Real Estate Analysis Report

Japanese Property Market Quarterly Review, First Quarter 2013

~Grade-A Office Rents Surge in Tokyo~

This is the English translation of Toru Matsumura, "大幅上昇となった東京都心Aクラスオフィス賃料 ー不動産クォータリー・レビュー2013年第1四半期" NLI Research Institute, *Real Estate Analysis Report*, April 23, 2013

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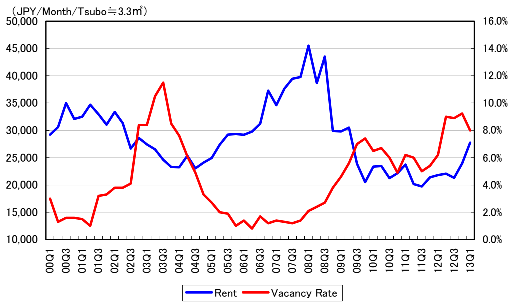
Summary

- Business confidence has improved considerably with the Japanese yen depreciation and the equity market rally since the inception of the second Abe cabinet. NLI Research Institute revised its Japan GDP growth forecast up to 2.5% for 2013. Housing starts increased for the sixth consecutive month in February, and secondary housing transactions continued to increase in the seventh consecutive month in the Tokyo metropolitan area. The land prices in the three major metropolitan areas shrank at milder paces than previous years and appear to be bottoming out since Nagoya residential land prices did not decline.
- The office rents in the Tokyo three wards finally recovered, while the Tokyo grade-A office rents soared in the second consecutive quarter and some smaller categories recovered to the level before the earthquake in the 2011. It seems the Tokyo office market will continue to recover since most of the supply scheduled in 2013, which is equivalent to only 33% of that in 2012, has already been completed. Hotel occupancy rates remained as high as those before the global financial crisis in 2008. Large logistics facilities have still been in short supply.
- The TSE REIT Index skyrocketed by 47.4% q-o-q in the first quarter. J-REITs acquired sizable assets totaling JPY 861 billion in the quarter, which is already larger than the annual number in 2012, while two J-REITs, Comforia Residential and Japan Prologis went public. The property investment market appears to be further improving on the back of the Japanese yen depreciation, the recovering equity market and the Tokyo office rent recovery.

Tokyo Grade-A Office Market



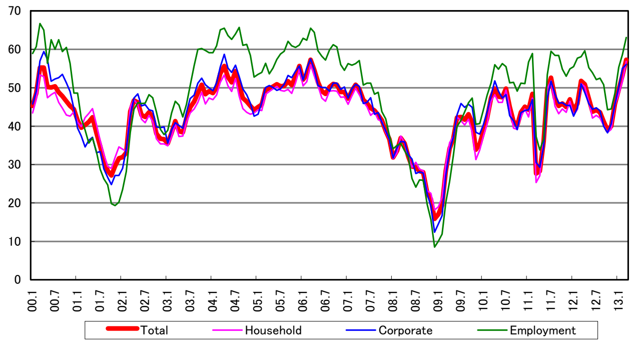
Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

1. Economy and Housing Market

Business confidence has improved considerably with the Japanese yen depreciation and the equity market rally based on "Abenomics," monetary easing, public spending and growth strategic policy by the second Abe cabinet, and "monetary easing in an entirely new dimension" by the Bank of Japan (Chart-1).

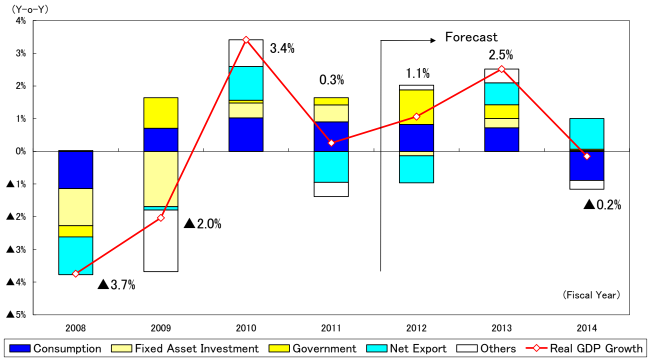
NLI Research Institute revised its Japan GDP growth forecast up to 2.5% for 2013 and down to -0.2% for 2014 (Chart-2), following the cabinet office announcement of the fourth quarter GDP growth at 0.2% adjusted from -0.4%.

Chart-1 Economy Watchers Survey (DI)



Source: Cabinet Office, Government of Japan

Chart-2 Japan GDP Growth Rate



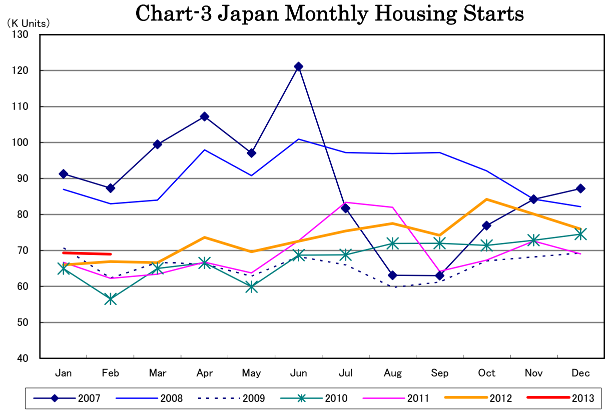
Source: Economic and Social Research Institute, Cabinet Office, Government of Japan "Quarterly Estimate of GDP"
NLI Research Institute "Weekly Economist Letter" March 11, 2013.

Housing starts in February increased for the sixth consecutive month to 69k units equivalent to 94.4k annually (Chart-3, 4). Housing starts of condominiums in January and February increased by 9.5% in the Tokyo metropolitan area, 14.8% in Chubu, 6.1% in Kinki and 2% in others.

New condominium units sold in the Tokyo metropolitan area increased by 48.4% to 5,139 in March (Chart-5). The March sales hit a record in six years as high as that of the boom in 2007, with an 82.1% contract rate, breaking 80% for the first time in seven months.

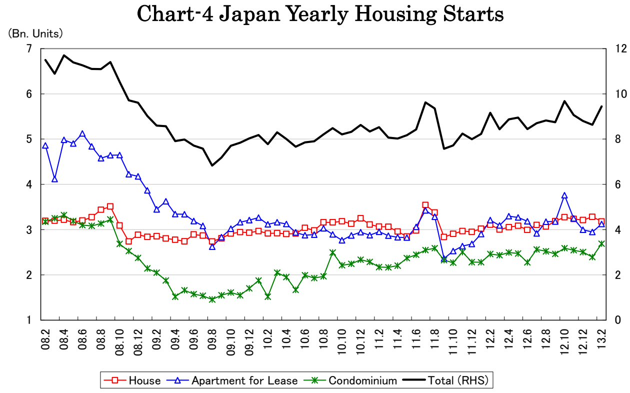
According to the Real Estate Information Network System (REINS), the transaction volume of secondary condominiums increased for the seventh consecutive month by 13% y-o-y to 3,830 (Chart-6) and the inventory declined for the fourth consecutive month by 9.2% y-o-y to 41,157. The inventory showed a y-o-y decline in February for the first time in 32 months since June 2010.

Chart-3 Japan Monthly Housing Starts



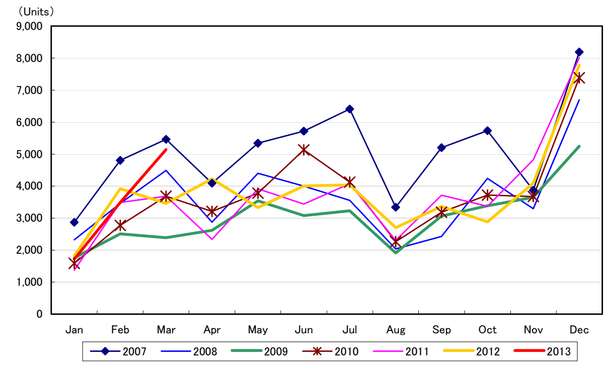
Source: MLIT

Chart-4 Japan Yearly Housing Starts



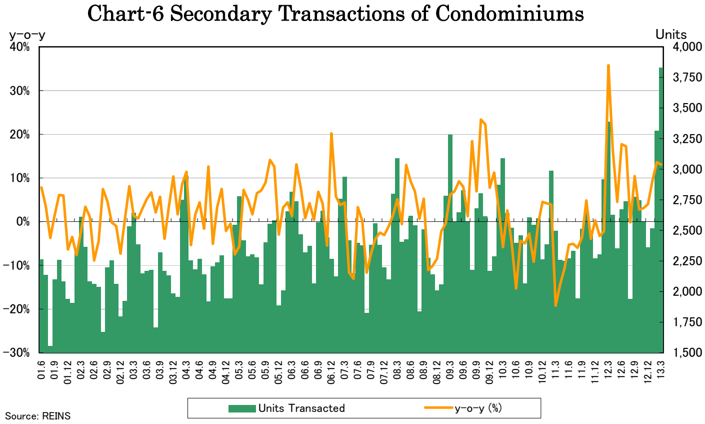
Source: MLIT

Chart-5 Monthly New Condominium Units Sold (Tokyo Metropolitan Area)



Source: Real Estate Economic Institute

Chart-6 Secondary Transactions of Condominiums



Source: REINS

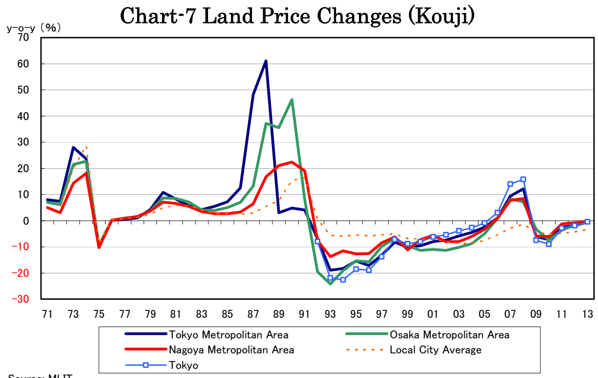
2. Land Prices

In “Kouji Chika” as of January 1, the national average land price declined by 1.8% y-o-y, with residential 1.6% and commercial 2.1% (Chart-7). However, the pace of the decline shrank for the third consecutive year, and the proportion of appreciating and unchanged monitoring points increased to 8.1% and 17.7% respectively from 2.1% and 7.3% in the previous year. The proportion of declining monitoring points decreased to 74.2% from 90.6% last year and 95% two years ago (Chart-8).

Land prices in the three metropolitan areas shrank at milder paces and appear to be bottoming out since Nagoya residential land prices did not decline, especially in Kariya and Ajiro city, in which residential land prices appreciated by more than 3% y-o-y. The pace of land price decline improved most in disaster hit areas. In particular, residential land prices in Miyagi Prefecture posted an appreciation +1.4% y-o-y, which was the best out of all prefectures.

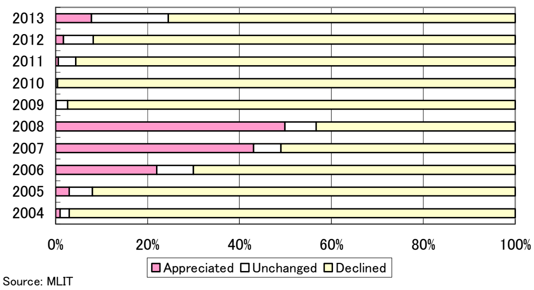
According to Nomura Real Estate Urban Net, the average residential land price in the Tokyo metropolitan area remained unchanged in the first quarter, recovering from -0.8% q-o-q in the fourth quarter. Tokyo 23 wards, Suburban Tokyo and Kanagawa Prefecture posted y-o-y appreciations of 0.8%, 0.5% and 0.1% in the first quarter, improving from 0.0%, -0.7% and -0.8% in the fourth quarter, respectively. Saitama Prefecture and Chiba Prefecture continued to decline by 0.7% and 0.8%, respectively. However, the pace of the decline of Saitama Prefecture shrank significantly from 1.9% in the previous year (Chart-9). Commercial land prices in the Tokyo metropolitan area remained stable, unchanged q-o-q and +0.4% y-o-y (Chart-10).

Chart-7 Land Price Changes (Kouji)



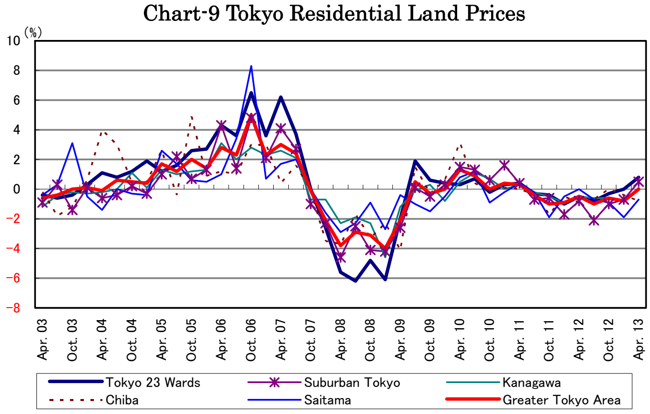
Source: MLIT

Chart-8 Proportion of Land Price Monitoring Points



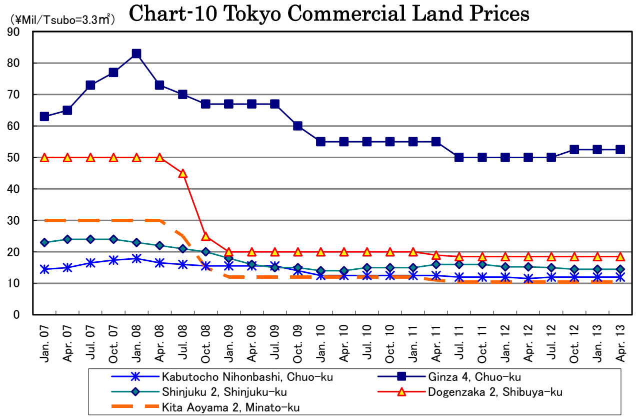
Source: MLIT

Chart-9 Tokyo Residential Land Prices



Source: Nomura Real Estate Urban Net

Chart-10 Tokyo Commercial Land Prices



Source: Nomura Real Estate Urban Net

3. Sub-sectors

1) Office

The Tokyo office market has improved considerably, though it had fallen behind other cities such as Osaka and Nagoya. Office vacancy rates in the Tokyo three wards improved to 7.1%, recovering to the level before suffering from an excessive supply in 2012 (Chart-11).

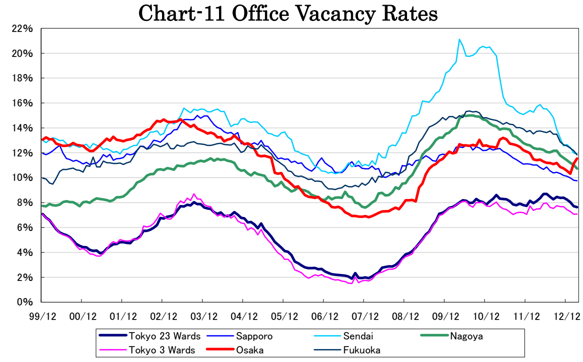
As seen in the rent index, a contract-based office rent index developed by Sanko Estate and NLI Research Institute, the rents of Tokyo grade-A[1] offices, which consists of top buildings, rose significantly by 15.8% q-o-q and 27.2% y-o-y to JPY 27,760 (Chart-12). Other categories also posted y-o-y positives; the average in the Tokyo three wards by 4% y-o-y, very large buildings by 10.4%, large buildings by 5% and middle and smaller buildings by 2.1%, which recovered to the level before the earthquake in 2011 (Chart-13, 14).

Though the net office supply increased noticeably in the Tokyo five wards in 2012, strong net demand managed to overcome the net supply (Chart-15). The net demand continued growing to 79k tsubos, surpassing 78k tsubos of net supply in the first quarter. The net supply in the first quarter was equivalent to 42% of the annual net supply in 2012 (Chart-15). The new building demand expanded to 188k tsubos in the first quarter, already larger than the annual new building demand in 2012 (Chart-16).

[1] Higher-spec buildings within the very large sized category by Sanko Estate Grade-A-Office Guidelines, urban area Tokyo five wards, main office areas and other specially integrated areas, with total floor areas of more than 33,000 m^2, main floor sizes of more than 990 m^2, building age of 15 years or less (including some well-refurbished older buildings), facilities with ceiling heights of 2.7m or more, individual air-conditioning, earthquake resistance, environmental friendliness.

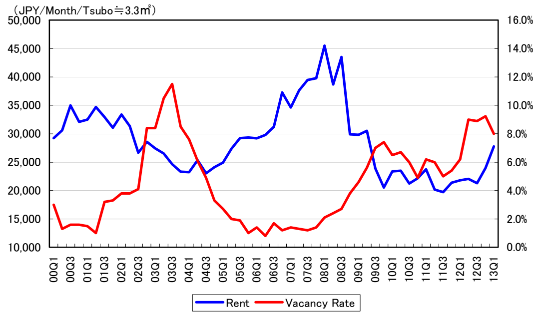
Mori Building forecasts the Tokyo office market will improve further, considering that most of the new office buildings in Tokyo scheduled in 2013, which is only 33% of that in 2012, have already been completed (Chart-17). It is possible that the market polarization that had progressed until last year could somewhat ease off, as lower grade buildings also recover.

Chart-11 Office Vacancy Rates



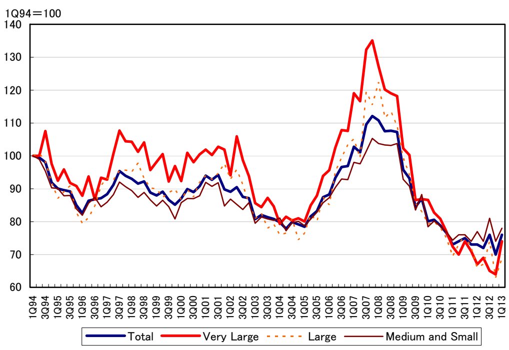
Source: Sanko Estate

Chart-12 Tokyo Grade-A Office Market



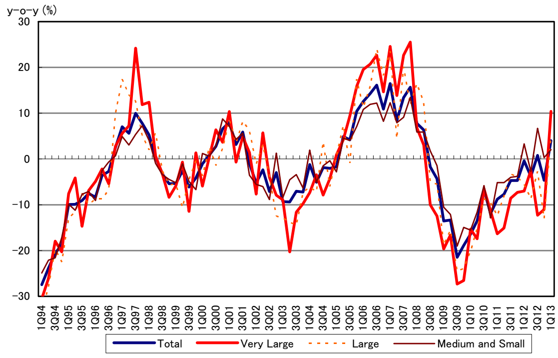
Source: Vacancy Rate･Sanko Estate, Rent･Sanko Estate and NLI Research Institute

Chart-13 Office Rent Index by Building Size (Tokyo Three Wards)



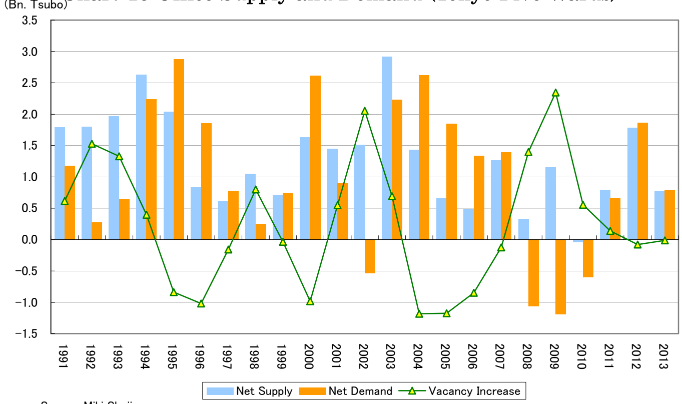
Very Large (Standard floor>200 tsubos), Large (100< and <200), Medium and Small (<100)
Source: Sanko Estate and NLI Research Institute

Chart-14 Office Rent Y-o-Y Changes by Building Size (Tokyo Three Wards)



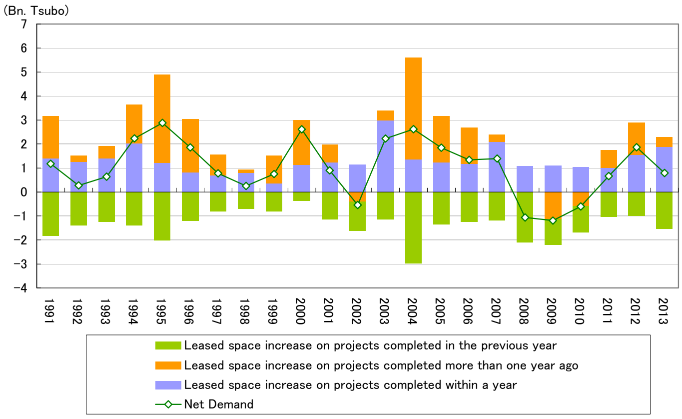
Very Large (Standard floor>200 tsubos), Large (100< and <200), Medium and Small (<100)
Source: Sanko Estate and NLI Research Institute

Chart-15 Office Supply and Demand (Tokyo Five Wards)



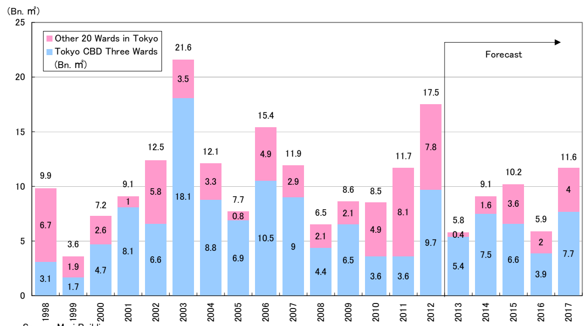
Source: Miki Shoji

Chart-16 Office Net Demand Break Down (Tokyo Five Wards)



Source: Miki Shoji

Chart-17 Office Supply Projection (Tokyo 23 Wards)



Source: Mori Building

2) Residential Rental

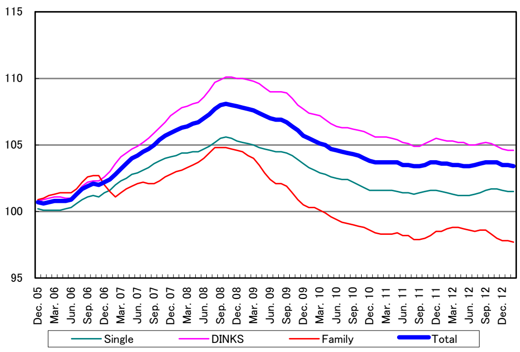
The Tokyo residential rents declined in the first quarter after showing some stability last year. In particular, DINKS[2] and family-categories fell markedly by 0.7% and 1%, respectively (Chart-18).

The Tokyo luxury residential market, which targets foreigners and high-income workers, is struggling to recover, with the vacancy rates deteriorating for the second consecutive quarter and the rents falling again. However, the market could stabilize after a while, considering the

[2] Double Income No Kids

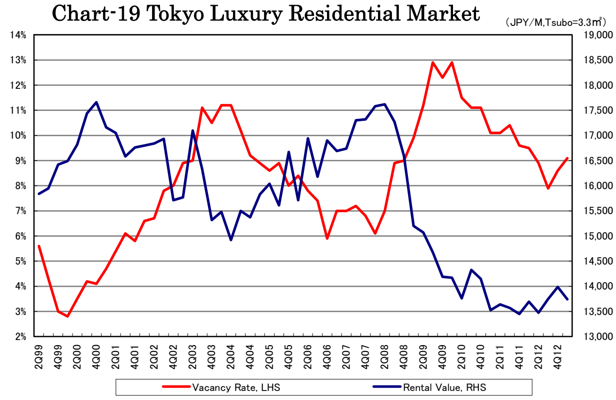
limited supply in the schedule. It seems Japanese demand lifted by the equity market rally makes up for declining foreigners' demand, which peaked in 2011.

Chart-18 Tokyo Residential Rent Index



Jan 2005＝100
Source: IPD・Recruit Residential Index

Chart-19 Tokyo Luxury Residential Market



*Sample consists of contracts with more than 300K JPY/M,Tsubo rental value or 30 Tsubo space.
Source: Ken Real Estate Advisors Ltd.

3) Retail, Hotel and Logistics

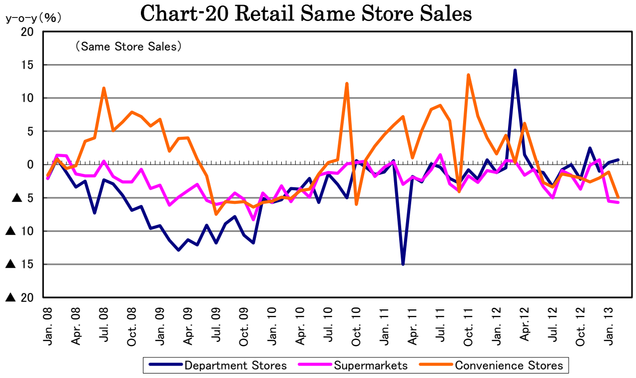
Retail sales weakened by 2.2% y-o-y in February, with the same store sales of supermarkets and convenience stores shrinking by 5.7% and 4.9%, respectively, which was the ninth consecutive month of decline (Chart-20). On the other hand, the same store sales of department stores posted a positive 0.7% growth pushed by the equity market rally in February even with the number of days one less than last year.

Several luxury hotel projects are planed in the Tokyo CBD, such as Aman Tokyo at Tokyo Prime Stage in Otemachi, Andaz Tokyo at Toranomon Hills and Hoshinoya Tokyo at DBJ reconstruction project in Otemachi. Hotel occupancy rates remain as high as those before the global financial crisis in 2008 (Chart-21). The Tokyo occupancy rates posted a positive y-o-y change in February for the first time in three months, following other major cities (Chart-22).

The number of foreign visitors increased by 33.1% y-o-y to 729.5k in February, following negative growth in January for the first time in eleven months (Chart-23). South Korea, Taiwan and Hong Kong posted significant y-o-y growth by 38.5%, 74.2% and 96.5%, respectively, though China declined by 2.1%.

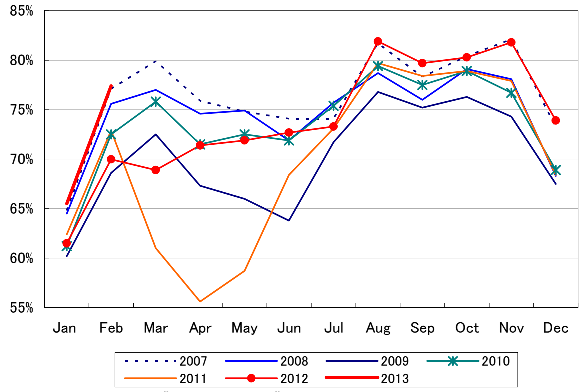
According to Ichigo Real Estate Service, the vacancy rates of large logistics facilities remained very low at 2.2% in the Tokyo metropolitan area and 1.5% in the Osaka metropolitan area (Chart-24). Property companies have a positive view of the market and plan to develop projects aggressively both in the Tokyo and Osaka metropolitan areas, while two J-REITs focusing on logistics facilities conducted IPOs recently.[3]

Chart-20 Retail Same Store Sales



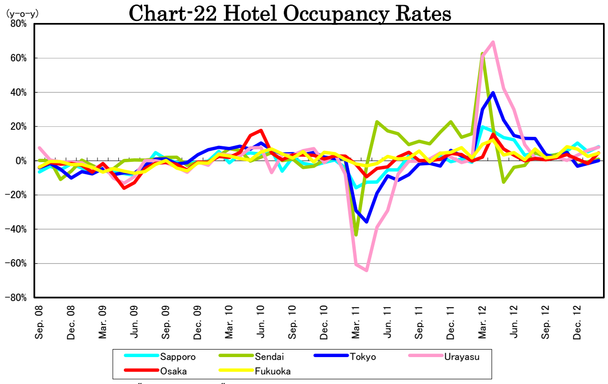
Source: Ministry of Economy, Trade and Industry

Chart-21 Hotel Occupancy Rates



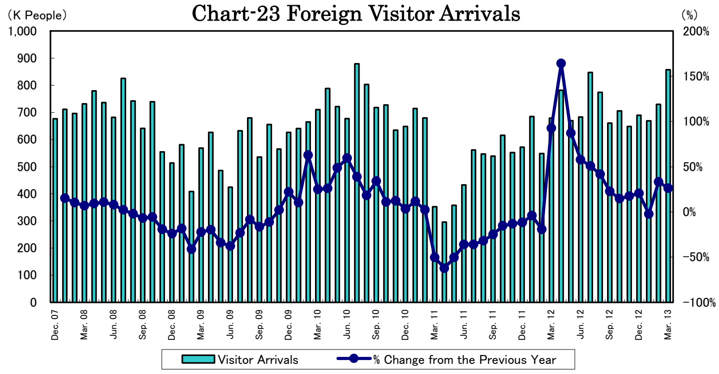
Source: Ohta Publications "Weekly HOTERES"

Chart-22 Hotel Occupancy Rates



Source: Ohta Publications "Weekly HOTERES"

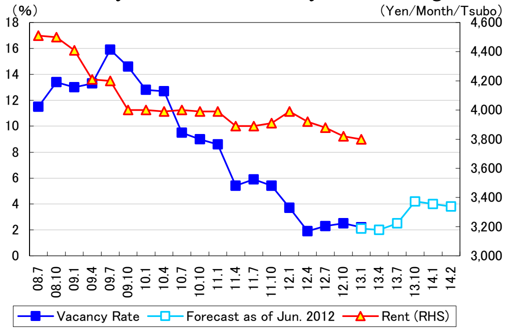
Chart-23 Foreign Visitor Arrivals



Source: Japan National Tourism Organization (JNTO)

[3] GLP J-REIT and Japan Prologis REIT went public on Dec 21, 2012 and Feb 14, 2013, respectively.

Chart-24 Logistics Facility Rents and Vacancy Rates (Large Sized Multi-Tenant-Use)



Source: Ichigo Real Estate Service Co. Ltd.

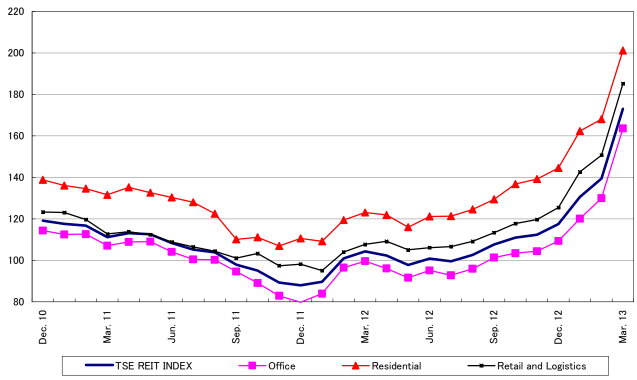
4. Property Investment and J-REIT Markets

The TSE REIT Index surged by 47.4% q-o-q recovering 1,600 points for the first time since February 2008, with the office sector by 49.6%, residential 39.2% and others including retail and logistics by 47.9% (Chart-25).

J-REITs acquired sizable assets totaling JPY 861 billion in the first quarter, which is already larger than the annual amount in 2012 (Chart-26). Two J-REITs conducted IPOs and existing J-REITs also aggressively acquired assets with fund raising through public offerings. BOJ announced allocation of another JPY 40 billon to the fund for purchasing J-REIT ETF totaling to JPY 170 billion. On the other hand, net operating incomes of office buildings, which account for more than half of the J-REIT portfolio, diminished by 5% y-o-y (Chart-27). The J-REIT P/NAV ratio expanded to 1.5 times and the dividend yield shrank to 3.2% with 2.7% yield gap on 10 year JGB.

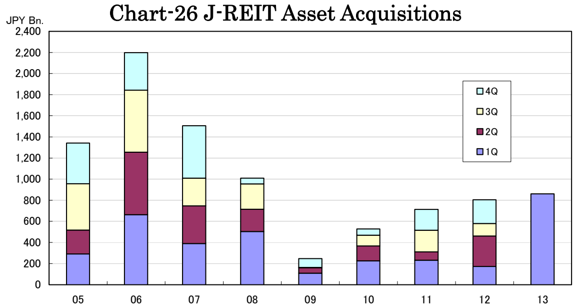
With the very favorable funding condition backed by Abenomics, J-REITs and other investors are aggressively transacting assets in any sector, not only in office but also in residential, retail and logistics facilities (Chart-28). Global manufacturers such as Panasonic and Sony became sellers of large sized office buildings to streamline their balance sheets. The property investment market appears to be improving further on the back of the Japanese yen depreciation, the equity market rally and the Tokyo office rent recovery.

Chart-25 TSE REIT Index



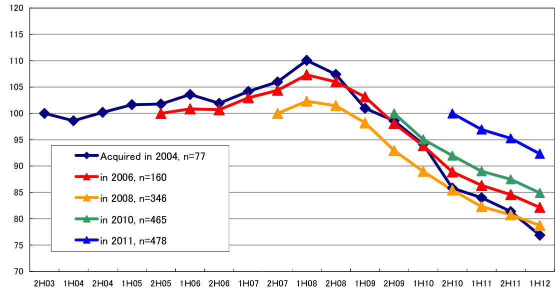
Source: Tokyo Stock Exchange

Chart-26 J-REIT Asset Acquisitions



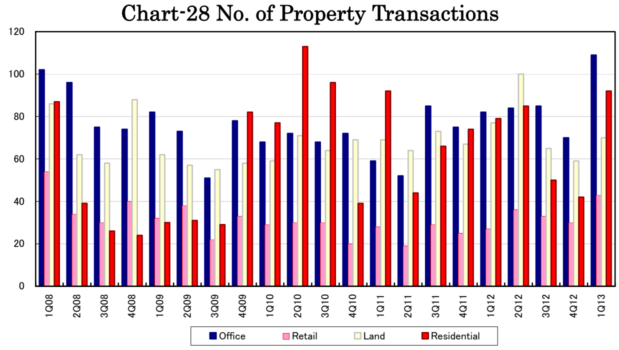
*New REIT assets are included on IPO
Source: NLI Research Institute

Chart-27 Office Net Operating Income by Acquisition Timing



Source: NLI Research Institute

Chart-28 No. of Property Transactions



*"Residential"does not include strata title transactions.
Source: NLI Research Institute based on Nikkei Fudosan Market Infomation

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