Real Estate Analysis Report

Desired Acceleration of Grade-A-Office Investment by J-REIT

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Summary

・Recently, more transactions of Grade-A-offices by J-REITs have been observed in the Tokyo prime office market. Currently, however, Grade-A-offices account for only a small portion of J-REIT portfolios. While property developers own a lot of Grade-A-offices, J-REITs play a very small role in the Tokyo prime office market.

・When more Grade-A-offices are invested by J-REITs, various benefits can be expected in the market. J-REITs can overcome obscurity among investors, especially retail and overseas investors, and can secure the competitiveness of their portfolios even in a more polarized and selective office market. J-REIT market liquidity can improve with the increasing market size, which leads to good accesses to large institutional investors. Regarding the overall property market, the transaction liquidity and the transparency of the Grade-A-office market will possibly improve. Moreover, property developers selling Grade-A-offices can pursue growth opportunities by reinvesting the proceeds from the sales into development projects in Asia.

Main Owners of Grade-A Offices in Singapore and Tokyo

	Singapore		Tokyo	
	No. of Projects	Ratio	No. of Projects	Ratio
REIT	19	**38.8%**	27	**13.8%**
Global Investors	9	18.4%	2	1.0%
Domestic Investors	0	0.0%	9	4.6%
Domestic Developers	16	32.7%	109	55.6%
Own-Use・CRE	5	10.2%	49	25.0%
Total	49	100%	196	100%

⇒ Grade A Ratio in REIT Office Portfolio
76.0% of the 25 City Offices in S-REIT Portfolios
4.8% of the 566 Tokyo Offices in J-REIT Portfolios
＊Ratio is based on the no. of projects not value

*Tried to cover all very large offices in prime office locations built in 1980's or later
*Guessed a main owner of each project（no duplication, REIT is counted as a main owner even with small stakes）
Source: NLI Research Institute

Tokyo Prime Office Market

The other day, Japan Prime Realty Investment Corp. announced intention to acquire the land portion of “Otemachi 1-6 Project” from the SPC invested by its sponsor, Tokyo Tatemono Co. Ltd. Although it is an unusual case to invest in the land only, acquisition of a high-rise prime Tokyo office by a J-REIT is quite remarkable. Only a few cases have been seen in the past such as “Roppongi Hills Mori Tower” and “Tokyo Shiodome Building.” This time, the location of the project is Otemachi-Marunouchi area where office rents are the most expensive in Tokyo.

By setting a certain Grade-A definition[1], 27 Grade-A-offices are recognized in current J-REIT Tokyo portfolios (Chart-1). Eight projects[2] of the 27 were acquired in 2011 or 2012. It seems J-REITs are acquiring Grade-A-offices at an unprecedented pace, which may suggest J-REITs will accelerate to invest in more Grade-A-offices hereafter.

Chart-1 Tokyo Grade-A Offices Invested by J-REITs

Project Name	Year	Floors	Space (Tsubo)	J-REIT
(tentative) Otemachi 1-6 Plan (Land Only)	2014	38/B6	547	Japan Prime Realty Investment Corp.
Hirakawamachi Mori Tower	2009	24/B2	480	Global One Real Estate Investment Corp.
Shiodome Building	2007	24/B2	1185	Japan Real Estate Investment Corp.
Kitanomaru Square	2006	26/B2	567	Japan Real Estate Investment Corp.
Akasaka Gerden City	2006	19/B2	470	Japan Excelent Investment Corp.
Tokyo Shiodome Building	2005	37/B4	1100	MORI TRUST Sogo Reit Inc.
Akasaka Inter-city	2005	29/B3	564	Japan Excelent Investment Corp.
NBF Pratinam Tower	2005	26/B2	412	Nihon Building Fund Inc.
Nibancho Gerden	2004	14/B2	1197	Japan Real Estate Investment Corp.
Mitsubushi Heavy Industry Building	2003	28/B3	590	Nihon Building Fund Inc.
Roppongi Hills Mori Tower	2003	54/B6	1409	Mori Hills REIT Investment Corp.
Mitsubushi Trust Bank H.Q. Building	2003	29/B4	544	Japan Real Estate Investment Corp.
Atago Green Hills	2001	42/B2	449	Mori Hills REIT Investment Corp.
Akasaka Tameike Tower	2000	25/B2	404	Mori Hills REIT Investment Corp.
Korakuen Mori Building	2000	19/B5	350	Mori Hills REIT Investment Corp.
Gatecity Osaki West Tower	1999	24/B4	1236	Nihon Building Fund Inc.
Nishi Shinjuku Mitsui Building	1999	27/B2	498	Nihon Building Fund Inc.
Tokyo Operacity Building	1996	54/B4	714	Japan Real Estate Investment Corp.
Shinjuku Islandcity	1995	44/B4	806	Invincible Investment Corp.
Shinjuku Mind Tower	1995	34/B3	533	Daiwa Office Investment Corp.
Ebisu Neonart	1994	18/B2	384	Japan Real Estate Investment Corp.
Akaska Park Building	1993	30/B2	660	Japan Real Estate Investment Corp.
Otemachi First Squrer East	1992	23/B5	517	Global One Real Estate Investment Corp.
NEC H.Q. Building	1990	39/B3	-	Top REIT Investment Corp.
Arc Mori Building	1986	37/B4	930	Mori Hills REIT Investment Corp.
Shiba NBF Tower	1986	18/B3	786	Nihon Building Fund Inc.
NBF Hibiya Building	1984	26/B4	296	Nihon Building Fund Inc.

*Tried to cover all very large offices in prime office locations built in 1980's or later
*Projects coloured were acquired in 2011 and 2012
Source: NLI Research Institute

The new supply in the Tokyo prime office market in 2012, mainly in Otemachi-Marunouchi area, is overwhelming next to the 2003 historic record. The number of recent new projects reaches 42 and J-REIT shows very limited presence accounting for only about 5% (Chart-2).

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[1] NLI Research Institute picked the projects in reference to Sanko Estate Grade-A-Office Guidelines, urban area Tokyo five wards, main office areas and other specially integrated areas, total floor area more than 33,000 m^2, main floor size more than 990 m^2, building age 15 years or less (including some well-refurbished older buildings), facilities ceiling height of 2.7m or more, individual air-con, quake resistance, environmental friendliness.

[2] Portions of Roppongi Hills Mori Tower, Arc Mori Building and Gatecity Osaki had already been acquired before 2011.

Chart-2 Main Owners of Tokyo New Grade-A Offices

	Tokyo	
	No. of Projects	Ratio
J-REIT	2	4.8%
Global Investors	0	0.0%
Domestic Investors	0	0.0%
Domestic Developers	28	**66.7%**
Own-Use・CRE	12	28.6%
Total	42	100%

⇒Two J-REIT Projects

Project Name	Year	Height (M)	Floors	J-REIT
(tentative) Otemachi 1-6 Plan (Land Only)	2014	200	38	Japan Prime Realty Investment Corp.
Hirakawamachi Mori Tower	2009	102	24	Global One Real Estate Investment Corp.

*Tried to cover all new Tokyo Grade-A-offices in prime office locations built in 2009 or later
*Guessed a main owner of each project (no duplication, REIT is counted as a main owner even with small stakes)
Source: NLI Research Institute

Most of those 42 Grade-A-offices have been developed by major domestic property developers and are likely to be held by them in the long term. Additionally, many other non-real estate companies are also Grade-A-office owners. These are cases where property developers presented redevelopment plans to the companies which have old buildings in prime office areas. With these redevelopment projects, the developers receive management fees without taking their own risks, and the owner companies can utilize their lands without selling them while banks are supportive to them favoring prime location lands for collateral.

Not only new Grade-A-offices, but old ones as well, are owned by building owners such as property developers, life insurers, railway operators and telecom companies. In contrast, investors like J-REITs, private and global funds are rarely observed as Grade-A-office owners. Although Tokyo has the largest property stock in the world, it rarely provides investors with opportunities to invest in Grade-A-offices.

For example, S-REITs invest in many landmark offices in Singapore's central business district. Compared with S-REITs, J-REITs still have ample room to progress gaining more market share in the prime office market and increasing the number of Grade-A-offices in their portfolios[3] (Chart-3).

Chart-3 Main Owners of Grade-A Offices in Singapore and Tokyo

	Singapore		Tokyo	
	No. of Projects	Ratio	No. of Projects	Ratio
REIT	19	**38.8%**	27	**13.8%**
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Source: NLI Research Institute

[3] Mamoru Masumiya "S-REIT (Singapore REIT) from the Viewpoint of Overseas Investors" NLI Research Institute, Real Estate Analysis Report, 24, April, 2012.

The recent supply in the Tokyo prime office market is so sizable that the balance sheets of building owners are swelling up. As many companies have high debt-equity ratios by making use of the current generous financial conditions, some of them may consider selling Grade-A-offices in order to streamline their balance sheets hereafter. Moreover, as they consider developing more new Grade-A-offices well equipped for disaster prevention and energy saving to meet increasing demand following the Great East Japan Earthquake, selling older Grade-A-offices can be the way to finance those developments.

Using the case of Singapore as a reference, it is imaginable that J-REITs will invest in many Grade-A-offices as the market matures.

Positive Impact of More Grade-A-Offices in J-REIT Portfolios

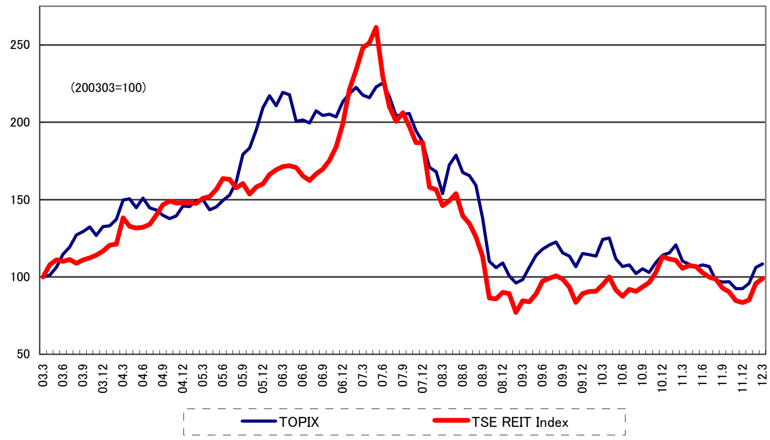
Generally Grade-A-offices have low income yield, therefore a J-REIT should have a lower dividend yield when investing in more Grade-A-offices. Conversely, positive effects by investing in Grade-A-offices can offset the lower dividend yield. Not only J-REIT itself but also the overall property market and property developers selling Grade-A-offices can expect a variety of positives.

1) Better Recognition and Interest among Investors

Grade-A-offices are generally well-known as landmarks and must be beneficial to J-REITs, as J-REITs struggle with obscurity among investors, especially retail and overseas investors.

The share price move of J-REITs looks just in line with that of equity shares, which suggests that J-REITs are recognized as one of equity shares (Chart-4).

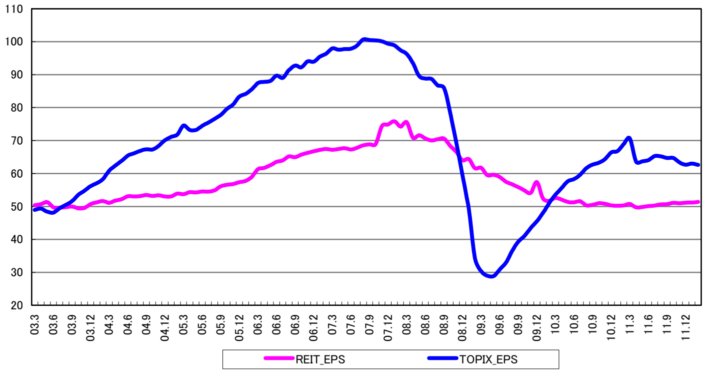
Chart-4 TOPIX and TSE REIT Index



Source: Tokyo Stock Exchange

However, compared with ordinary companies, the earning structure of J-REITs is much simpler with the collection of stable rents from a diversified property portfolio. Even in the Great East Japan Earthquake, J-REIT earnings were not affected. Actually, the stability of J-REIT earnings is very different from those of ordinary companies (Chart-5).

Chart-5 EPS of J-REIT and General Equity Stocks (TOPIX)



Source: NLI Research Institute

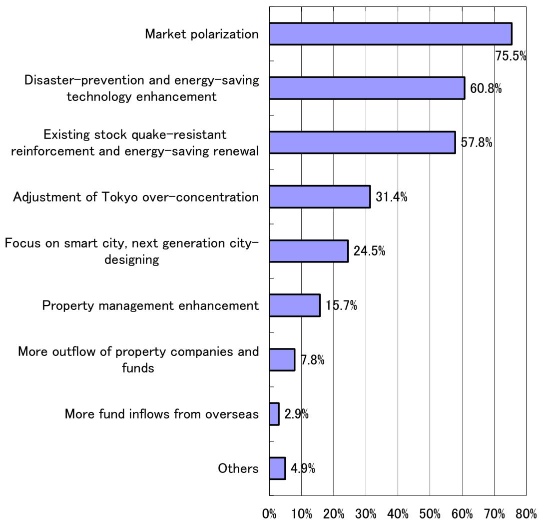
Therefore, it is possible that the J-REIT share moves can become as stable as earnings, when J-REITs are well understood by investors. In that case, the low yield of Grade-A-offices can be reasonably accepted by investors. As Grade-A-offices are favored especially by overseas investors who face difficulty to find information for obscure properties, more Grade-A-offices in the portfolios should lead to attract more overseas investors to J-REITs.

2) Securing Competitiveness in a More Polarized and Selective Office Market

After the Great East Japan Earthquake, the trend of favoring sustainable buildings emerged in the office market reflecting the appetite for disaster prevention and energy saving. Then J-REITs will possibly be requested to invest in such buildings hereafter.

The specifications of latest Grade-A-offices have become higher with functions and facilities like quake-resistance, emergency electric batteries and food storage facilities, and for daily energy saving through high quality glass and LED lights. For example, the result of the survey conducted last year showed market polarization is the main predictable change in the market (Chart-6)[4].

Chart-6 Predicted Long Term Changes in the Market



Source: NLI Research Institute, October 2011

[4] Mamoru Masumiya " Polarization Progresses in Disaster-prevention and Energy-saving,and Remarkable Change Seen in Sector Preference-The Eighth Japanese Property Market Survey-" NLI Research Institute, Real Estate Analysis Report, 25, October, 2011

So far the building quality of J-REIT offices is regarded better than average, as most of them were built after the introduction of the new quake-resistant regulation in 1981. Further, there is concern that traditional offices will struggle against tougher competition when high-spec buildings become common. As J-REITs are required to keep stable dividends for many years, they must maintain portfolio competitiveness even in a polarized and more selective market. Investing in Grade-A-offices should be an effective measure to meet this request.

3) Larger J-REIT Market Size and Liquidity

When J-REITs accelerate investing in Grade-A-offices and expand their market size, the liquidity will also improve. Currently, the J-REIT market capitalization is JPY 3.5 trillion in total of 34 firms, but this size is not large enough to provide good liquidity for large institutional investors. When they make changes to their portfolios, they can not avoid disadvantageous market impacts. Thus, expanding the market size and the liquidity will lead to open the door for large institutional investors to invest in J-REITs.

4) More Property Transactions

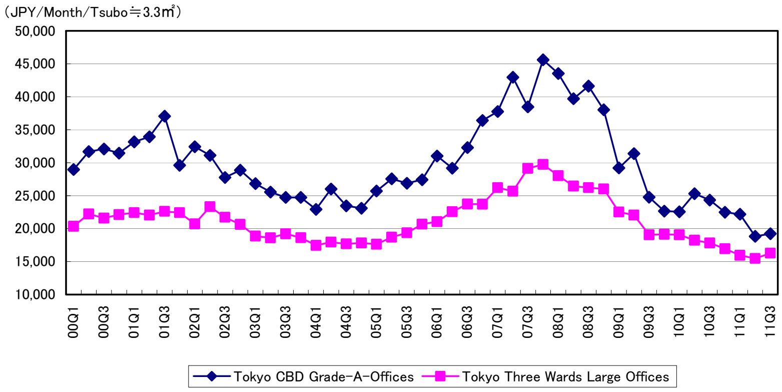
Basically the building owners like major property developers just keep Grade-A-offices in the long term and do not seek opportunities to sell, so the liquidity of the Grade-A-office market is quite limited. When J-REITs which seek portfolio growth by acquiring and switching assets invest in high number of Grade-A-offices, there will be more transactions in the market. In that situation, overseas investors and domestic pension funds can possibly start investments in the property market. Consequently, property developers can take more advantageous selling opportunities.

5) Better Grade-A Market Transparency

Many Grade-A-offices are owned by major property developers and not a small part of them are leased by themselves without using leasing brokers, which leasing information is not reflected in the market data. Therefore, understanding and analyzing the Grade-A-office market is pretty difficult. Checking the Grade-A-office rent index developed by Sanko Estate and NLI Research Institute, Grade-A-office rents and vacancy rates seem to fluctuate more than those of other smaller large offices, though this is based on limited data (Chart-7, 8).

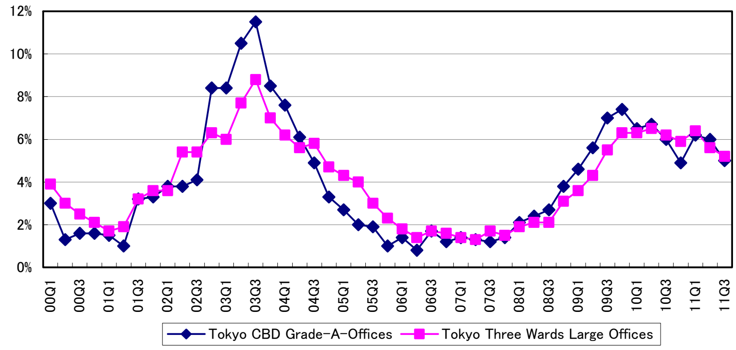
Generally, Grade-A-offices have low income yields. If more individual NOI and appraised values of Grade-A-offices are provided by J-REITs, the reason of the low yield can be analyzed and better understood. Thus, more investment by J-REITs can lead to the better transparency of the Grade-A-office market.

Chart-7 Tokyo Grade-A-Office Rent Index



Source: Sanko Estate "Office Rent Data 2012"

Chart 8- Tokyo Grade-A-Office Vacancy Rates



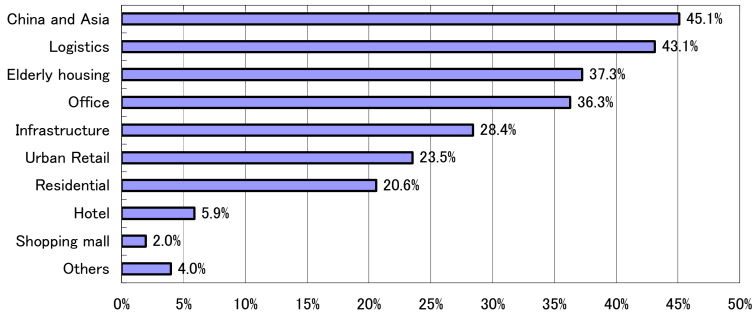
Source: Sanko Estate "Office Rent Data 2012"

6) Growth Opportunity for Property Developers

The better market transparency and more selling opportunities are expected benefits for developers selling Grade-A-offices. Moreover, they can seek new growth opportunities like developments in Asia by reinvesting the proceeds from completed project divestiture. For example, a major Singaporean developer, Capitaland, sells completed projects mainly in Singapore and reinvests the proceeds into development projects in emerging markets like China.

Japanese property developers and home builders have proactively invested in Asia recently, while the attention of the market participants is focused on Asia (Chart 9). Thus, providing Grade-A-offices to J-REIT and seeking Asian growth opportunities should be one of the ideal strategies that property developers can pursue.

Chart-9 Preferred Sectors Expected Price Appreciation and Market Expansion



Source: NLI Research Institute, October 2011

Final Note

It has been more than ten years since the inception of J-REIT in 2002. J-REIT has contributed greatly to consolidating property market data. Regrettably, however, as an investment product, J-REIT has not been well understood by a range of investors. It is hoped that more Grade-A-offices in J-REIT portfolios can have a variety of positive effects on the J-REITs and the property market.

