NLI Research Institute November 8, 2013

Real Estate Analysis Report

Japanese Property Market Quarterly Review, Third Quarter 2013

~Rent Recoveries in All Sectors Follow Investment Optimism~

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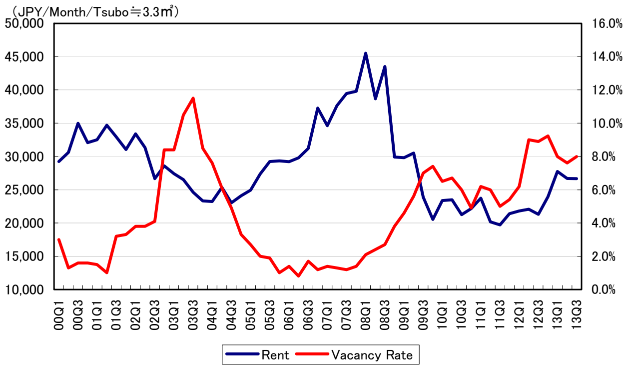
Summary

- The economic sentiment has continued to improve even amidst global uncertainties. Although household income has not yet increased, private consumption is driving the economic recovery. The numbers in the housing market have shown excellent positive y-o-y growth. Land prices in the major metropolitan areas posted positive y-o-y growth for the first time since 2008.
- The Tokyo office market has come to a standstill after the significant improvement in the first quarter, which, however, seems to have not affected the rent recovery trend.
- The Tokyo residential rents seem to have entered a recovery phase following the rising condominium prices. Parts of the retail sector have shown a recovery. The hotel sector has been performing well and the logistics sector has been facing a tight supply-demand balance.
- The TSE REIT Index performed strongly following the announcement of winning the bid to the 2020 Tokyo Olympic Games, turning out a +8.1% q-o-q return.
- The optimistic sentiment has already dominated the investment market followed by rent recovery in all rental markets. It seems investors have to acquire assets at higher prices before the transaction volume increases further.

Tokyo Grade-A Office Market



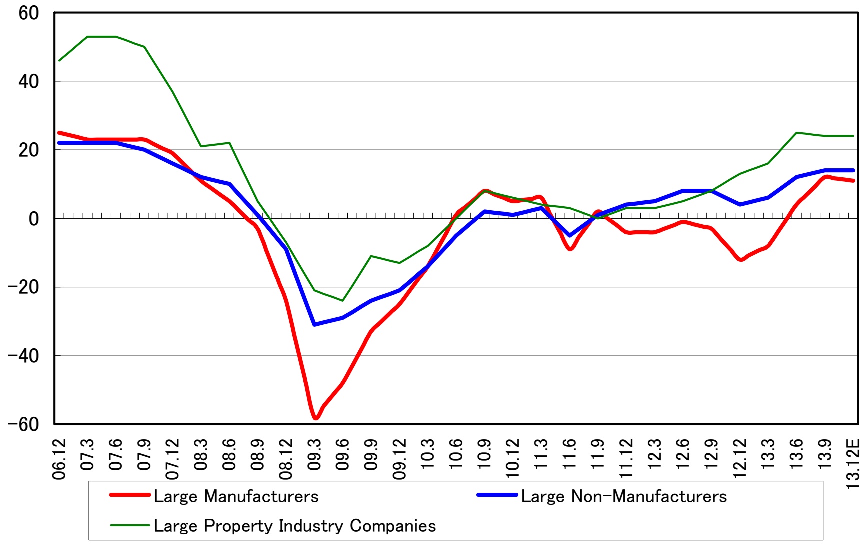
Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

1. Economy and Housing Market

The domestic economic sentiment has continued to improve even amidst global uncertainties supported by the overwhelming victory of the ruling party in the Upper House election in July and the long-awaited announcement in September of winning the bid to the 2020 Tokyo Olympic Games. Unemployment rates shrank below 4% for the first time since October 2008, with 3.9% and 3.8%[1] in June and July, respectively. Although household income has not yet increased, private consumption is driving the economic recovery.

In the BOJ Tankan Survey third quarter 2013, the current business confidence D.I. of large manufacturers improved for the third consecutive quarter by eight points to 12, which is the highest for five and a half years. Moreover, the D.I. of large non-manufacturers also improved by two points to 14, and that of large property industry companies remained at a very high 24 by declining only one point (Chart-1).

Chart-1 BOJ Tankan Survey



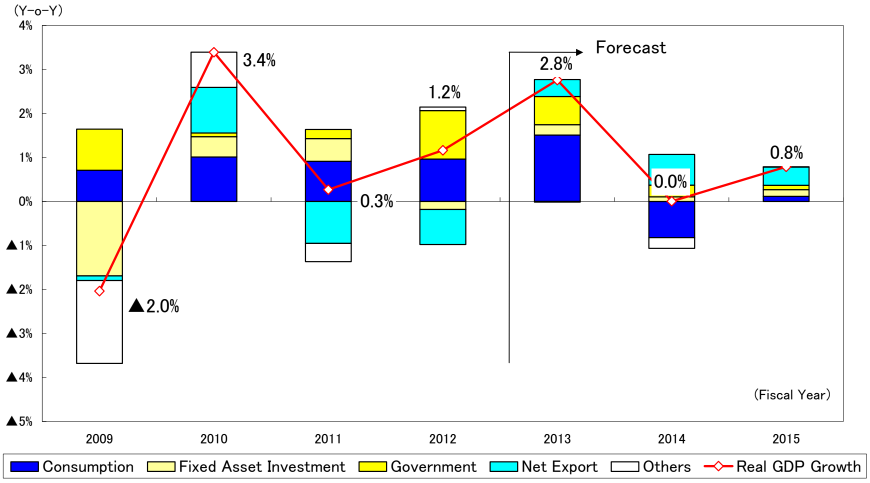
Source: BOJ "Tankan Survey"

Japan GDP growth rates are expected to maintain high numbers in 2013 with JPY depreciation, aggressive government spending and rush demand before the consumption tax hike. However, the numbers will slow in 2014, with shrinking demand as a reversal of the rush demand and smaller actual household income with approaching inflation.

NLI Research Institute revised its Japan GDP growth forecast up to 2.8% for 2013 and maintained those for 2014 at 0.0% and 2015 at 0.8%, following the cabinet office upward revision of the second quarter GDP growth (Chart-2).

[1] Latest numbers deteriorated slightly at 4.1% and 4% in August and September, respectively.

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" September 9, 2013.

The numbers in the housing market have shown excellent positive y-o-y growth.

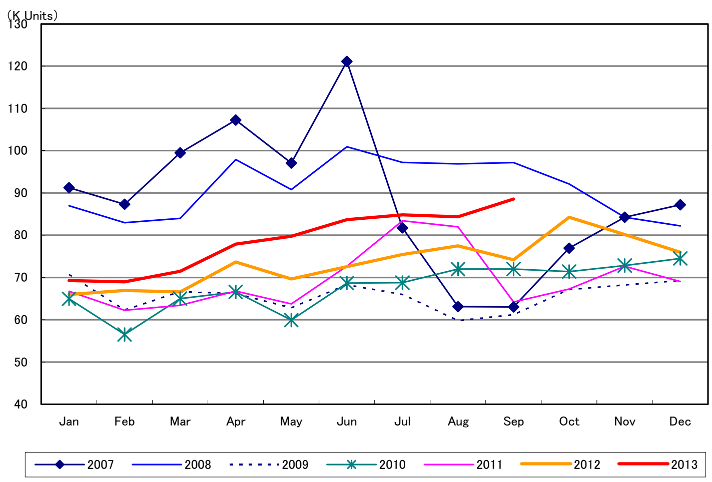
Housing starts posted positive y-o-y growth for the twelfth consecutive month by 19.4% to 88.5k units in September (Chart-3).

New condominium units sold in the Tokyo metropolitan area increased significantly by 77.3% y-o-y to 5,968 in September (Chart-4).

Transaction volume in the secondary condominium market increased by 16% y-o-y, posting positive growth for the twelfth consecutive month in August. The average price of the transactions grew by 3.5% y-o-y to 25.6 million JPY.

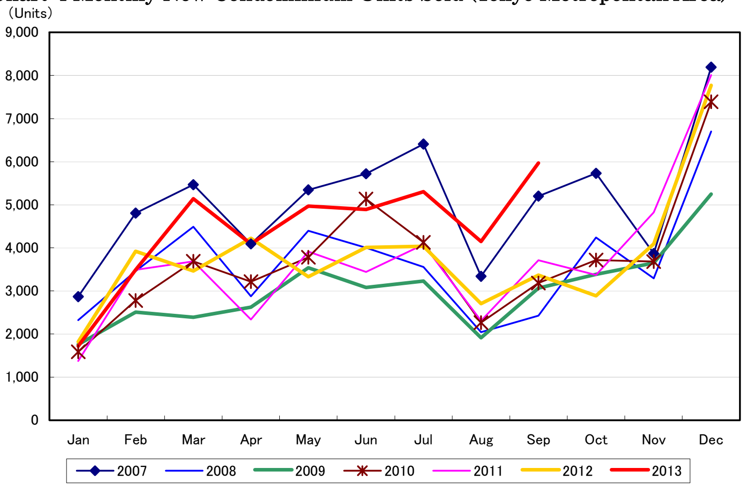
TSE Home Price Indices in the Tokyo metropolitan area have been on a recovering trend from the bottom in 2012 (Chart-5).

Chart-3 Japan Yearly Housing Starts



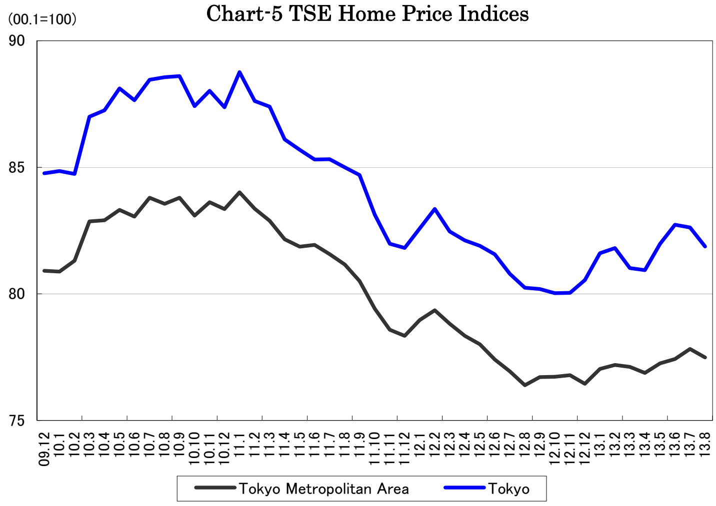
Source: MLIT

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



Source: Real Estate Economic Institute

Chart-5 TSE Home Price Indices



Source: Tokyo Stock Exchange "Home Price Indices"

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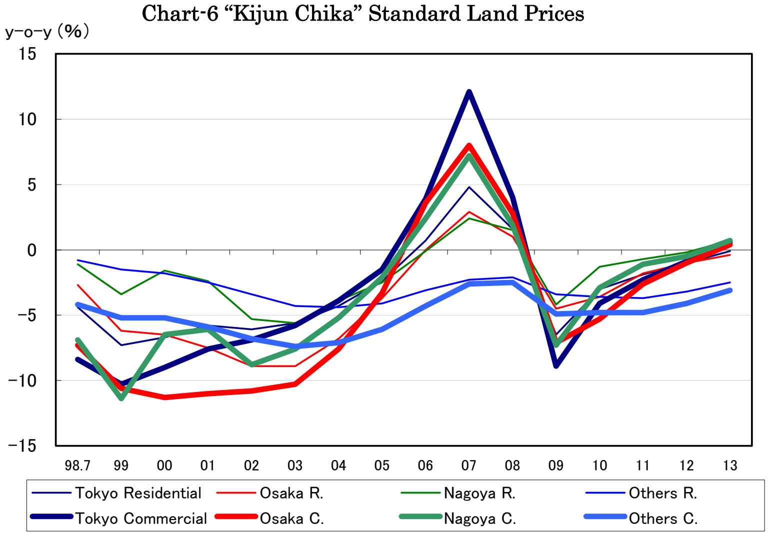
3. Land Prices

Regarding "Kijun Chika," the national standard land prices as of July 1, 2013, those in the three major metropolitan areas of Tokyo, Osaka and Nagoya, posted positive y-o-y growth for the first time since 2008, with positives in commercial areas offsetting negatives in residential areas (Chart-6). However, those in local areas continued to decline and the national average number dropped by 1.9% posting the 22nd consecutive negative y-o-y growth.

According to Nomura Real Estate Urban Net, the average residential land price in the Tokyo metropolitan area remained unchanged in the third quarter (Chart-7). Residential land prices in the Tokyo 23 wards, greater Tokyo and Kanagawa prefecture rose for the third consecutive quarter by 0.4%, 0.8% and 0.4% q-o-q, respectively, although those in Saitama and Chiba prefectures declined by 1.1% and 0.5%, respectively.

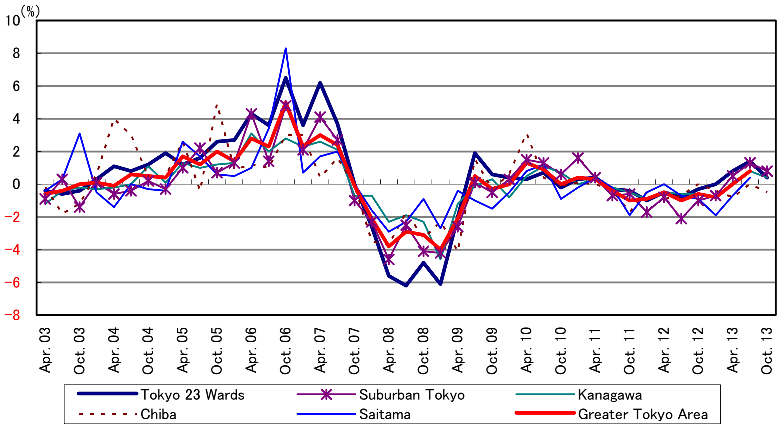
Commercial land prices in the Tokyo metropolitan area remained mostly unchanged in the third quarter (Chart-8).

Chart-6 "Kijun Chika" Standard Land Prices



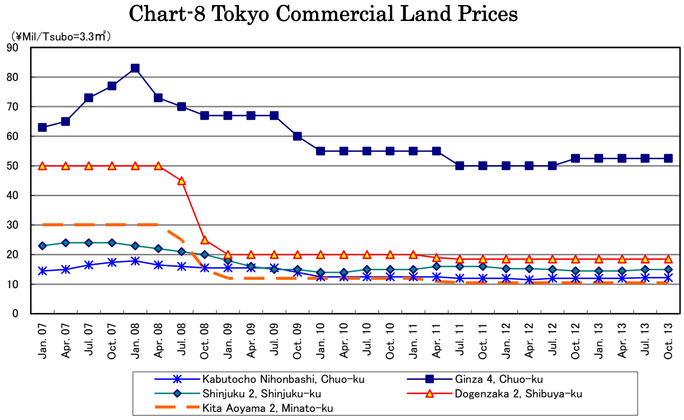
Source: MLIT

Chart-7 Tokyo Metropolitan Area Residential Land Prices



Source: Nomura Real Estate Urban Net

Chart-8 Tokyo Commercial Land Prices



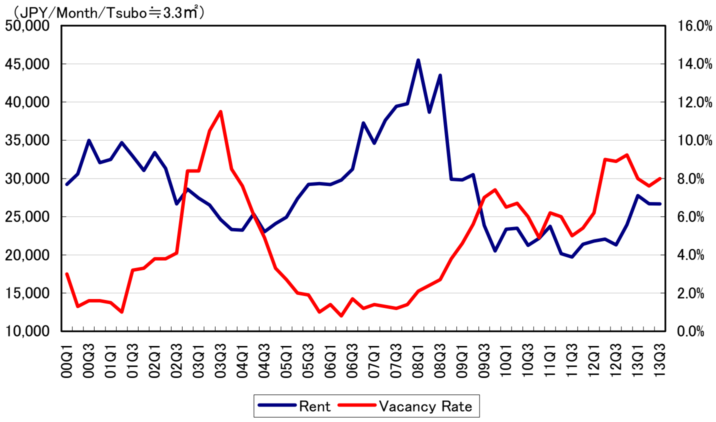
Source: Nomura Real Estate Urban Net

4. Sub-sectors

1) Office

The Tokyo office market has come to a standstill after the significant improvement in the first quarter. The vacancy rates of Tokyo grade-A[2] offices and very large sized offices in the Tokyo three wards deteriorated slightly by 0.4% and 0.2% q-o-q in the third quarter to 8% and 6.1%, respectively. Moreover, the office rents almost sidelined in the quarter, as seen in that the office rent index of Tokyo grade-A slid by 0.1% q-o-q and that of very large sized offices in the Tokyo three wards rose slightly by 1% q-o-q. In contrast to new buildings which have secured tenants successfully, older buildings which lost tenants against those new competitors seem to be struggling. It looks like that further demand growth is necessary before the vacancy rates show a visible improvement.

Chart-9 Tokyo Grade-A Office Market



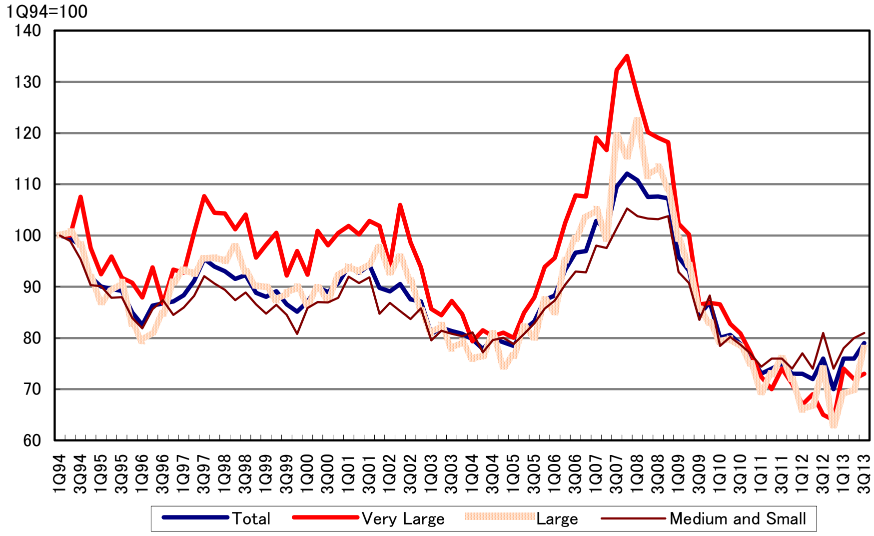
Source: Vacancy Rate･Sanko Estate, Rent･Sanko Estate and NLI Research Institute

Despite the slight rent decline of Tokyo grade-A offices, the office rent indexes for the Tokyo three wards rose in all size categories, very large, large, medium and small. Especially, the large sized offices posted a remarkable q-o-q gain of eight points (Chart-10).

NLI Research Institute forecasts the rents will continue to rise for the time being, based on the view the recent standstill has not affected the medium term recovery trend (Chart-11).

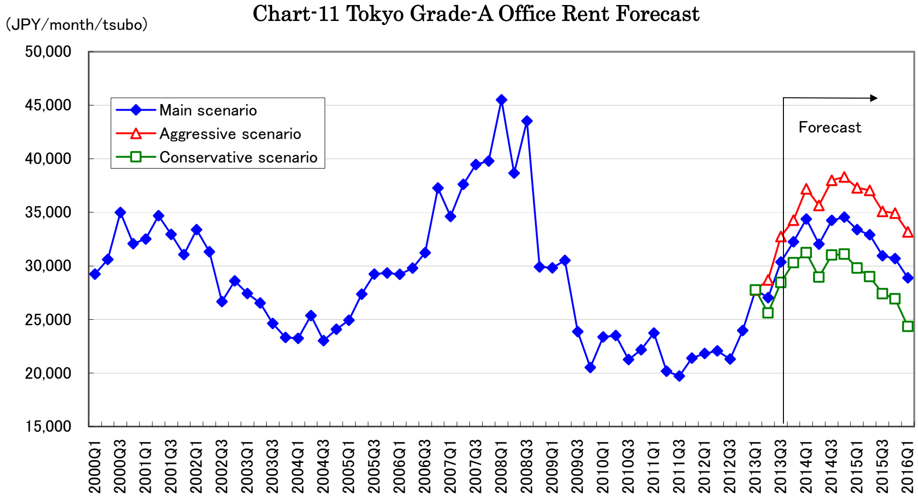
[2] Higher-spec buildings within the very large sized category by Sanko Estate Grade-A-Office Guidelines, urban area Tokyo five wards, main office areas and other specially integrated areas, with total floor areas of more than 33,000 m^2, main floor sizes of more than 990 m^2, building age of 15 years 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-10 Tokyo Three Ward Office Rent Indexes



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

Chart-11 Tokyo Grade-A Office Rent Forecast



Source: Sanko Estate, NLI Research Institute

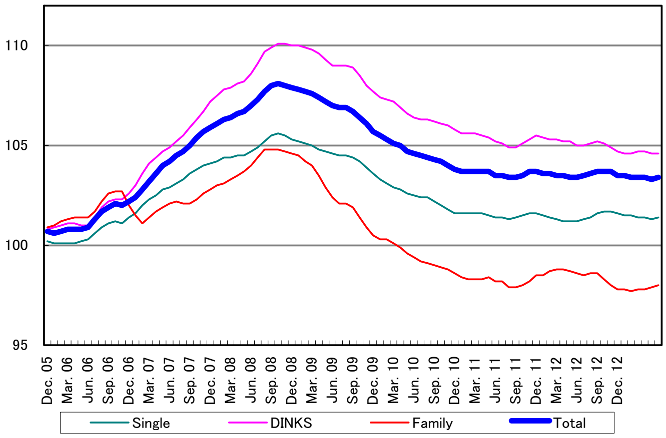
2) Residential Rental

The Tokyo residential rents seem to have entered a recovery phase following the rising condominium prices. The Tokyo residential rent-indexes in all type categories, single, DINKS[3] and family, have continued to rise since May (Chart-12). In the Tokyo five wards, the rents seem to rise gradually, excluding those correcting in Shinjuku ward where rents had risen significantly last year (Chart-13).

The vacancy rates of the Tokyo luxury residential market which had struggled with large supply provided until 2011 have been improving. Moreover, the rents rose for the first time in three quarters, which might suggest the recovery trend has been secured (Chart-14).

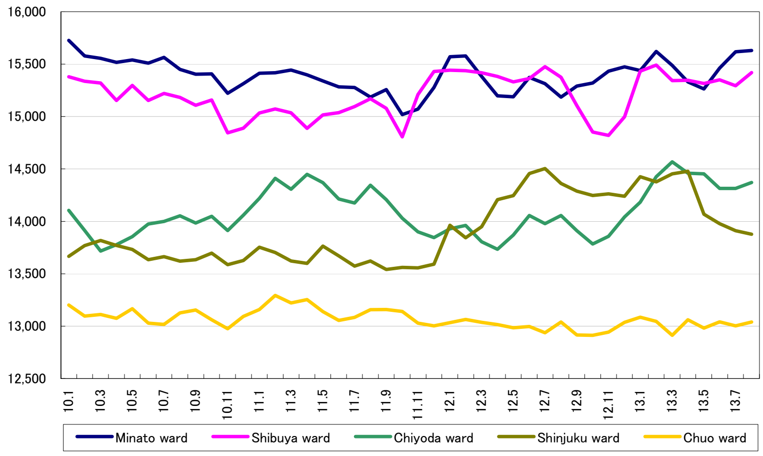
[3] Double Income No Kids

Chart-12 Tokyo Residential Rent Index



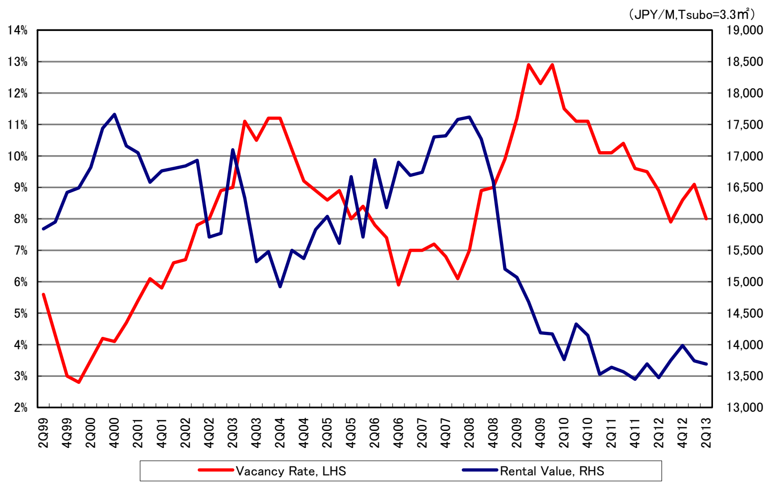
Jan 2005＝100
Source: IPD・Recruit Residential Index

Chart-13 Tokyo Residential Rents



Source: Leasing Management Consulting

Chart-14 Tokyo Luxury Residential Market



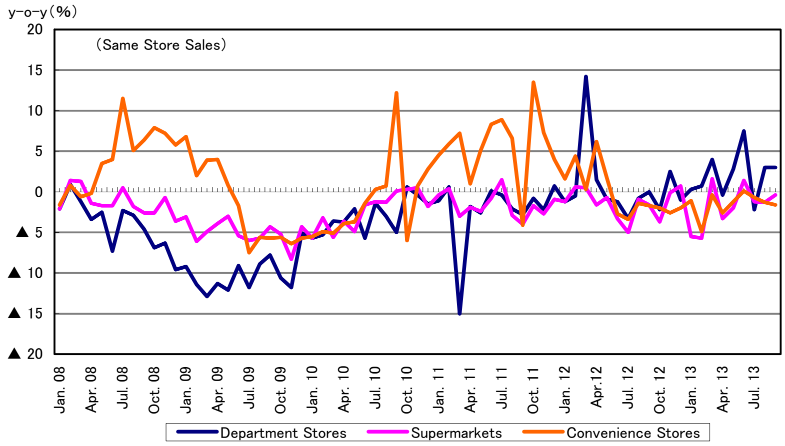
*Sample consists of contracts with more than 300K JPY/M,Tsubo rental value or 30 Tsubo space.
Source: Ken Real Estate Advisors Ltd.

3) Retail, Hotel and Logistics

Parts of the retail sector have shown a recovery. The same store sales of department stores posted 3% y-o-y growth in September (Chart-15). It seems luxury goods are selling well and driving a consumption recovery. Tokyo top retail rents on the representative high streets such as Ginza Chuo Street and Omote Sando Street are on the rise (Chart-16).

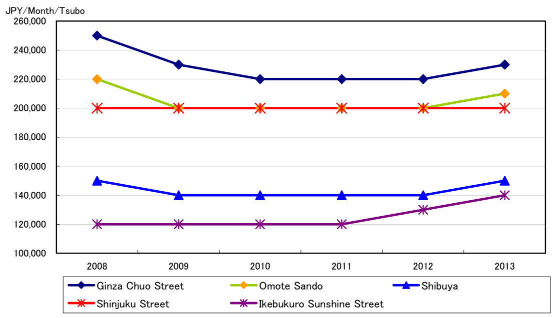
However, the same store sales of supermarkets and convenience stores slid by 0.4% and 1.6% y-o-y respectively in September (Chart-15). Especially convenience stores have been facing aggressive new store supply recently.

Chart-15 Retail Same Store Sales



Source: Ministry of Economy, Trade and Industry

Chart-16 Tokyo Highest Retail Rents (Ground Floor)



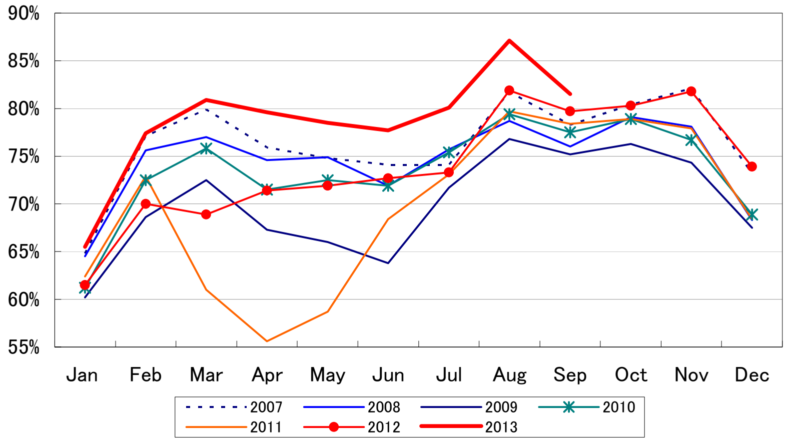
Source: CBRE "Office Japan"

The hotel sector has been performing well, with higher occupancy rates than those in recent years (Chart-17). Regarding the major cities, the occupancy rates in Tokyo posted 82.6% in September, Nagoya 86.4%, Osaka 85.9%, Sapporo 92.4% and Fukuoka 77.8%, improving by 0.7% y-o-y, 1.1%, 4.8%, -0.7% and -2.2%, respectively.

The foreign visitor arrival numbers have posted significant y-o-y growth in 2013, with a 31.7% y-o-y increase in September (Chart-18). The JPY depreciation, enhanced flight frequency and LCC route addition have pushed the inbound flow. In addition, the Japanese government simplified the VISA issuing process for visitors from Southeast Asia, which turned out a significant visitor increase from the region. Even those from China posted a 28.5% growth in September[4] following lackluster numbers since the dispute on Senkaku Islands intensified last September.

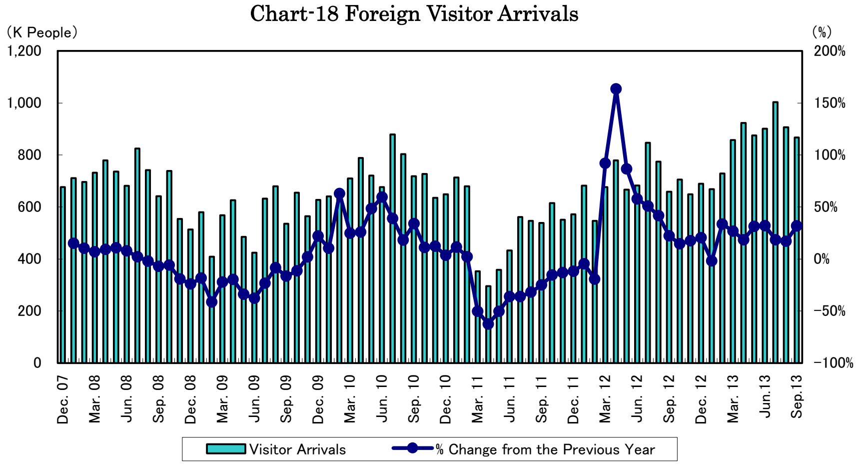
The medium term visibility of the sector is also positive with the government promoting the tourism industry to benefit from Asian consumption growth. Several world brands plan to open new hotels in Tokyo such as Tokyo Marriot Hotel in Shinagawa, Courtyard By Marriot in Kyobashi, Andarz Tokyo in Toranomon and Aman Tokyo in Otemachi. Though finding large development space has become more difficult, an increasing number of small and medium size hotels might be developed considering additional demand for the 2020 Tokyo Olympic Games.

Chart-17 Hotel Occupancy Rates



Source: Ohta Publications "Weekly HOTERES"

Chart-18 Foreign Visitor Arrivals



Source: Japan National Tourism Oganization (JNTO)

The logistics sector has been facing a tight supply-demand balance. The vacancy rates of large logistics facilities for multi-tenants in the Tokyo metropolitan area maintained a very low level at 4.3% in the third quarter, though worse than the 2.6% in the second quarter.

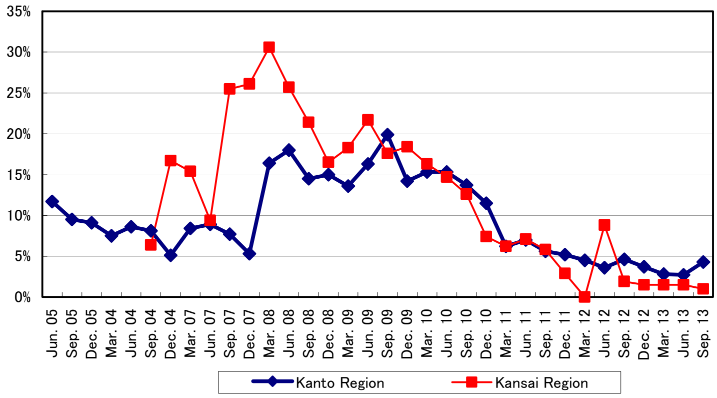
[4] The number exceeded not only that of 2012 but also 2011 and 2010 before the Great East Japan Earthquake.

That of the Osaka metropolitan area remained unchanged at 1% (Chart-19). Growing internet home shopping and 3PL services have created strong demand and the vacancy rates did not surge even with a large supply including very large Logiport Sagamihara[5].

The large supply seems to continue for the time being; however, it looks unlikely the vacancy rates will surge critically considering many facilities have already secured tenants in advance of completion.

Four development plans of large logistics facilities were announced in the third quarter.

Chart-19 Logistics Facility Rents and Vacancy Rates (Large Sized Multi-Tenant-Use)



*Large sized multi-tenant-use (GFA 33,000㎡ or more, 49 assets)
Source: CBRE

5. Property Investment and J-REIT Markets

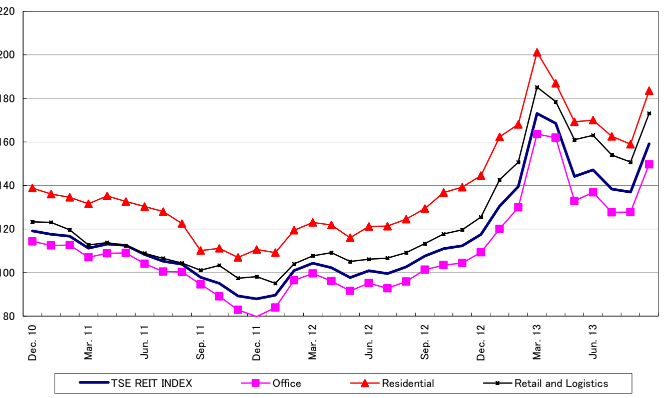
The TSE REIT Index plunged below 1,300 points at the end of August, however, rebounded strongly following the announcement of winning the bid to the 2020 Tokyo Olympic Games and turned out a +8.1% q-o-q return and a +35.5% y-t-d return. The office sector rose by 9.3%, residential 7.9% and others including retail and logistics by 6.1% (Chart-20).

J-REITs acquired 108 assets amounting to JPY 250 billion in the third quarter, totaling JPY 1.6 trillion in 2013 (Chart-21). With two IPOs and five POs having been announced since October, the total acquisition amount by J-REITs will reach JPY 2 trillion in 2013, which will be the fourth consecutive y-o-y growth. Moreover, the appraisal values of J-REIT assets have entered an upward revision cycle with shrinking CAP rates (Chart-22).

At the end of September, the J-REIT market value was JPY 7.1 trillion, the price to NAV ratio was 1.4 times and the dividend yield was 3.6% with a 2.9% yield gap on ten year JGB.

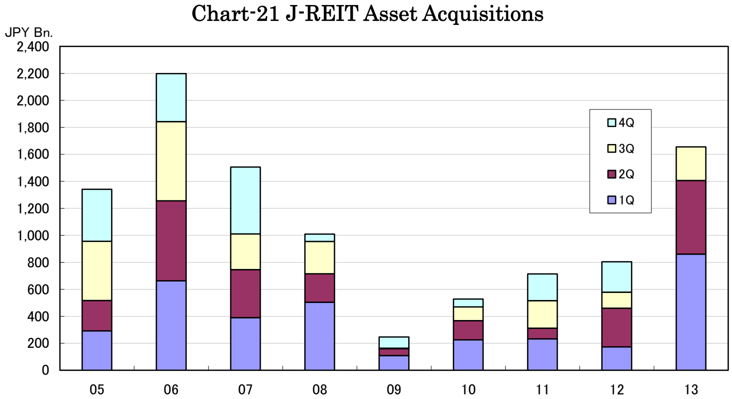
[5] One of the largest logistics facilities in Japan with GFA nearly 210,377m² for multi-tenants developed by Lasalle Investment and Mitsubishi Real Estate.

Chart-20 TSE REIT Index



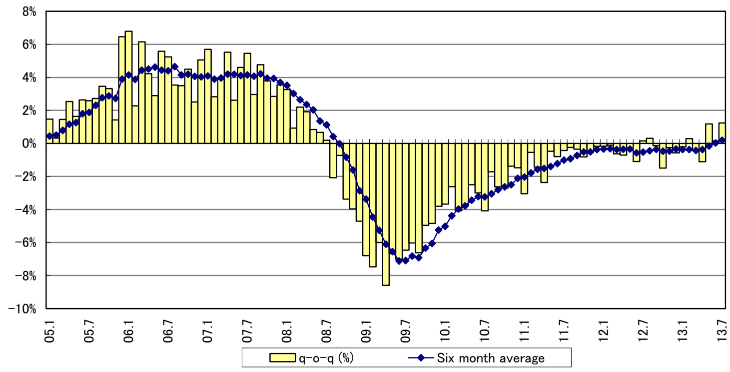
Source: Tokyo Stock Exchange

Chart-21 J-REIT Asset Acquisitions



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

Chart-22 J-REIT Asset Appraisal Value



Source: NLI Research Institute

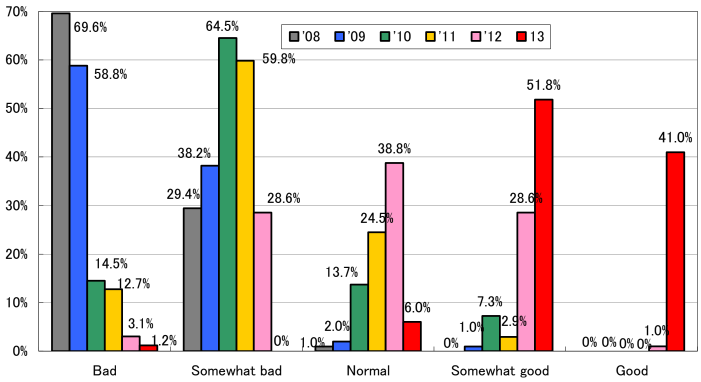
The transactions in the property investment market have been active. Although J-REIT IPOs decreased significantly q-o-q (Chart-21), other transactions have been increasing. Foreign investors have also been transacting actively, and more than a few Western investors have appeared as sellers.

The office sector accounts for nearly half of the transactions, however, other sectors such as residential, retail, logistics and hotel have been transacted actively as well.

The tenth annual *property market survey*[6] by NLI Research Institute resulted in a very optimistic current investment sentiment, with “Good” and “Somewhat good” responses accounting for more than 90% of the respondents (Chart-23). Moreover, market participants expect further improvement, with “Somewhat better” and “Better” responses predicting higher prices or more transactions accounting for 70% of the respondents in the six-month outlook (Chart-24).

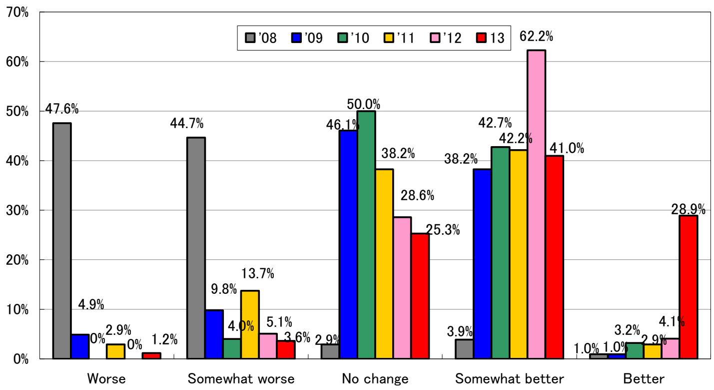
Thus, the optimistic sentiment has already dominated the investment market, and rental markets follow it with rents recovering in all sectors. It seems investors have to acquire assets at higher prices based on aggressive income assumption before the transaction volume increases further. However, more than a few factors such as some Western investors having appeared as sellers and J-REITs having become dominant acquiring players seem to be different compared with those during the “Mini Bubble Era” in 2006 and 2007.

Chart-23 Current Market Sentiment



Source: NLI Research Institute, *Propety Market Survey,* 2008～13

Chart-24 Six-Month Market Outlook



Source: NLI Research Institute, *Propety Market Survey,* 2008～13

[6] Mamoru Masumiya, “Dominant Optimistic Sentiment with Further Improving Outlook ～The Tenth Japanese Property Market Survey～” in Real Estate Analysis Report, NLI Research Institute, October 22, 2013.

