Real Estate Analysis Report

Japanese Property Market Quarterly Review, Second Quarter 2013

~Steady Property Market with Economic Recovery~

This is the English translation of Kazumasa Takeuchi, "景気回復の本格化と不動産市況の着実な改善 － 不動産クォータリー・レビュー2013 年第２四半期" NLI Research Institute, *Real Estate Analysis Report*, July 29, 2013

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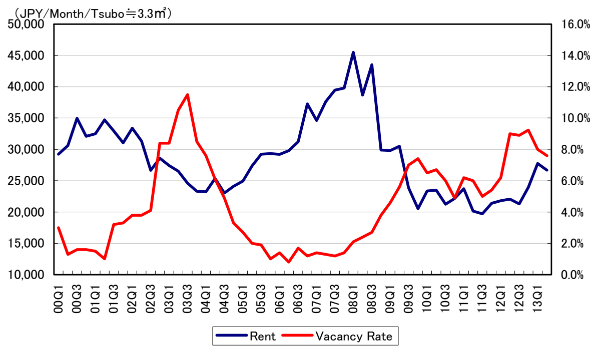
Summary

- Japan's GDP grew by 1% q-o-q equivalent to annual 4.1% in the first quarter of 2013. Both domestic and foreign economic factors are improving, although the equity and foreign exchange markets have run out of steam since May. Housing starts recovered the volume equivalent to annual one million units for the first time in four and a half years in May. New condominium sales are expected to remain steady for a while, supported by the economic recovery, rush demand before consumption tax raise, expectation of property price increase and interest rate rise.
- Tokyo grade-A office rents declined by 3.9% q-o-q in the second quarter following a 15.8% surge in the first quarter, while office rents of large sized category rose continuously. Tokyo office rents are forecasted to continue rising until the first quarter of 2014. Foreign visitor arrivals grew strongly by 31.9% y-o-y in May on the back of JPY depreciation and flight additions. Then, hotel occupancy rates remained as high as those before the global financial crisis in 2008. Luxury residential occupancy rates improved significantly.
- J-REITs acquired sizable assets totaling JPY 1.4 trillion in the first half, which is already 1.7 times as large as the total amount of last year. Foreign investors have become active again with the JPY depreciation and economic recovery. If Tokyo wins the 2020 Summer Olympic Games at the 125th IOC session in September, domestic consumption and investment could be more active in the medium term.

Tokyo Grade-A Office Market



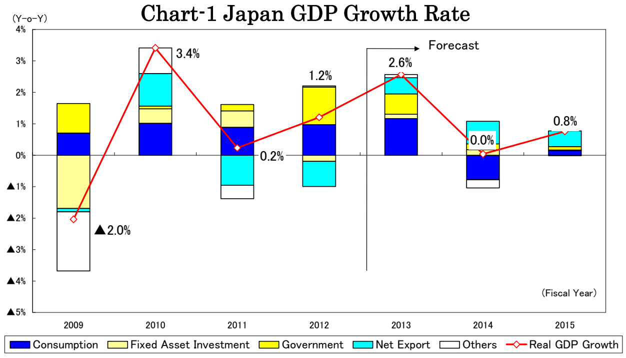
Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

1. Economy and Growth Strategy

The equity market rally and rapid JPY depreciation based on expectations of Abenomics have run out of steam since May. However, the first quarter Japan GDP growth rate was revised up to 1% q-o-q equivalent to annual 4.1% from a preliminary 3.5%, and the economic recovery looks steady with both domestic and foreign economic factors improving. The cabinet office announced that the Japanese economy is picking up steadily and shows some movements on the way to recovery. Then, NLI Research Institute revised its Japan GDP growth forecast up to 2.6% for 2013 (Chart-1). Japan GDP growth rates are expected to remain high in 2013 with JPY depreciation, aggressive government spending and rush demand before consumption tax raise.

The second Abe cabinet approved the national growth strategy "Japan is back" on June 16th. It aims at 3% nominal GDP growth rates in the coming decade through speedy policy implementation in an entirely new dimension. It also aims 1.5 million JPY increase of GNI per capita in ten years, while the latest GNI per capita was 3.84 million JPY in 2012.

Chart-1 Japan GDP Growth Rate

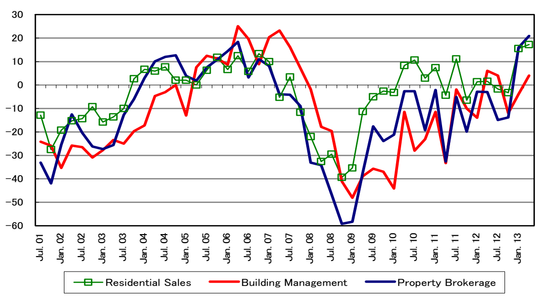


Source: Economic and Social Research Institute, Cabinet Office, Government of Japan "Quarterly Estimate of GDP"
NLI Research Institute "Weekly Economist Letter" June 11, 2013.

2. Property Business Confidence and Housing Market

Regarding the property business confidence index by The Land Institute of Japan, all three categories of business confidence viewing three months ahead posted positive numbers for the first time since January 2007, with 17.2 points on residential sales business, 20.9 points on property brokerage business and 4.0 points on building management business (Chart-2).

Chart-2 Property Business Confidence Index



*Brokerage (Commercial) data is semi-annual.
Source: The Land Institute of Japan "Property Business Confidence Survey"

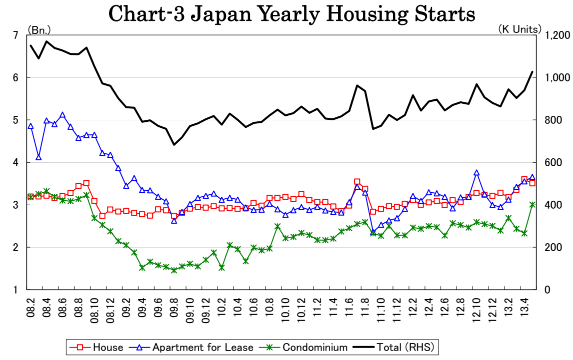
Housing starts recovered the volume equivalent to annual one million units for the first time in four and a half years in May (Chart-3). Especially condominium sales grew significantly by 33.1% y-o-y.

New condominium units sold in the Tokyo metropolitan area increased by 20.7% y-o-y to 13,948 in the second quarter (Chart-4). The inventory decreased for the eleventh consecutive month with high contract rate at 81.6 % in June.

The condominium transaction volume in the secondary market posted positive y-o-y growth for the tenth consecutive month. A total of 9,344 units were transacted in the second quarter, which was biggest second quarter number since 2001 (Chart-5).

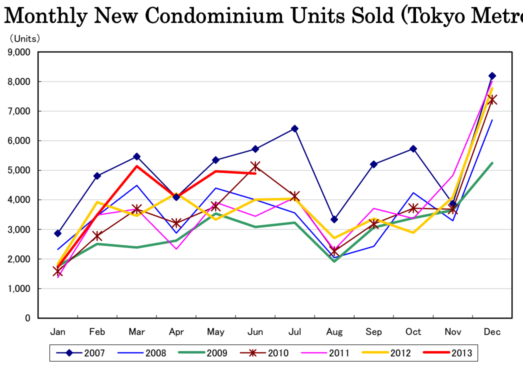
New condominium sales are expected to remain steady for a while, supported by the economic recovery, rush demand before consumption tax raise, expectation of property price increase and interest rate rise.

Chart-3 Japan Yearly Housing Starts



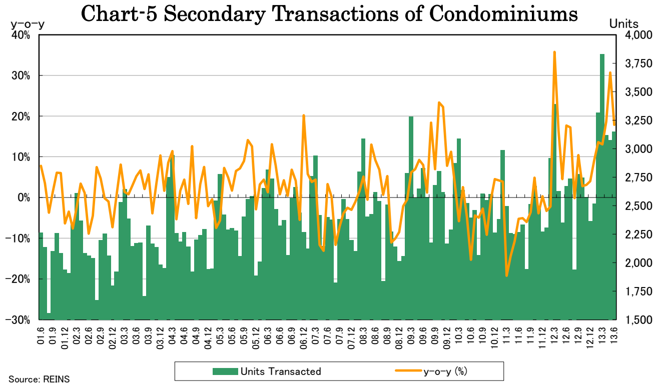
Source: MLIT

Chart-4 Monthly New Condominium Units Sold (Tokyo Metropolitan Area)



Source: Real Estate Economic Institute

Chart-5 Secondary Transactions of Condominiums

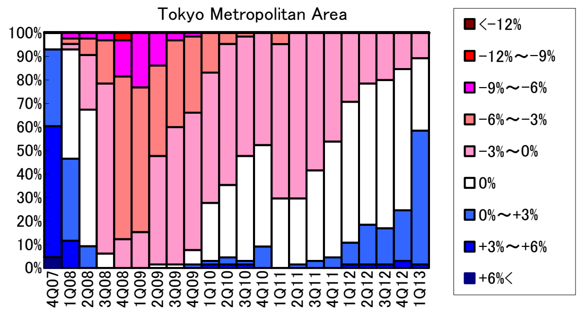


Source: REINS

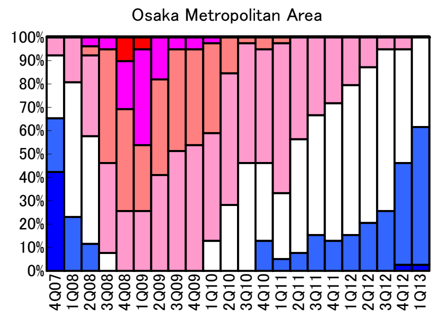
3. Land Prices

In “Chika Look Report” by MLIT, the proportion of land price appreciating points in Tokyo metropolitan area doubled to 58.5% in the first quarter from 24.6% in the fourth quarter (Chart-6). It is the first time in five years from the fourth quarter in 2007 before the Lehman Shock that more than half of the monitoring points posted appreciation. The proportion of land price appreciating points in Osaka was 61.5%, Nagoya 50%, others 34.4% in the first quarter, improving respectively from 46.2%, 50% and 31.3%. In addition, Osaka and Nagoya had no land price depreciating points in the first quarter. Checking by sectors, the proportion of land price appreciating points of residential land was 59.1% and that of commercial land was 50.9%, improving respectively from 45.5% and 29.2%.

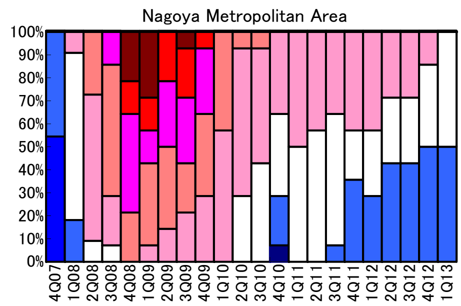
Chart-6 Proportions of Land Price Appreciation and Depreciation



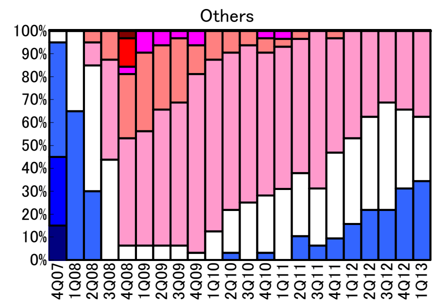
Source: MLIT "Chika Look Report"



Source: MLIT "Chika Look Report"



Source: MLIT "Chika Look Report"

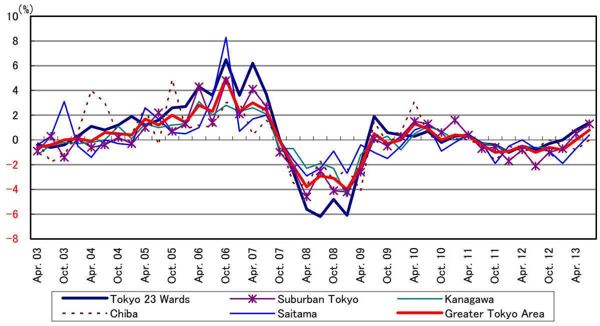


Source: MLIT "Chika Look Report"

According to Nomura Real Estate Urban Net, the average residential land price in the Tokyo metropolitan area rose by 0.8% q-o-q which was the first time in nine quarters. All areas posted q-o-q appreciation, with Tokyo 23 wards, Suburban Tokyo, Kanagawa Prefecture, Saitama Prefecture and Chiba Prefecture posting 1.4%, 1.3%, 0.8%, 0.4% and 0.0% in the second quarter, improving from 0.8%, 0.5%, 0.1%, -0.7% and -0.8% in the first quarter, respectively (Chart-7).

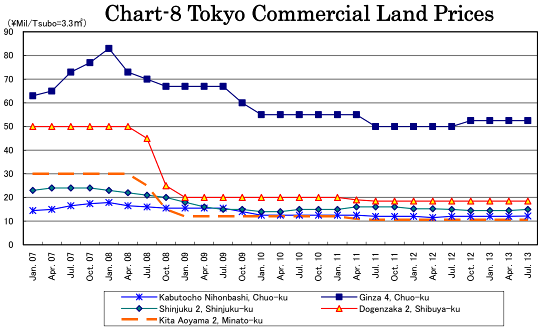
Commercial land prices in the Tokyo metropolitan area increased by 1.1% q-o-q and 1.3% y-o-y, accelerating from 0% q-o-q and 0.4% y-o-y (Chart-8).

Chart-7 Tokyo Metropolitan Area Residential Land Prices



Source: Nomura Real Estate Urban Net

Chart-8 Tokyo Commercial Land Prices



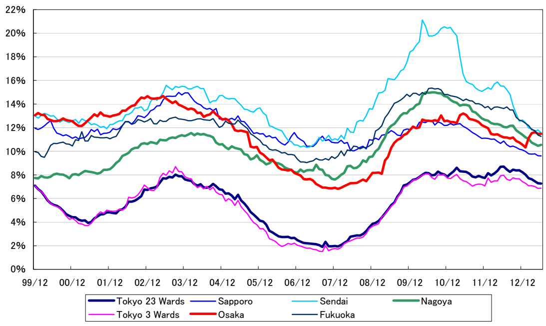
Source: Nomura Real Estate Urban Net

4. Sub-sectors

1) Office

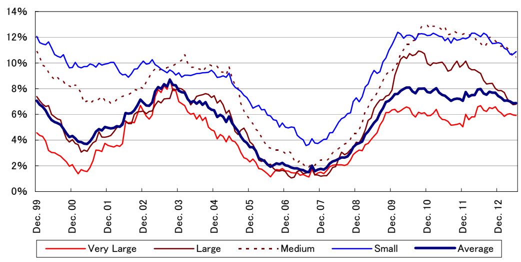
The Tokyo office market is improving, though not all categories are on a good pace. Office vacancy rates in the Tokyo three wards improved to 6.9%, improving by 1.1% from the recent peak of 8% in July 2007. In other areas, only the vacancy rates in Osaka deteriorated with new supply of a very large project, Grand Front Osaka, in the second quarter (Chart-9). By sizes, large sized category showed remarkable vacancy improvement (Chart-10).

Chart-9 Office Vacancy Rates



Source: Sanko Estate

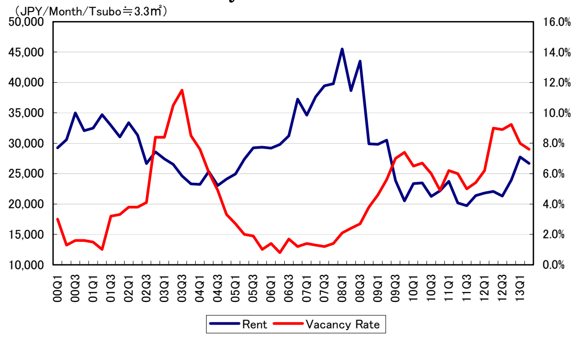
Chart-10 Office Vacancy Rates by Size



Source: Sanko Real Estate

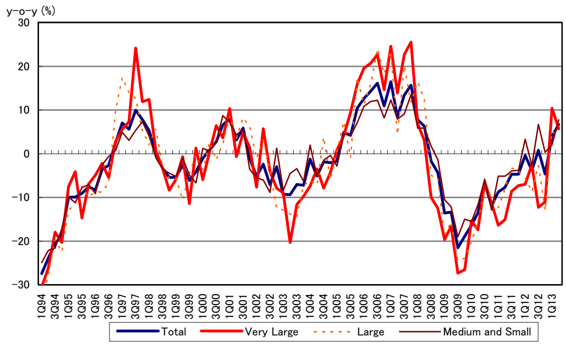
As seen in the rent index, a contract-based office rent index developed by Sanko Estate and NLI Research Institute, the rents of Tokyo grade-A[1] offices, which consists of top buildings, declined by 3.9% q-o-q, just following the 15.8% q-o-q surge in the first quarter (Chart-11). However all size categories posted positive y-o-y growth for the second consecutive quarter, with grade-A posting 21%, very large size 5.7%, large size 4% and medium to small size 7.7% (Chart-12).

Chart-11 Tokyo Grade-A Office Market



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

Chart-12 Office Rent Y-o-Y Changes by Building Size (Tokyo Three Wards)



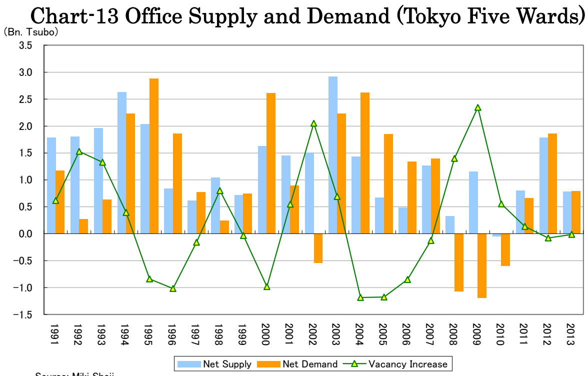
Very Large (Standard floor>200 tsubos), Large (100< and <200), Medium and Small (<100)
Source: Sanko Estate and NLI Research Institute

The office stock and occupied space increased by 57k and 67k tsubos in Tokyo five wards (Chart-13). Regarding the Tokyo five wards office stock increase, 60% of that was explained by Chiyoda ward, 29% by Chuo ward, 25% by Minato ward, -12.6% by Shinjuku ward and -1.5% by Shibuya ward. In particular, Minato ward increased occupied space significantly in the second quarter.

NLI Research Institute forecasts Tokyo grade-A office rents will continue to rise until the first quarter 2014. The Tokyo grade-A office rents can decline with sizable supply in 2016. However, a better picture could be possible depending on success of Abenomics strategy and the outcome of the bid for the Tokyo Olympic Games in 2020.

[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.

Chart-13 Office Supply and Demand (Tokyo Five Wards)



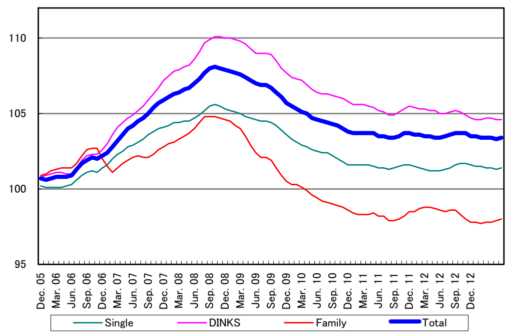
Source: Miki Shoji

2) Residential Rental

The Tokyo residential rents remained almost unchanged in the second quarter (Chart-14). Single and DINKS[2]-categories declined by 0.3% and 0.1% respectively over the past six months until May, and family-category rose slightly by 0.1%.

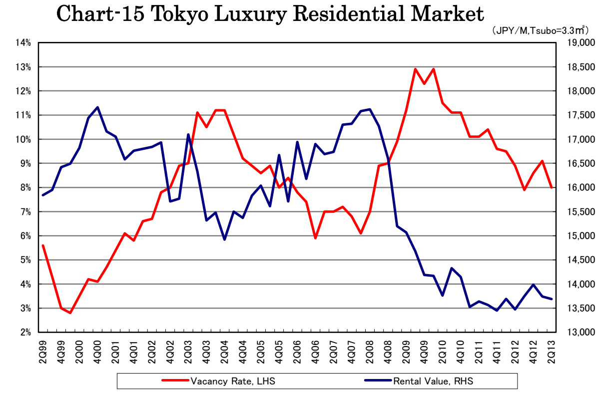
The Tokyo luxury residential vacancy rates improved significantly to 8% and the rents look no more on the downward trend at 13,690 JPY (Chart-15). Limited supply has contributed to the market balance since last year, and the recent JPY depreciation makes luxury units affordable to foreigners.

Chart-14 Tokyo Residential Rent Index



Jan 2005=100
Source: IPD・Recruit Residential Index

Chart-15 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.

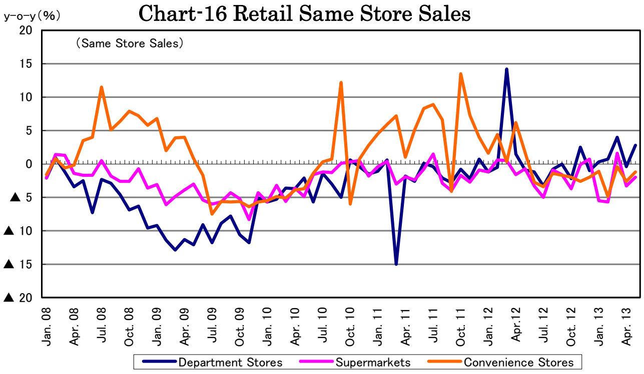
[2] Double Income No Kids

3) Retail, Hotel and Logistics

Retail sales grew by 0.8% y-o-y in May for the first time in five months. While the same store sales of department stores posted 2.8% y-o-y growth, those of supermarkets and convenience stores shrank by 2% and 1.2%, respectively (Chart-16). Although the same store sales of convenience stores posted negative y-o-y growth for the twelfth consecutive month, total convenience store sales grew by 4.2% with many stores opening.

In June, fine weather contributed to retail sales and the same store sales of all three categories posted positive growth. In addition, department store sales of foreign customers more than doubled owing to the recent JPY depreciation.

Chart-16 Retail Same Store Sales



Source: Ministry of Economy, Trade and Industry

Hotel occupancy rates remained as high as those before the global financial crisis in 2008 (Chart-17). The Tokyo occupancy rates posted 83.3% in May, Nagoya 85.5%, Osaka 73.7%, Sapporo 81.5% and Fukuoka 73.9%, improving by 1.5% y-o-y, 5.2%, 4.5%, 6.2% and 3.3%, respectively (Chart-18).

According to Japan Tourism Agency, total overnight visitors accommodated in Japan increased by 2.7% y-o-y to 101.4 million in the first quarter. In particular those of foreigners increased strongly by 15.6% y-o-y to 6.6 million.

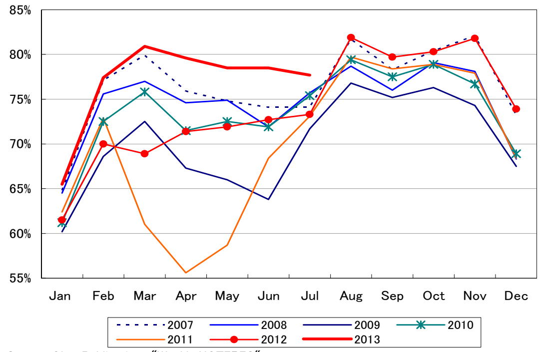
The foreign visitor number grew by 31.9% y-o-y to 901k in June. The number above 800k continued for the fourth consecutive month (Chart-19), contributed by the JPY depreciation, enhanced flight frequency and LCC line addition.

The half year number increased by 22.8% y-o-y to 4.95 million in 2013, which can reach annual 10 million for the first time. South Korea, Taiwan, U.S., Hong Kong and Thailand posted strong numbers 1.32 million, 1.03 million, 397 k, 336 k and 202 k, respectively, growing by 38.4% y-o-y, 49.4%, 9.9%, 43.1% and 52.7%, while only China posted 27% y-o-y decline to 536 k.

According to Ichigo Real Estate Service, the vacancy rates of large logistics facilities remained very low at 2.3% in the Tokyo metropolitan area and 1% in the Osaka metropolitan area (Chart-20).

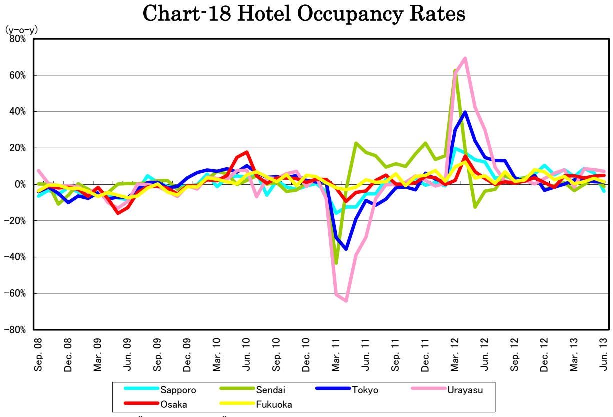
According to CBRE, eight large multi-tenant logistics facilities equivalent to 270 k tsubos of space will be supplied in the second half of 2013. However, it seems 60% of the space has already been pre-committed. The rents started recovering by 2.1% q-o-q reflecting the healthy occupancy rates.

Chart-17 Hotel Occupancy Rates



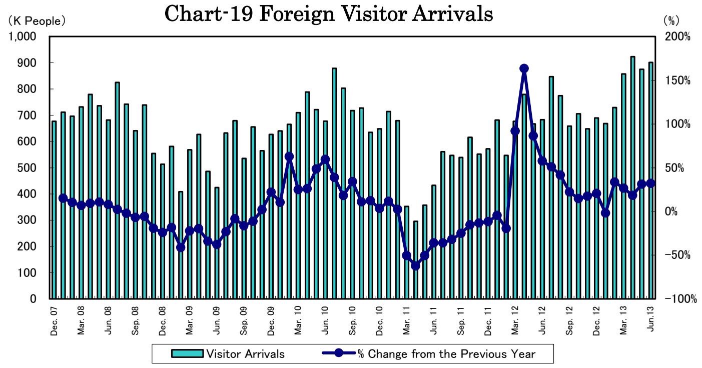
Source: Ohta Publications "Weekly HOTERES"

Chart-18 Hotel Occupancy Rates



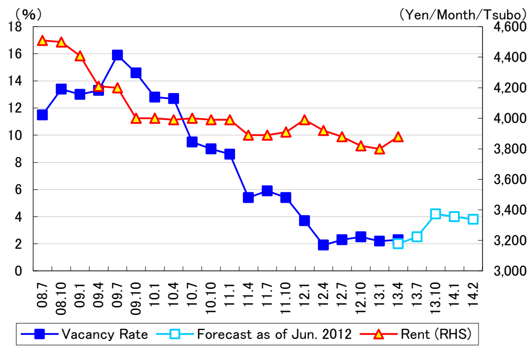
Source: Ohta Publications "Weekly HOTERES"

Chart-19 Foreign Visitor Arrivals



Source: Japan National Tourism Organization (JNTO)

Chart-20 Logistics Facility Rents and Vacancy Rates (Large Sized Multi-Tenant-Use)



Source: Ichigo Real Estate Service Co. Ltd.

5. Property Investment and J-REIT Markets

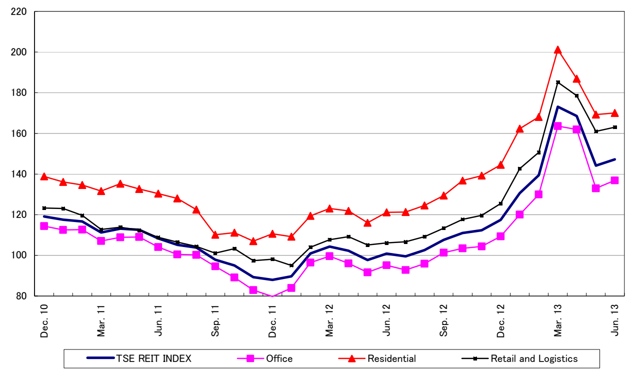
The TSE REIT Index plunged by 15% q-o-q in the second quarter reversing the 50% surge in the first quarter, with rising interest rates and Nomura Master Fund IPO which was one of the largest fund raisings ever. The office sector plunged by 16.3%, residential 15.5% and others including retail and logistics by 11.9% (Chart-21).

The market size of J-REIT grew strongly by acquiring sizable assets totaling JPY 1.4 trillion in the first half, which is already 1.7 times as large as the total amount of last year (Chart-22). Four IPOs and twenty POs have been conducted raising 750 billion JPY from the equity market in 2013. On the contrary, J-REIT dividends remain stagnated compared with other industrial sectors (Chart-23). The current J-REIT market shows 6.5 trillion JPY of market value, 1.3 times of Price to NAV and 3.8% dividend yield with 0.8% JGB yield at the end of June 2013.

According to Urban Research Institute Corporation, total property transactions reached 2.36 trillion JPY in the first half of 2013, which was largest since 2005. Transactions have been active in all sectors (Chart-24). Transactions by foreign investors have been increasing again backed by the JPY depreciation and economic recovery.

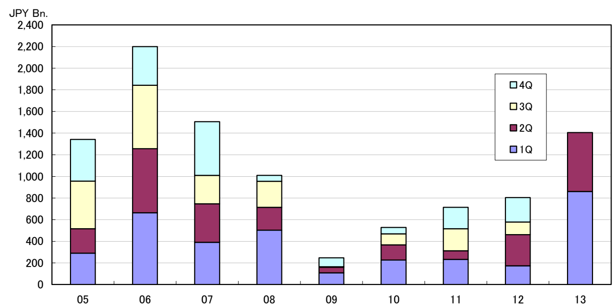
If Tokyo wins the 2020 Summer Olympic Games at the 125th IOC session in September, significant economic effects could be expected in the medium term, such as related domestic consumption increase and construction of the athlete village and other facilities accommodating foreign visitors.

Chart-21 TSE REIT Index



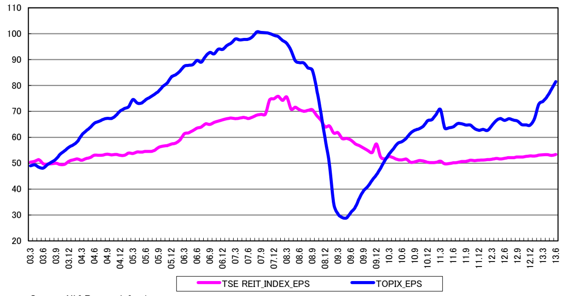
Source: Tokyo Stock Exchange

Chart-22 J-REIT Asset Acquisitions



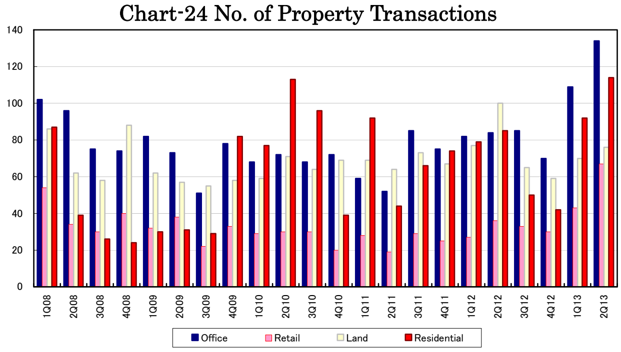
*New REIT assets are included at IPO
Source: NLI Research Institute

Chart-23 EPS of J-REIT and TOPIX



Source: NLI Research Institute

Chart-24 No. of Property Transactions



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

* This report includes data from various sources and NLI Research Institute does not guarantee the accuracy and reliability. In addition, this report is intended only for providing information, and the opinions and forecasts are not intended to make or break any contracts.