

Real Estate Analysis Report

Japanese Property Market Quarterly Review

Second Quarter 2011

This is the English translation of
Toru Matsumura, “不動産クォーターリー・レビュー 2011年第2四半期”
NLI Research Institute, *Real Estate Analysis Report*, July 29, 2011.

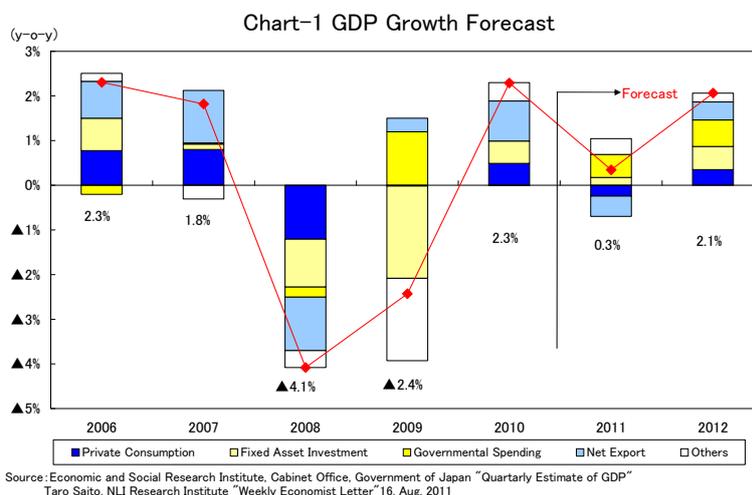
Real Estate Investment Team, Financial Research Group

Toru Matsumura

omatsu@nli-research.co.jp

1. Economy Outlook

NLI Research Institute forecasts Japan's GDP growth at 0.3% in 2011 following the Great East Japan Earthquake, and 2.1% in 2012 considering the economy has already bottomed out with the supply chain restoration and production recovery (Chart-1).¹



Housing starts recorded 63k, 6.4% y-o-y growth, in May 2011 (Chart-2). While the number of new apartments increased, that of individual houses declined. Annual new housing starts are forecasted at about 850k in 2011,² larger than the number in 2010, but it is anticipated that after the earlier termination of the Eco-point program³, the housing support policy will be reviewed in order to secure the budget to reconstruct disaster hit areas.

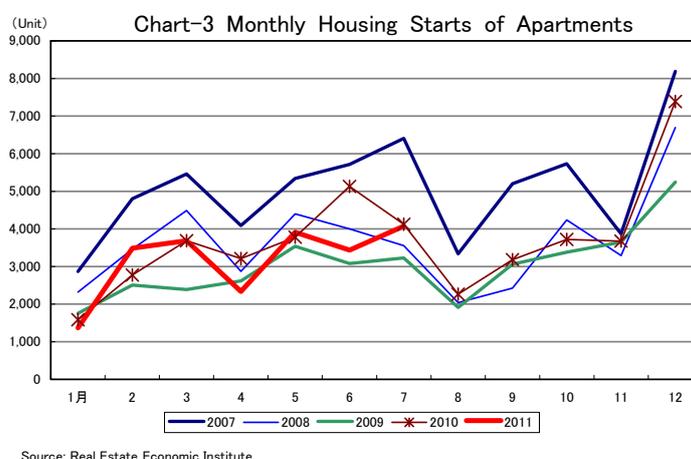
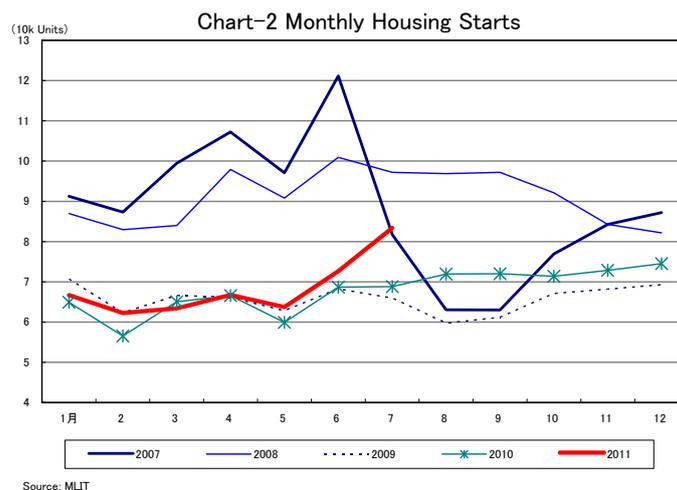
The apartment supply in the Tokyo metropolitan area in May grew 3.6% y-o-y for the first time in three months (Chart-3). Now customer attention is focused on ground stability, location altitude and building quake-resistance. The transaction volume in the secondary housing market in May decreased for the third consecutive month, with weaker prices affected by the

¹ Taro Saito, "Economic Forecast for 2011 and 2012: Revision of Real GDP Growth Forecast following the 1Q number," in *Weekly Economist Letter*, NLI Research Institute, June 10, 2011.

² Research Institute of Construction and Economy forecasts the new housing starts at 847k in fiscal year 2011 and 873k in 2012, according to the *Daily Fudosan Keizai Tsushin* (July 28, 2011).

³ Some eco-friendly houses or equipments are covered by the governmental consumption support program to offer gift vouchers to consumers who buy designated eco-friendly products.

earthquake.



2. Land Price and Market Confidence

“Kouji-chika, 2011”⁴, the official national land price, recorded a decline for the third consecutive year, but the 3% y-o-y decline was better than the 4.6% in the previous year, and more price check points resulted in price appreciation. However, further price decline is anticipated next year due to the effects of the earthquake.⁵

Regarding “Land Price Look Report 1Q 2011” published by MLIT, 98 price-check-points out of 146⁶ resulted in price depreciation compared to the 77 last year, and only two points showed appreciation compared to the 16 last year. Land prices indicated some recovery in the previous quarter, but the shrinking housing demand or retail sales by the earthquake put downward pressure on land prices.

According to Nomura Real Estate Urban Net, residential land prices declined in all areas around Tokyo in their survey as of July 1st, and many price checkpoints of Tokyo CBD commercial land also declined (Chart-4). As customers have become more selective in land

⁴ The official national land price released once a year on January 1st by MLIT, Ministry of Land, Infrastructure, Transport and Tourism.

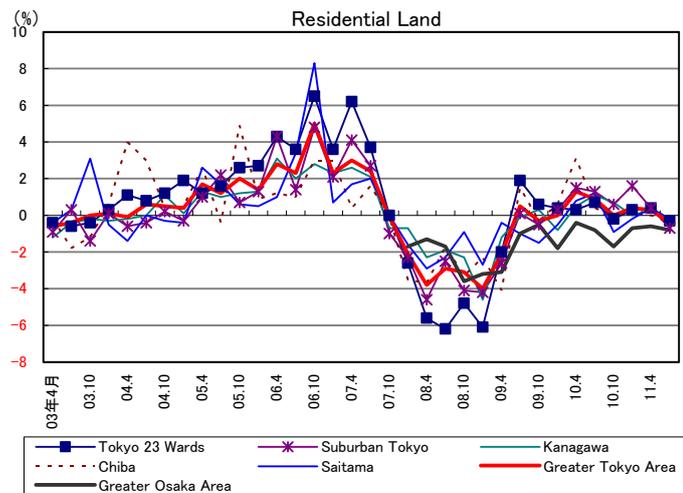
⁵ “Forecast for Urban Land Price Index 2011” published by Japan Real Estate Institute in March 2011, forecasts commercial land prices of six major cities and the most expensive points will decline farther.

⁶ Usually 150 price-points are checked, but this time points in disaster hit cities, Sendai and Urayasu Chiba, were excluded.

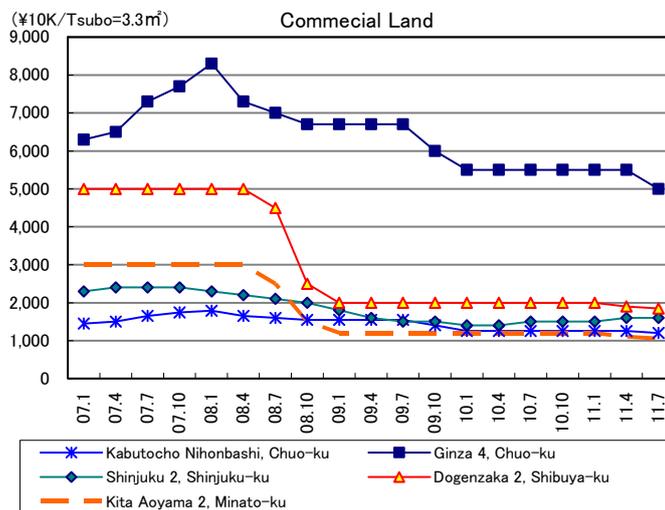
choice, price polarization will possibly develop in the market. The next market attention is focused on “Kijun-Chika⁷ July 1st”, another public land price index, to be announced in September.

Regarding the property business confidence surveyed by The Land Institute of Japan, residential land sales, transactions and leasing contracts apparently deteriorated in April (Chart-5). In addition, according to the “Building Management Survey, April 2011” by Tokyo Building Association, office confidence indexes, which reflect the three-month-view, of both rent and vacancy rates are anticipated to deteriorate respectively to -18% and -10.5%, compared to -12.9% and -3.4% last year.

Chart-4 Land Price



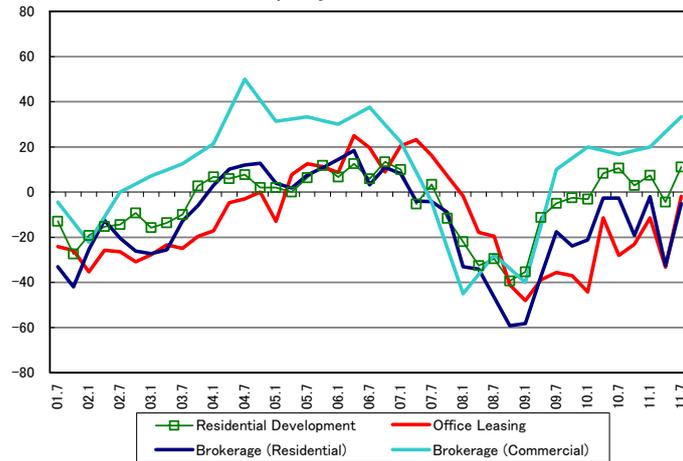
Source: Nomura Real Estate Urbannet



Source: Nomura Real Estate Urbannet

⁷ Municipal governments are responsible for “Kijun Chika”.

Chart-5 Property Business Confidence Index



*As only Brokerage(Commercial) data is semi-annual, the April number is not plotted.
Source: The Land Institute of Japan "Property Business Confidence Survey"

3. Sub-sectors

① Office

The vacancy rate of very large size buildings (standard floor larger than 200 tsubos) in Tokyo three wards office market improved for the first time in three quarters in 2Q 2011. But office rents continuously declined, as seen in the index, contract-base office rent index developed by Sanko Estate and NLI Research Institute (Chart-6). But the smaller building categories (standard floor smaller than 200 tsubos) showed some recovery for the first time in four quarters (Chart-7). As other vacancy rate data from leasing brokers and research firms also indicated some recovery, the market supply-demand balance is apparently improving. As a rent recovery in the very large size category is required for a full-fledged office market recovery, it is possible the rent market of A-class buildings with high-quake-resistance or emergency-use power batteries is already recovering, considering the recent thirst for safety. As new large size buildings will be well equipped⁸ for safety and power saving, market polarization between old and new buildings should be clearly recognized in the future.

Now that electrical power saving is a critical issue for office building management, and actually, the power consumption by office tenants in areas covered by TEPCO and Tohoku-EPCO easily satisfied the required target of a 15% y-o-y cut, realizing a 19.5% cut in April and 20.5% in May⁹. And building owners are also making efforts to save electrical power, such as establishing power saving MOUs with tenants or providing web systems to monitor power consumption with breakdowns by time frame, place and usage.

Office buildings had been requested to conduct energy saving in response to global warming before, but following the power crisis after the earthquake, market attention is focused on effective power control such as saving, storing, generating and diversifying. Concepts such as energy saving and green buildings had been recognized as measures mainly for CSR (corporate

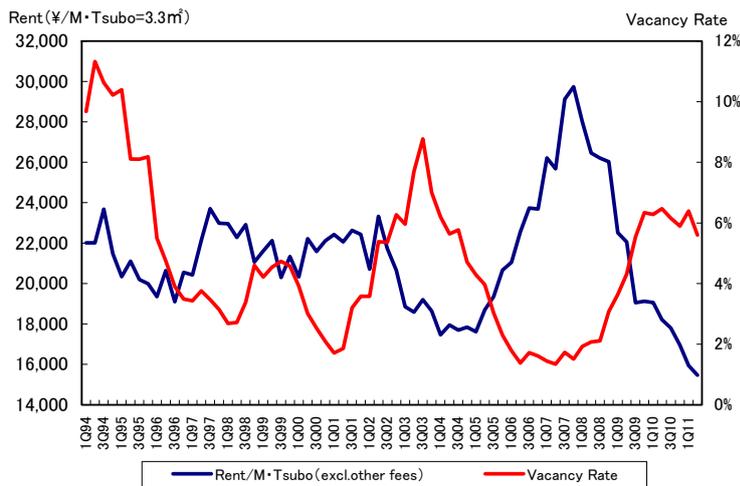
⁸ Mori Building will equip emergency-use power generating units in Toranomon-Roppongi tower complex redevelopment project that will be completed in 2012. Iino Lines will also prepare for tenant needs to equip emergency-use power generating units in its new office tower project.

⁹ Xymax Real Estate Marketing Institute announced the results based on 1,723 office tenant's data managed by Xymax, one of the major office property managers in Japan.

social responsibility), but now they can be considered as building competitiveness and factors for premium rents.

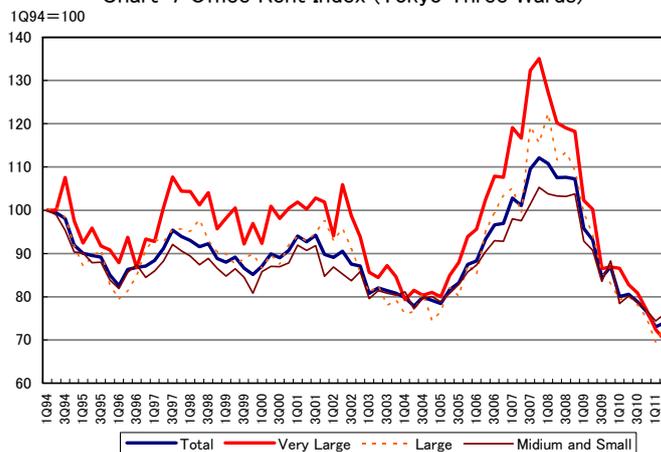
It seems more companies are considering moving to high quality buildings on stable ground. With serious consideration of BCP (business continuity plan) or potential risks from the over-concentration of Tokyo, earthquakes and nuclear power plant accidents, it is possible that more companies will be diversifying H.Q. functions or back-up systems in the medium term, and global companies may review Japan offices from the point of view of their global strategy¹⁰.

Chart-6 Tokyo Three Wards Office Market



Very Large Size Buildings (standard floor larger than 200 tsubos)
 Source: Vacancy Rate·Sanko Estate, Rent· Sanko Estate and NLI Research Institute

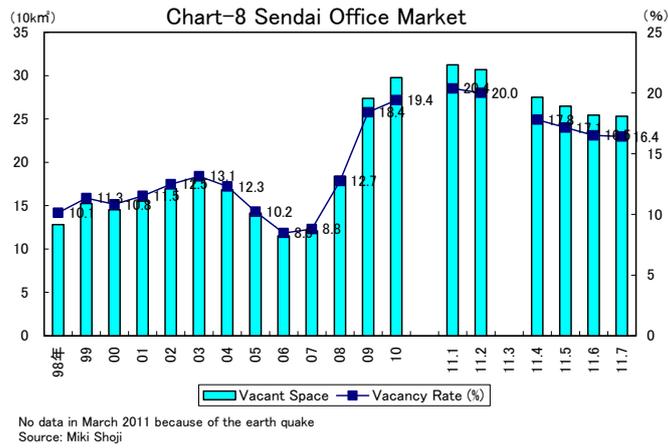
Chart-7 Office Rent Index (Tokyo Three Wards)



Very Large (Standard floor > 200 tsubos), Large (100 < and < 200), Medium and Small (< 100)
 Source: Sanko Estate and NLI Research Institute

Regarding the Sendai office market, the vacancy rate improved rapidly with evacuees from disaster hit areas and clouds of reconstruction supporters from other areas (Chart-8). While this temporary demand might disappear soon, it is possible that the Tohoku region is further integrated and will create some more demand in the regional center of Sendai.

¹⁰ Omron (Kyoto) is reported to be considering the diversification of H.Q. functions to overseas.

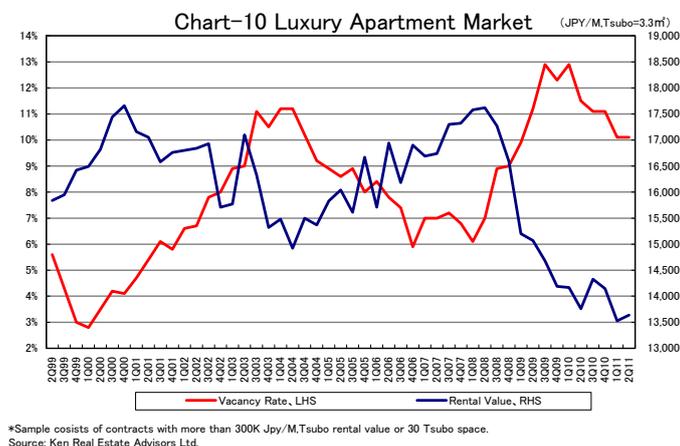
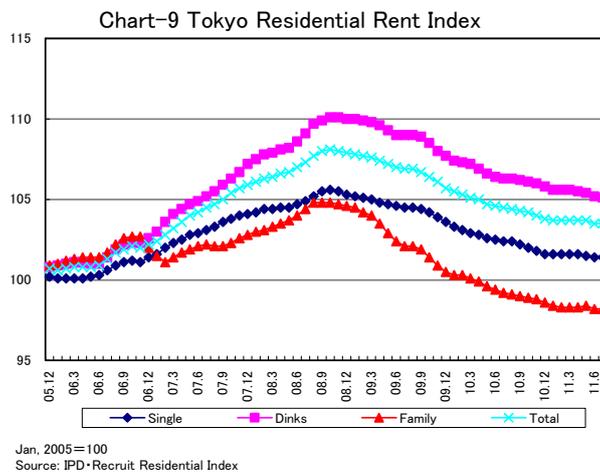


② Rental Apartment

The Sendai rental apartment market tightened with evacuees from disaster hit areas and reconstruction supporters from other areas, as some space became unusable due to the damage.

Contrarily, in Tokyo where signs of recovery were noticed before, the rents indicated some weakness after the earthquake (Chart-9). But the Tokyo luxury market where foreigners and high-income workers are the main customers still remains unchanged (Chart-10), after excess supply lowered rents in 2010.

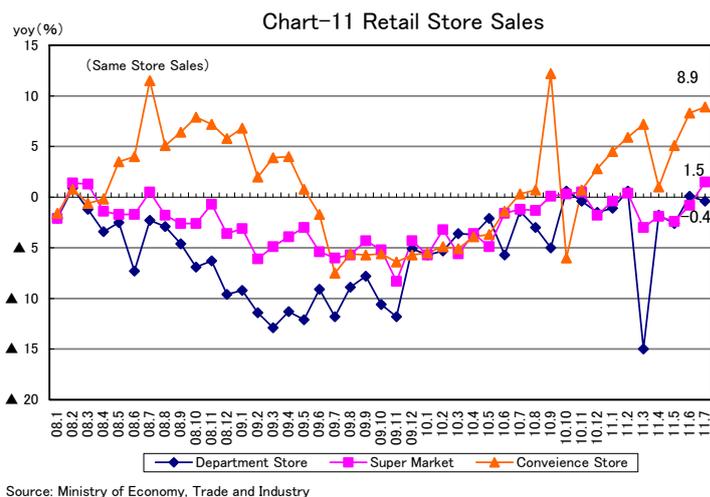
In addition, high-grade rental apartments owned by J-REITs and large private funds have kept their high occupancy rates even after the earthquake.



③ Retail, Hotel, and Logistics

Same store retail sales showed some stability by shrinking only 2.4% y-o-y in May after plunging 7.5% in March. While department stores continued to show negative sales growth, convenience stores recorded several-month-consecutive positive growth (Chart-11).

Even though the consumer confidence index turned positive in May for the first time in four months, uncertainty still remains in the labor market. Thus it appears that consumption of unnecessary luxury goods and leisure services will take time to recover.¹¹ But on the other hand, e-commerce via the internet and energy-saving goods consumption are expected to expand.



Before the earthquake totally changed the hotel market trends, recovery signs had been recognized by improving occupancy rates and even higher room rates in some areas. The national hotel room occupancy rate remains low, though it has recovered from the bottom recorded in April (Chart-12). Chiba Urayasu made the largest plunge, due to the halt of operations at Tokyo Disney Resort, and is still slow with both domestic and foreign visitors not yet returning. The Tokyo area was affected harshly compared to Osaka or Fukuoka. However, the Sendai occupancy rate improved as much as 20 points y-o-y in May and June, supported by the temporal reconstruction demand, after plunging significantly in March (Chart-13).

The hotel sector was most seriously affected by the earthquake, and it is dependent on the return of foreign visitors. Though the June foreign visitor arrivals, -36% y-o-y, indicated some stabilization, it seems that it will take a long time¹² to return to normal, following the deterioration of the Japanese brand image of safety and security (Chart-14).

Even in this market momentum, luxury hotel brands are newly entering the Kyoto hotel market (Chart-15). This is because Kyoto has established its brand as a world prestigious tourism site and only limited operators compete under the strict scenery protection regulations.

¹¹ Tourism demand rapidly recovered in July and August, but this applies only to short flights to Korean and Asian cities and expensive long flights to the U.S. or Australia have not yet made a turnaround. (Nikkei, June 28)

¹² Jones Lang LaSalle forecasts the hotel market will recover in the latter half of 2012 as long as the nuclear plant issue is managed appropriately.

Chart-12 Hotel Occupancy Rate

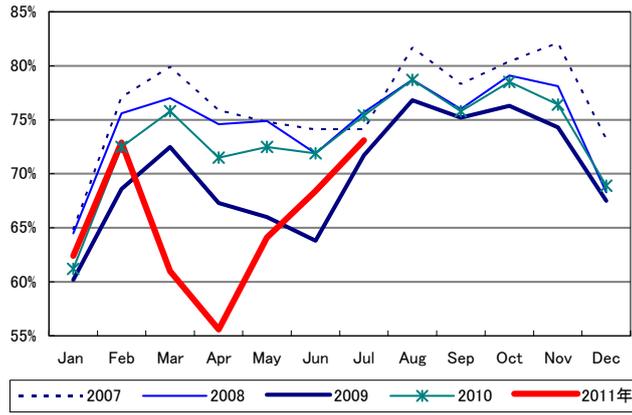


Chart-13 Hotel Occupancy Rate

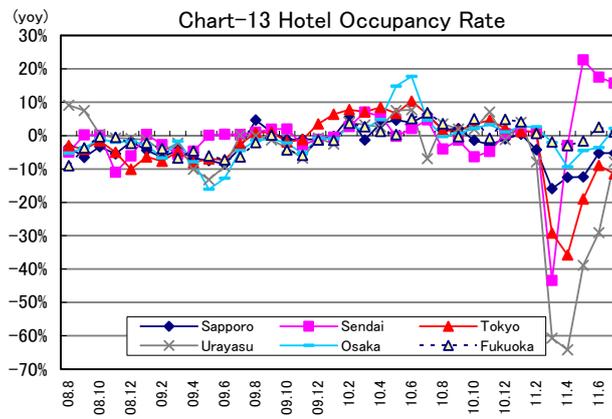


Chart-14 Foreign Visitor Arrivals

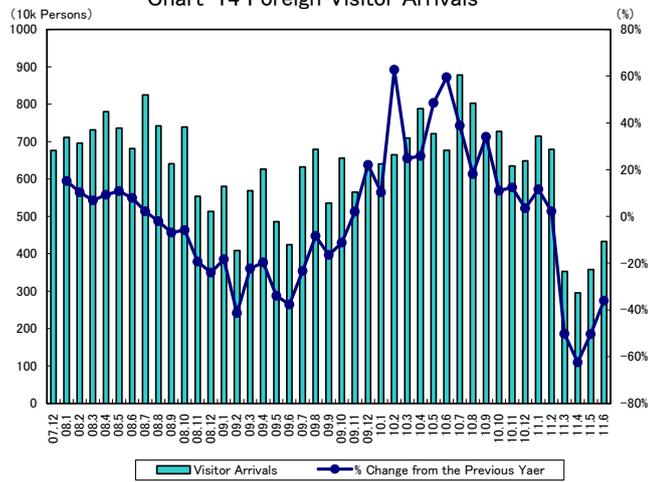


Chart-15 Hotel Development Projects in Kyoto

Completion	Project	Developer	No. of Rooms
2011	Royal Park Hotel The Kyoto	Royal Park Hotel & Resorts	175
	Hotel Anteroom Kyoto	Urban Design System	61
	Kinu No Yu-Kadensho	Kyoritsu Maintenance	105
2012	Hotel Kintetsu Kyoto Station	Kintetsu Coporation	368
2014	Four Seasons Hotel	Pacific Star	200
	The Ritz Carlton Hotel Kyoto	Sekisui House	136

Source: NLI Research Institute

Regarding the logistics leasing market, the replacement demand from damaged capacities made the Tokyo vacancy rate significantly lower. While the weak economic growth and the supply chain disorder can press logistics rents in the short term, the structural trend of e-commerce expansion and third party logistics penetration remains intact. Even after the earthquake, new entrants and developments have been noticed in the large size logistics market where J-REITs and private funds like to invest.¹³

4. Property Investment and J-REIT Markets

The TSE REIT index plunged by 22% to 838.9 points immediately after the earthquake. But considering the overwhelming scale of the earthquake, the total repair expenses for damages seem unexpectedly small, costing only ¥3.2bil, equivalent to 0.04% of total J-REIT assets and 2% of forecasted annual profits. Furthermore, the index recovered to 1,000 point on March 18 (Chart-16), after BOJ announced that it would expand its J-REIT buying fund amount on March 14, and investors started to focus on the stability and high dividend yields of J-REITs. But office and other J-REITs have to be cautiously monitored, since their profitability will deteriorate continuously.

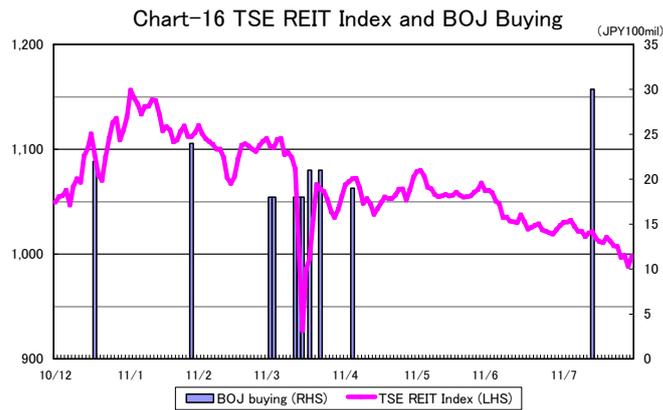
While financial institutions conservatively keep making loans, private fund players do not have funding issues and do not feel pressured to sell buildings. At the moment, in terms of liquidity and stability, no alternative to the Japan market is recognized in Asia, and the yield gap in Japan looks better than those in other markets. While many foreign investors are just in a wait and see stance after the earthquake, domestic investors, developers and Asian investors from Singapore and Hong Kong are already active in the investment market.

Regarding the “investor survey by JREI in April 2011”, the expected cap rates on standard A-class buildings remained unchanged in most areas, excluding Sendai and Chiba (Chart-17). In Tokyo the expected cap rates in most sectors remain unchanged excluding logistics facilities in the bay area (Chart-18). Another similar survey by CBRE also showed expected cap rates unchanged in most sectors.¹⁴

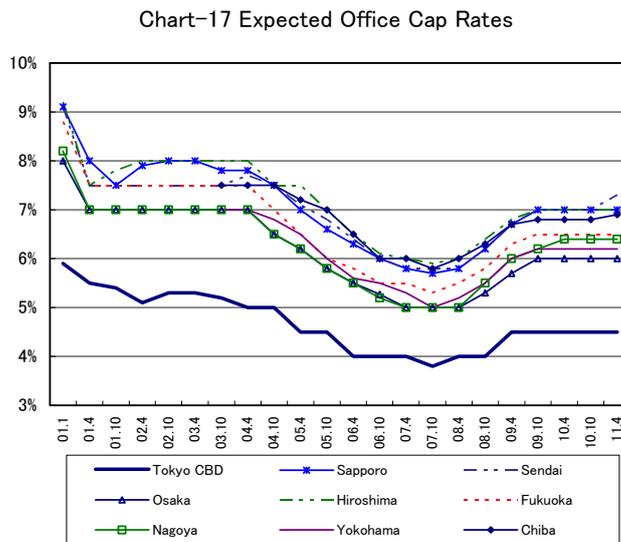
However, in questions regarding the impact of the earthquake in the JREI survey, 62% of respondents replied “the earthquake has had a negative impact on new investments” and 43% replied “they are reviewing risk premiums”, which suggests the market should be monitored cautiously.

¹³ Mitsubishi Real Estate entered into logistics development and LaSalle Investment Management acquired a land to develop in Kanto in-land area, while Prologis has development projects in Saga, Saitama, Kanagawa prefectures. And major warehousing companies, Mitsui Souko and Mitsubishi Souko, focus on consulting, 3PL logistics services and overseas businesses, as they can not rely on simple warehousing businesses.

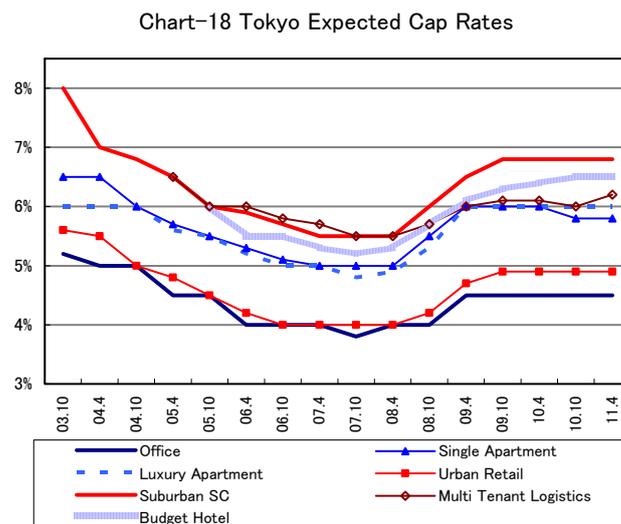
¹⁴ As the survey was conducted soon after the earthquake, it is possible that many investors just hesitated to make decisions.



Source: Tokyo Stock Exchange, BOJ



Source: Japan Real Estate Institute "Real Estate Investor Survey"



Source: Japan Real Estate Institute "Real Estate Investor Survey"