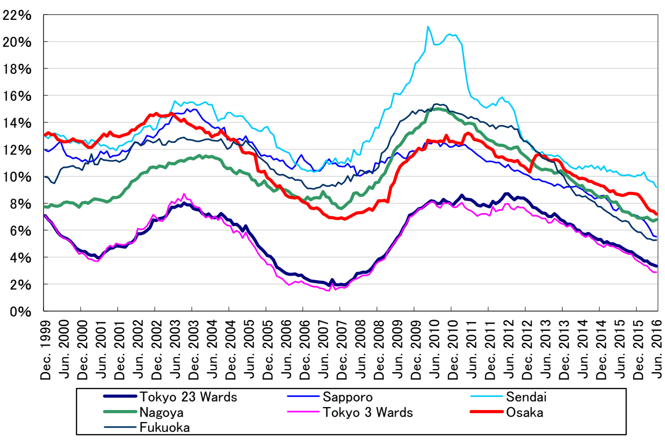
Source: Miki Shoji

Chart-13 Office Supply in Tokyo



Source: Mori Buliding

Chart-14 Office Vacancy Rates in Major Cities

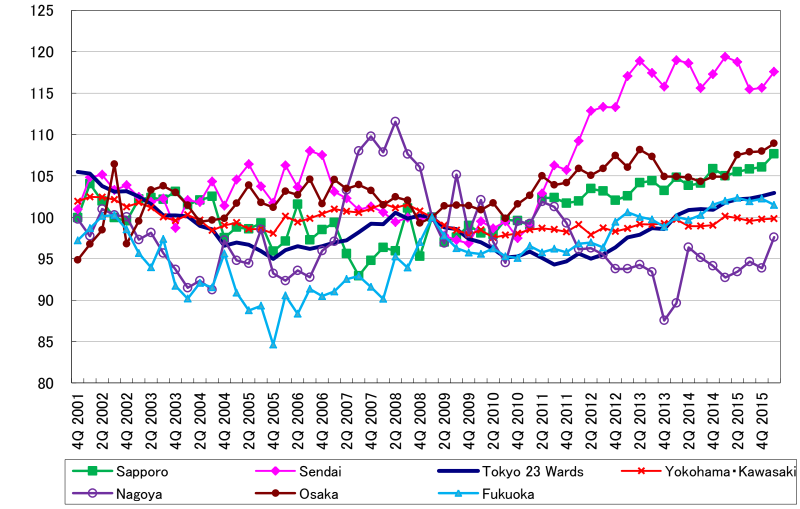


2) Residential Rent

Residential rents in Tokyo and other major cities have been rising (Chart-15). However, vacancy rates of flats for lease in the Tokyo metropolitan area deteriorated to more than 30% as land owners have accelerated building flats to save on inheritance taxes.

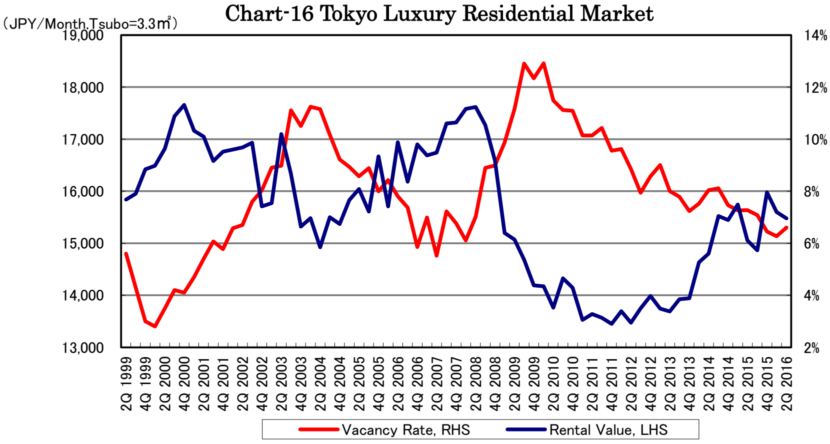
The vacancy rates of Tokyo luxury apartments have improved to as low as those in 2007, with luxury residential rent prices rising by nearly 15% from the bottom in 2011.

Chart-15 Residential Rents in Major Cities



Source: Sumitomo Mitsui Trust Research Institute, At Home

Chart-16 Tokyo Luxury Residential Market



*Sample consists of contracts with more than 300K JPY/Month, tsubo rental value or 30 tsubo space.

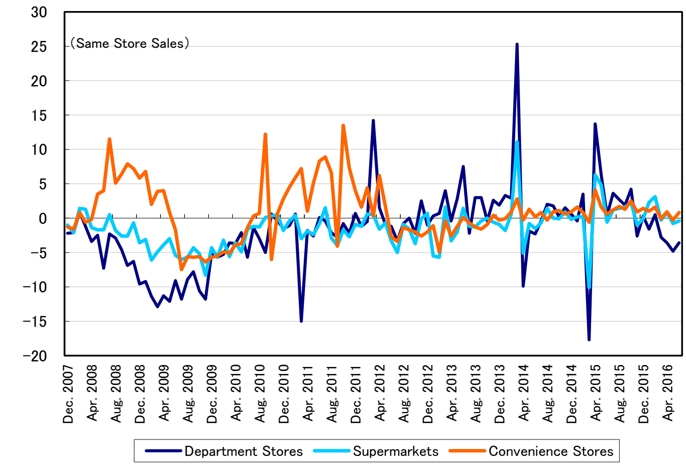
3) Retail, Hotel and Logistics

While same store sales of supermarkets and convenience stores grew y-o-y moderately, those of department stores declined by 4.0% y-o-y in the second quarter (Chart-17). Duty free sales declined by 15% y-o-y, as Chinese tourists bought less big ticket items than before, affected by the appreciation of the yen and the reviewed Chinese tariffs for individual imports.

Japanese customers accounting for 95% of department store sales have also refrained from buying luxury items, affected by the earthquake in Kumamoto and the plunge of the equity market.

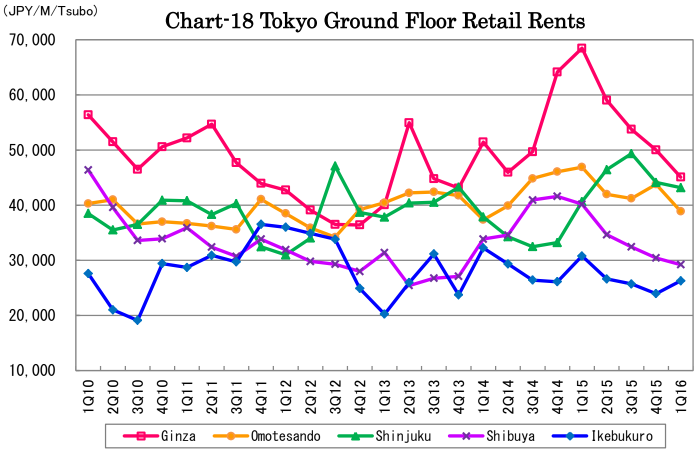
Retail rents of ground floors in the center of Tokyo such as Ginza have been declining to the level seen in 2014 (Chart-18), while retail rents for all floors have not changed noticeably.

Chart-17 Retail Same Store Sales



Source: Ministry of Economy, Trade and Industry

Chart-18 Tokyo Ground Floor Retail Rents

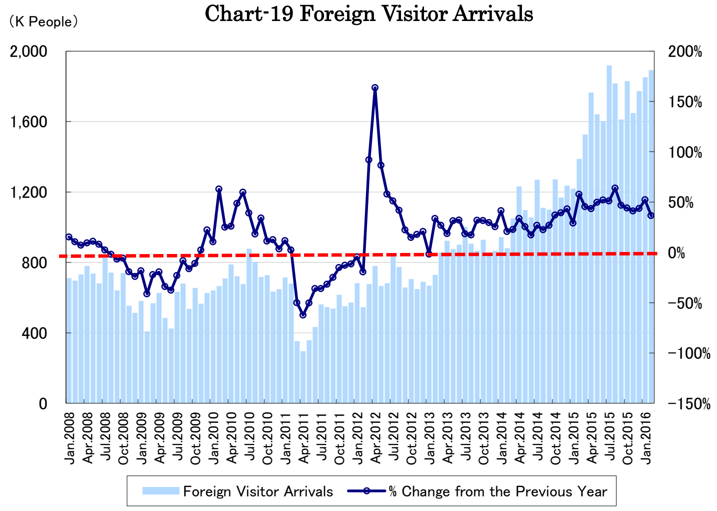


Source: Style Act, Nikkei Real Estate Market Report

The number of foreign visitors grew by 19.0% y-o-y to 5.96 million in the second quarter (Chart-19). Though still increasing, the pace of increase has decelerated from 48% y-o-y in the same quarter 2015, affected by the earthquake in Kumamoto and the appreciation of the yen. Now, further improving hotel occupancy rates looks to be difficult (Chart-20).

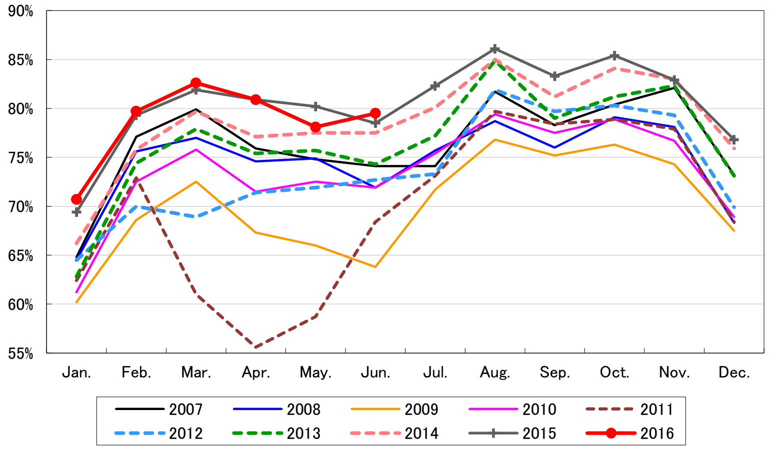
The total number of overnight stays in Japan declined by 2.5% y-o-y to 116 million in the second quarter. The appreciation of the yen encouraged Japanese tourists to go overseas, increasing overseas trips by 4.3% y-o-y, thus, the number of overnight stays in Japan by Japanese tourists declined by 4.1 million, or 4.1% (Chart-21). Additionally those by foreign visitors decelerated to grow by only 6.3% y-o-y in the quarter compared to a 50.3% y-o-y growth in 2015.

Chart-19 Foreign Visitor Arrivals



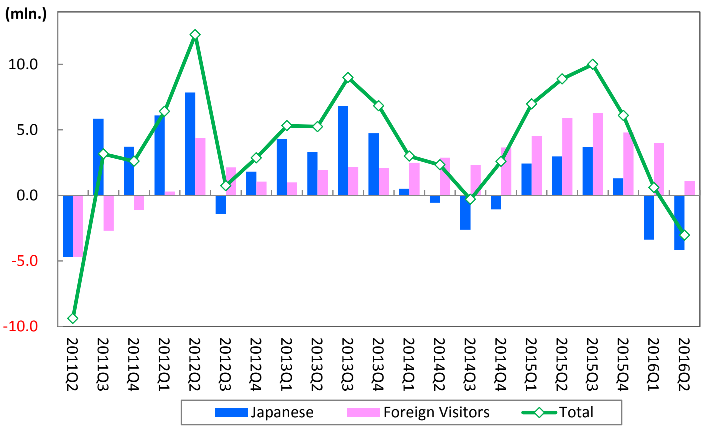
Source: Japan National Tourism Organization (JNTO)

Chart-20 Hotel Occupancy Rates



Source: Ohta Publications "Weekly HOTERES"

Chart-21 Total Number of Overnight Stays (y-o-y)

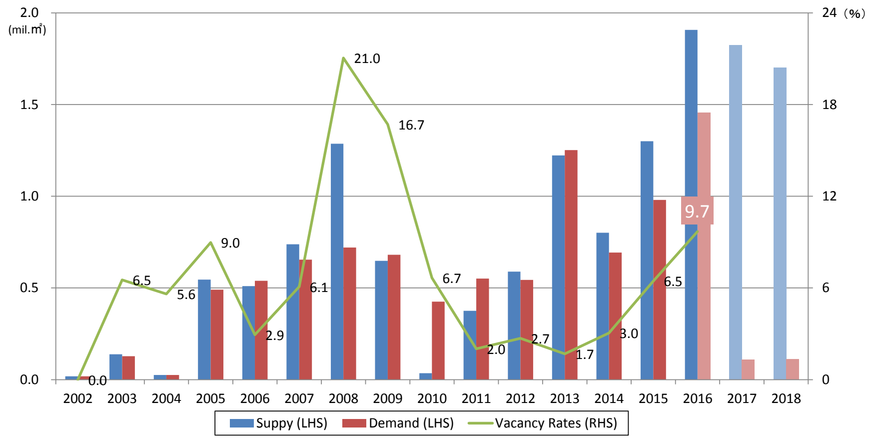


Source: MLIT

The largest ever supply of logistics facilities will come into the markets (Chart-22) in both the Tokyo and Osaka metropolitan areas from 2018 to 2020.

Japan Logistics Field Institute forecasts vacancy rates will increase to 9.7% in the Tokyo metropolitan area in 2016. Even with the gigantic new supply, strong demand can absolve most of them. As vacancy rates of logistics facilities built more than a year ago have remained low, new supply should be gradually occupied by 3PL operators based on growing demand for net shopping.

Chart-22 Logistics Supply and Demand in the Tokyo Metropolitan Area



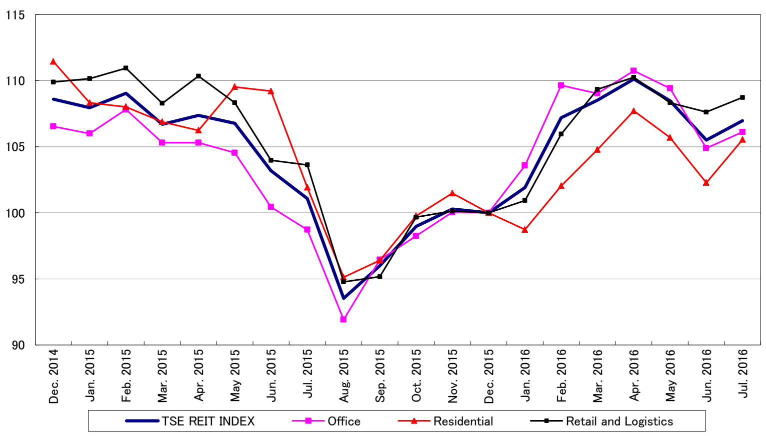
Source: Japan Logistics Field Institute

6. J-REIT and Property Investment Markets

The TSE REIT index has declined by 2.8%, due to the events of Brexit during the second quarter (Chart-23). Office, residential and retail-logistics sectors declined by 3.8%, 2.4% and 1.6% respectively. However, the index still rose by 5.5% in the first half of 2016, outperforming TOPIX which declined by 19.5%.

At the end of June, the J-REIT market value was JPY 11.6 trillion, while the price to NAV ratio was 1.3 times and the dividend yield was 3.4% with a 3.6% yield spread on ten year Japanese government bonds.

Chart-23 TSE REIT Index



Source: Tokyo Stock Exchange

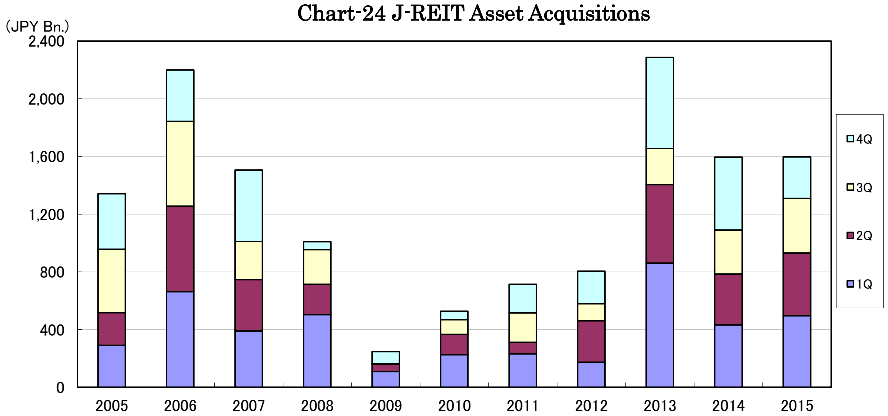
J-REITs acquired property assets of JPY 386 billion in the second quarter and JPY 937 billion in the first half (Chart-24), 19% smaller and 1% larger than those in 2015, respectively.

Star Asia REIT with 18 assets valued at JPY 685 billion was listed in April 20, raising the number of J-REITs to 54. Two new REITs are scheduled to be listed and two existing REITs will be delisted as results of mergers in the third quarter.

The negative interest rate policy pushed bond yields down by 0.4% and can lead to incremental values of the J-REIT portfolios. The average CAP rate of the J-REIT portfolios is 4.5% and the total NAV is JPY 8.8 trillion. Supposing that CAP rates can shrink by 0.4% accordingly, the value of the portfolios and the total NAV will increase by 9% and 16% to JPY 16.3 trillion and JPY 10.2 trillion, respectively.

However, the investor survey conducted by Japan Real Estate Institute shows that many investors consider CAP rates will remain unchanged from the time before the negative interest rate policy was introduced. As CAP rates have been already very low, property incomes now have to grow for sustainable value enhancement.

Chart-24 J-REIT Asset Acquisitions



*New J-REIT assets are included at IPO
Source: NLI Research Institute

