

# Real Estate Analysis Report

## Japanese Property Market Quarterly Review, Second Quarter 2014

~Leasing and Investment Activity Steady, but Labor Shortage Risk~

Real Estate Investment Research  
Financial Research Department

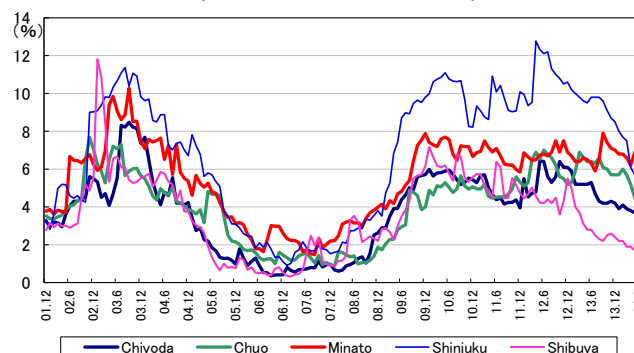
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### Summary

- The impact of April's consumption tax rate increase is greater than when it was last raised in 1997. However, consumer confidence is already stabilizing and economic growth is expected to be maintained. A labor shortage in the construction industry is severe and increasing costs are likely to push condominium prices upward.
- Housing starts for owner-occupied houses and condominiums declined significantly after the consumption tax rate hike. Nationwide residential vacancy rates reached 13.5% and are anticipated to increase on the back of the declining and aging population.
- Office vacancy rates have decreased in Tokyo due to active corporate relocations and expansions. With moderate supply, rents are expected to rise in the latter half of 2014. Tokyo grade-A office prices have risen by 10.7% y-o-y and 70.9% since the third quarter 2011.
- Residential rents are recovering, especially in Tokyo and Sendai. The number of foreign visitors increased by 26% y-o-y and sustained hotel occupancy rates at high levels.
- The J-REIT market rose steadily in the quarter driven by foreign investors. Market participants are paying more attention to the Government Pension Investment Fund beginning to invest in J-REITs and whether other pension funds will follow suit.

Tokyo Five Ward Office Vacancy Rates

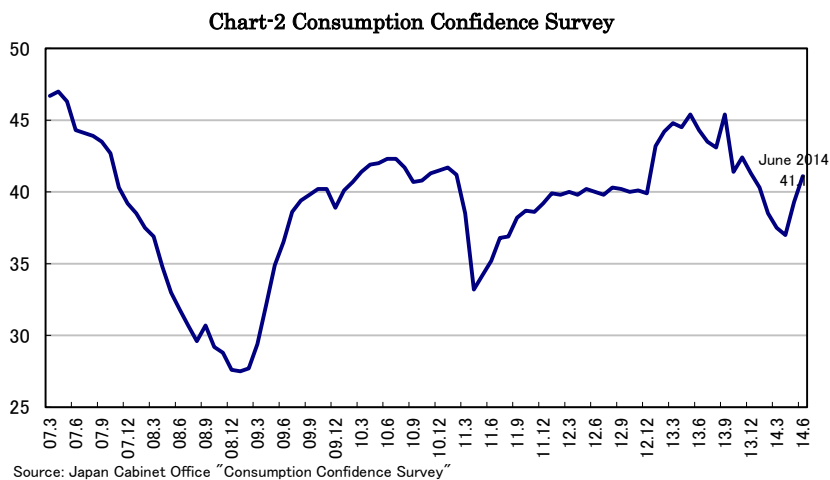
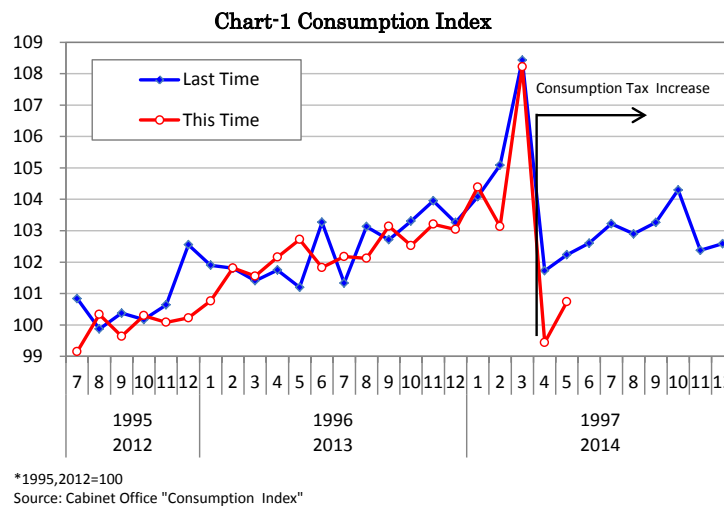


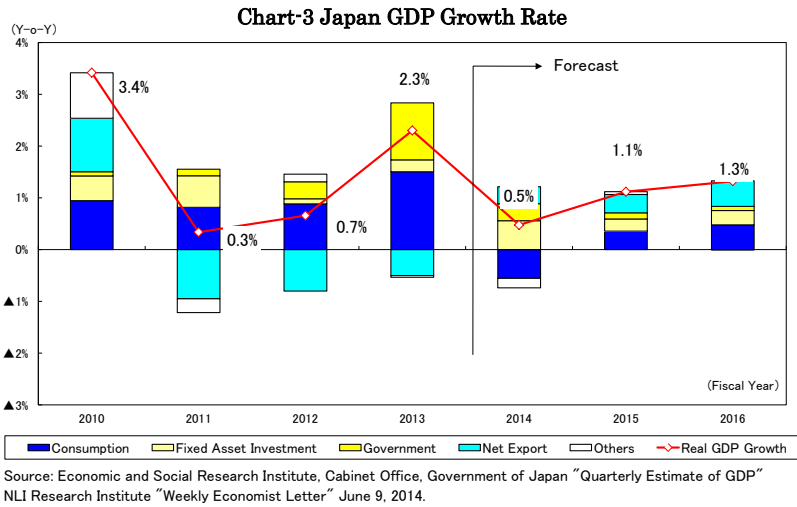
Source: Sanko Estate

## 1. Economy and Housing Market

Consumer spending dropped in the second quarter on the back of the reversal effect from the rush demand prior to the consumption tax rate increase on April 1. The impact of the consumption tax rate increase is greater than that of when the tax rate was last raised in 1997 (Chart-1). However, while consumption confidence has begun to stabilize (Chart-2) and employment rates have improved, the government revised up its economic outlook for the first time in six months in July. NLI Research Institute revised its GDP growth forecasts by -0.5% to -5.6% for the second quarter 2014, but by +0.2% to 2.4% for the third quarter, and expects positive growth will follow in 2014 and 2015 (Chart-3).

In 2014 the Shinzo Abe cabinet concluded a reviewed plan for Japan’s revival as well as an economic and fiscal reform policy, the so-called “honebuto policy.” The honebuto policy includes reform measures to combat the nation’s declining and aging population, and sets a population maintenance target of 100 million for 2050.

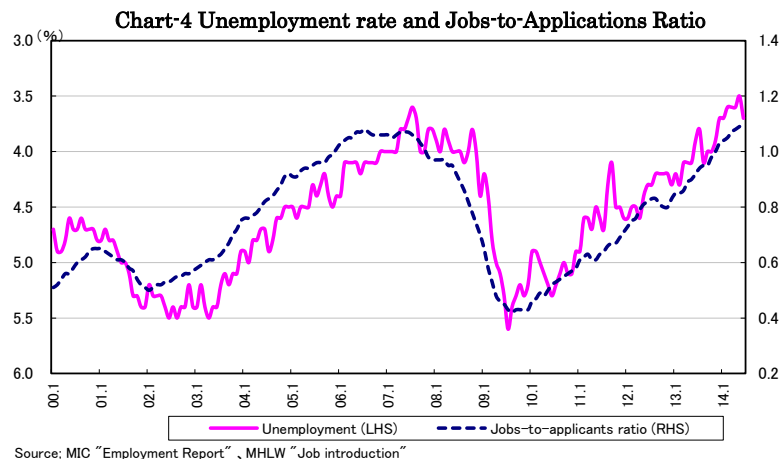




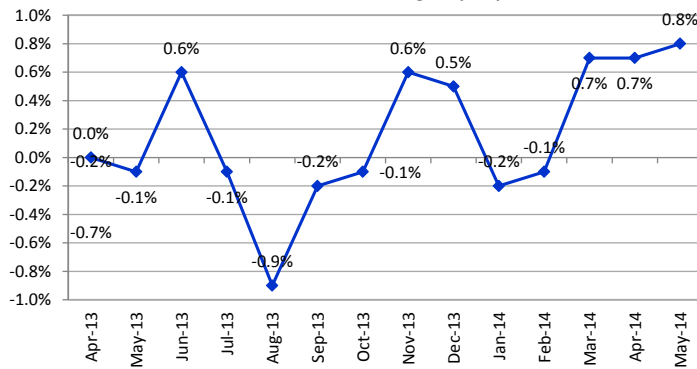
## 2. Labor Shortage and Construction Cost Increase

The unemployment rate and the jobs-to-applications ratio improved to 3.7% and 1.1x respectively, close to levels seen before the global financial crisis in 2008 (Chart-4). Wages are rising due to a labor shortage, as indicated in the monthly MHLW labor survey and cash incomes have made strong gains for the third consecutive month (Chart-5), especially part-time jobs increasing for the fifth consecutive month.

The construction sector is experiencing a severe and problematic labor shortage on the back of reconstruction demand after the East Japan earthquake and preparations for the 2020 Tokyo Olympic Games. The industry's labor shortage ratio remains extremely tight and construction costs are rising in tandem with increased wages. The construction cost index has accelerated sharply since January 2013 (Chart-6). Such cost increases are likely to push condominium prices upward.

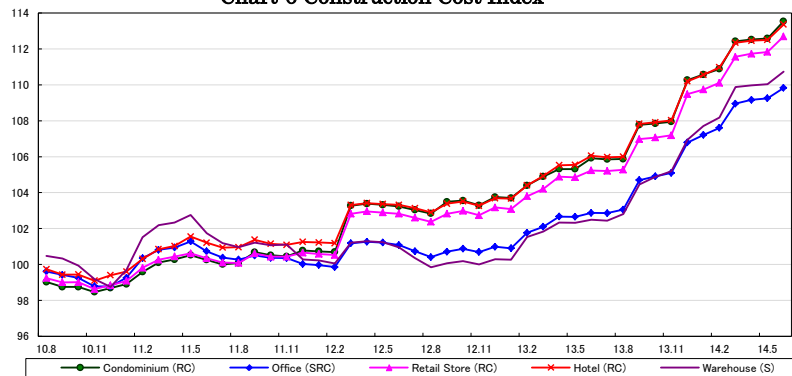


**Chart-5 Cash Income Changes (y-o-y)**



Source: MHLW "Monthly Labor Survey"

**Chart-6 Construction Cost Index**



Source: Construction Research Institute

### 3. Housing Market

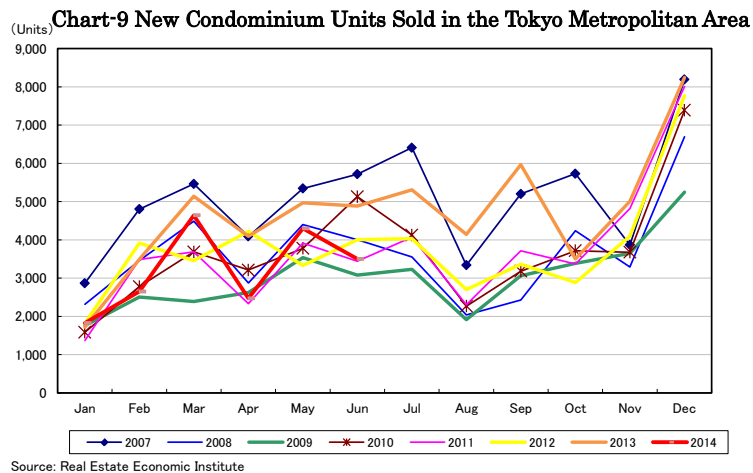
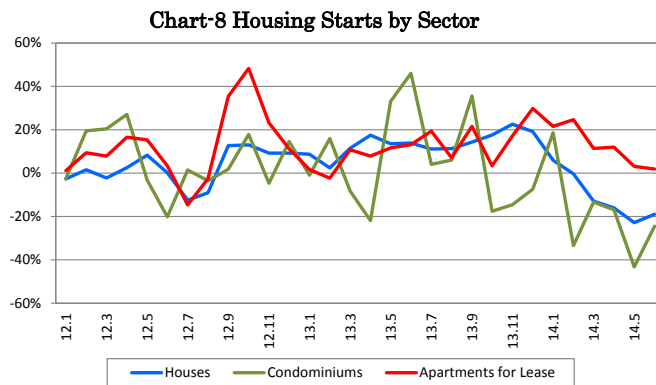
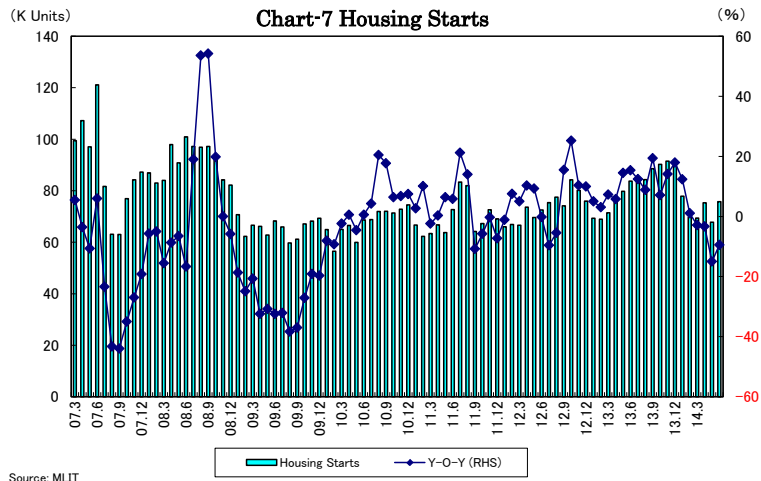
Housing starts have fallen by nearly 20% since peaking in November 2013 (Chart-7) and continue to shrink in a reversal of the rush demand prior to the consumption tax rate increase. While housing starts for owner-occupied houses and condominiums are declining, housing starts of apartments for lease have maintained positive growth for the 16th consecutive month (Chart-8).

New condominium sales also fell in the Tokyo metropolitan area. While a 52.6% y-o-y increase in sales was recorded in the third quarter 2013 on the back of the rush demand prior to the consumption tax rate hike, it turned negative in January 2014 and declined by 26.3% y-o-y in the second quarter (Chart-9).

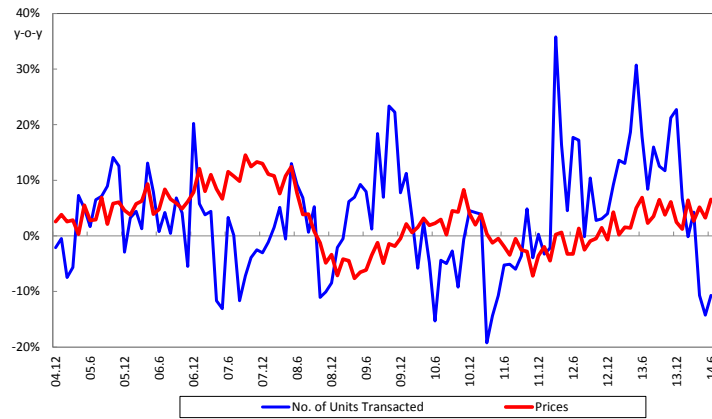
The transaction volume of the secondary condominium market in the Tokyo metropolitan area shrank by 10.7% y-o-y in June, marking the third consecutive month of decline in a reversal of strong growth before March. Meanwhile, prices have continued to grow for 18 months (Chart-10) and inventories have declined for 17 months. However, according to Tokyo Kantei, condominium prices in the secondary market began to drop in April.

Nationwide residential vacancy rates were announced by the Statistics Bureau of Japan for the first time in five years. Total and vacant residential stock in Japan reached 60.6 and 8.2 million units respectively, with the average vacancy rate rising by 0.4% to 13.5%

(Chart-11). Though vacant stock recorded a historic high, the pace of increase mitigated to 8.3% y-o-y due to slower housing starts after the global financial crisis, which was the first time a less than 10% increase has been recorded since 1963. Vacancy rates improved in some cities such as Tokyo, Chiba, Sendai and Fukuoka. However, given Japan's declining and aging population, vacancy rates are anticipated to increase in the future.

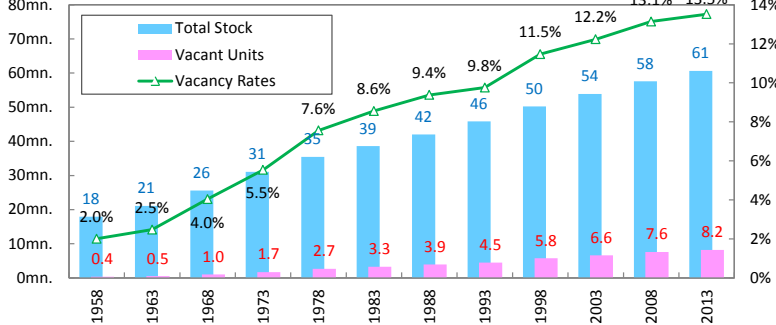


**Chart-10 Secondary Condominium Transaction Volume and Prices in the Tokyo Metropolitan Area**



Source: REINS

**Chart-11 Housing Stock and Vacancy Rates**



Source: Statistic Bureau of Japan "Housing and Land Survey 2013"

**4. Land Prices**

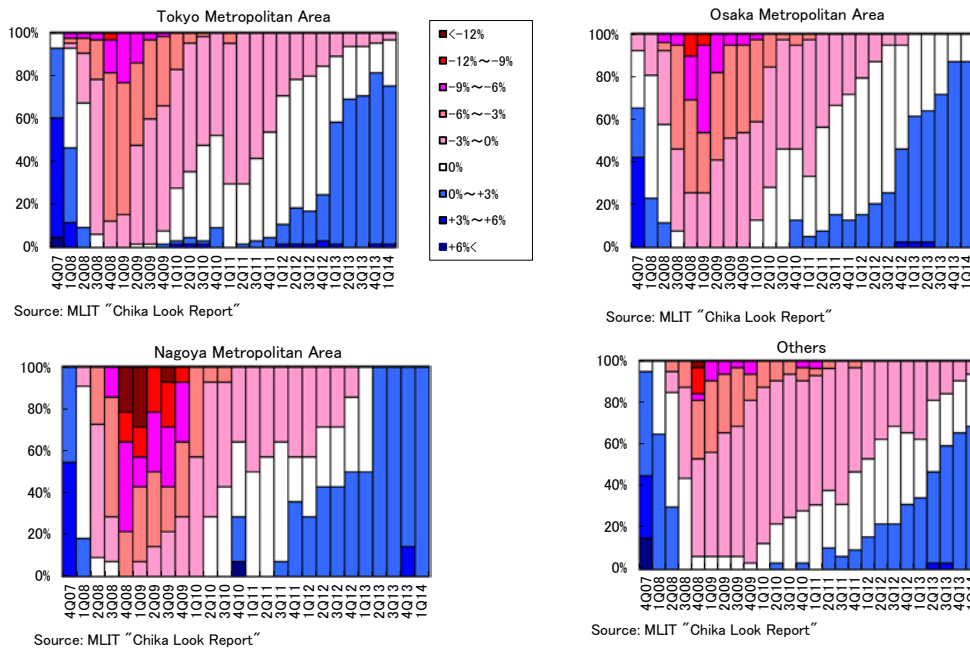
Land prices have appreciated not only in major cities but also in local cities. According to “Chika Look Report” by MLIT, 79% of nationwide land price monitoring points recorded positive q-o-q growth (Chart-12).

According to Nomura Real Estate Urban-net, residential land prices in the Tokyo metropolitan area rose by 0.1% q-o-q in the second quarter (Chart-13). Land prices in the 23 wards of Tokyo rose by 0.7% q-o-q for the fifth consecutive quarter of increase and those of Osaka turned positive for the first time in four quarters, while those in Chiba prefecture fell by 1.2% q-o-q for the third consecutive quarter of decrease.

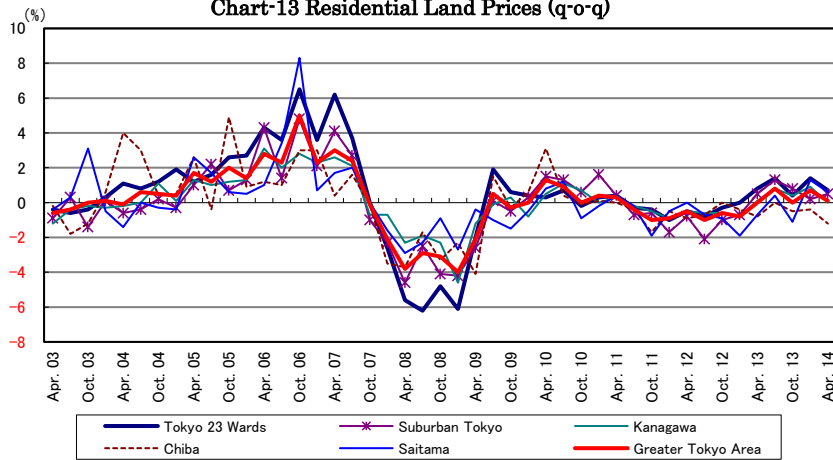
According to “Rosenka,” residential land prices annually published by the National Tax Agency in July, land prices appreciated in eight prefectures and fell in 38 prefectures, improving from two and 45 prefectures respectively last year.

In most cases, land prices rose on the back of population growth except for Fukushima and Chiba prefectures, where severe declines were recorded after the East Japan earthquake.

**Chart-12 Land Price Changes (q-o-q)**



**Chart-13 Residential Land Prices (q-o-q)**



## 5. Sub-sectors

### 1) Office

Tokyo and major city office vacancy rates have declined due to steady demand (Chart-14), as demonstrated by Toranomon Hills Mori Tower being completed and mostly fully occupied in June. In particular, vacancy rates of large buildings in central Tokyo rapidly improved to low levels such as only 1.55% in Shibuya ward, and 4.44% in Shinjuku ward from 12% two years before (Chart-15).

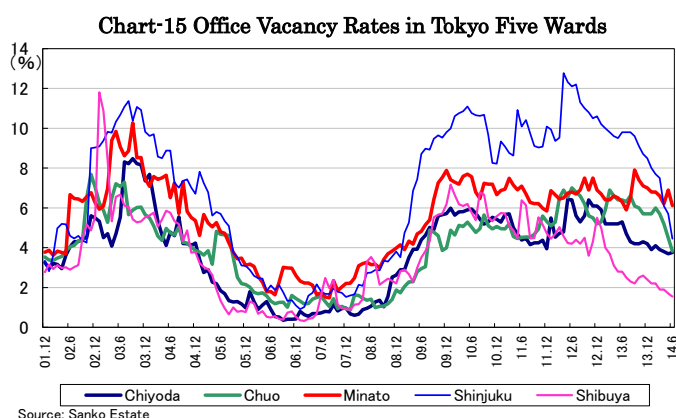
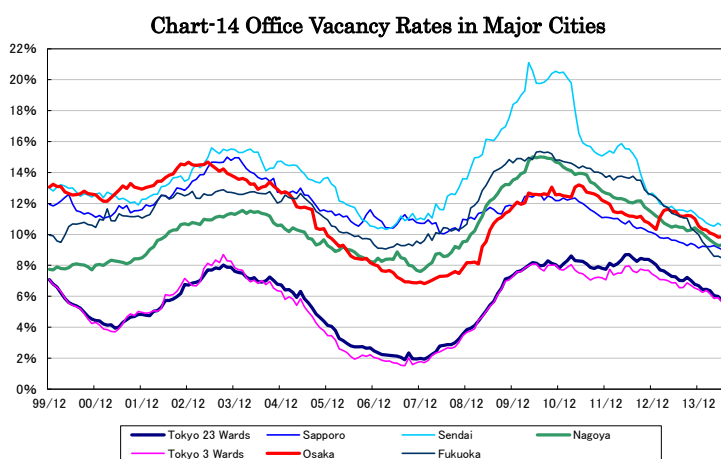
Robust demand has driven the recent vacancy rate improvement, as net absorption of 100k tsubos by far exceeded net supply of 40k tsubos in 2014, according to Miki Shoji.

While the vacancy rates of grade-A offices also improved, the grade-A office rent index declined by 3.3% q-o-q (Chart-16). With a sizable supply and high vacancy rates, relatively expensive grade-A rents were not easily raised in the second quarter.

However, companies have been active in adding office space in their buildings and integrating group companies into larger facilities. As limited supply is expected, rents are forecasted to rise in the latter half of 2014.

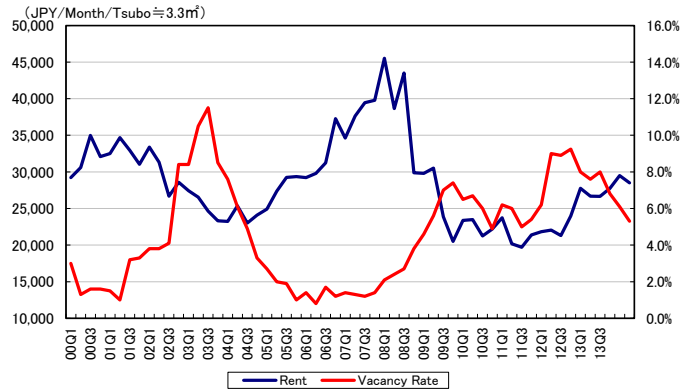
According to Mori Building, office supply in the Tokyo 23 wards will be 880k square meters in 2014 (Chart-17), smaller than the twenty-year average for the second consecutive year. However, it is forecasted that office supply will exceed a sizable one million square meters for the fourth consecutive year from 2015.

Daiwa Real Estate Appraisal published its first “Office Price Index” (Chart-18) based on the grade-A office rent index by Sanko Estate and NLI Research institute (Chart-16). Tokyo grade-A office prices rose by 6.7 million JPY or 10.6% y-o-y in the second quarter, a significant 70.9% increase from when they had bottomed out in the third quarter 2011.



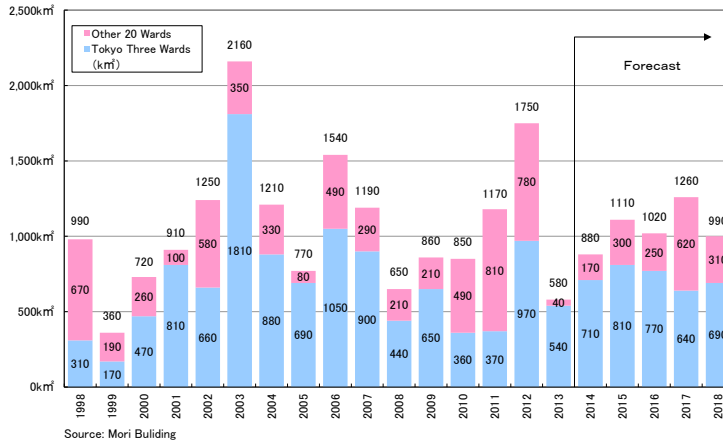


**Chart-16 Tokyo Grade-A Office Rents and Vacancy Rates**



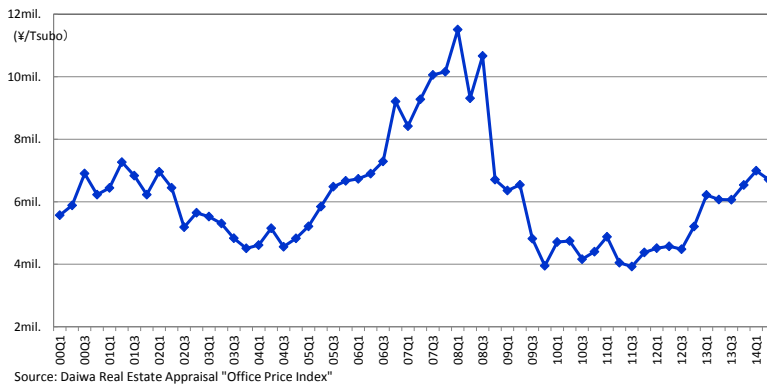
Source: Vacancy Rate·Sanko Estate, Rent·Sanko Estate and NLI Research Institute

**Chart-17 Tokyo Office Supply**



Source: Mori Building

**Chart-18 Tokyo Grade-A Office Price Index**

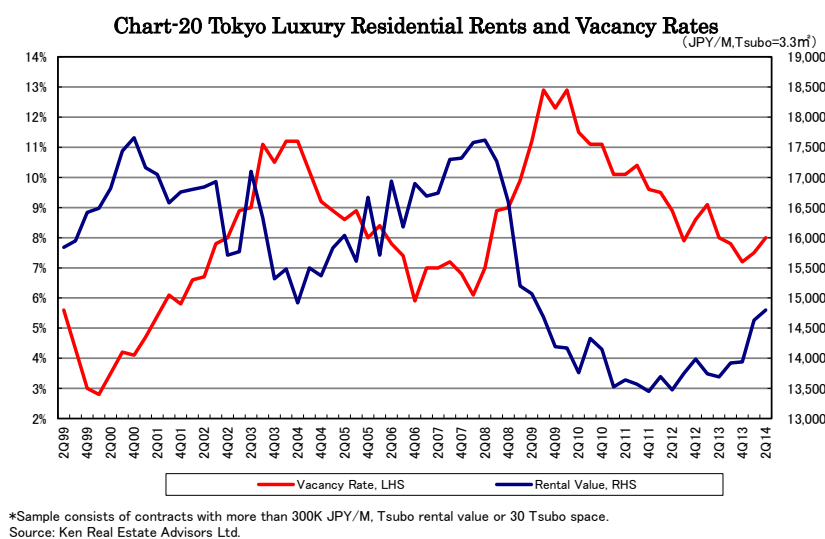
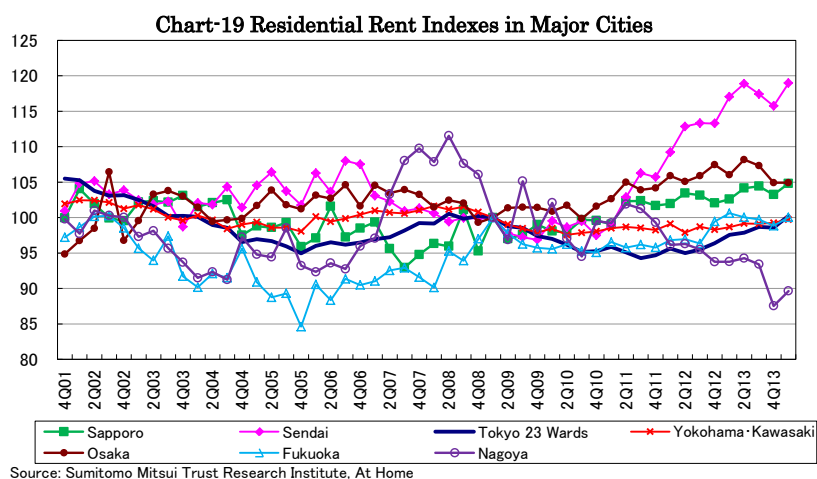


Source: Daiwa Real Estate Appraisal "Office Price Index"

## 2) Residential Rental

Tokyo residential rent index has improved by 6.3% since bottoming out in the third quarter 2011. Rents in other major cities have also been recovering and Sendai, in particular, has shown more than 20% recovery since the East Japan earthquake (Chart-19).

Tokyo luxury residential rents grew by 8.1% y-o-y, entering into a full-fledged recovery phase (Chart-20). Serviced apartments are also in a tight demand-supply balance. Thanks to deregulation lifting the law requiring customers to stay more than one month, serviced apartments can now accommodate short-stay customers in the special economic zones. Many serviced apartments will be supplied in preparation for the 2020 Tokyo Olympic Games.



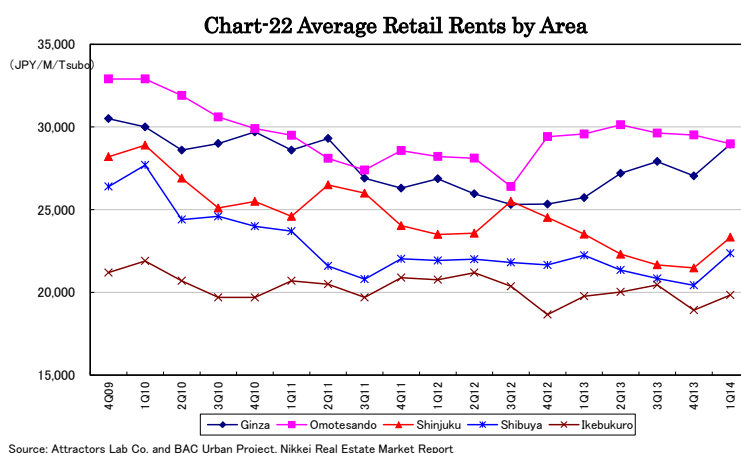
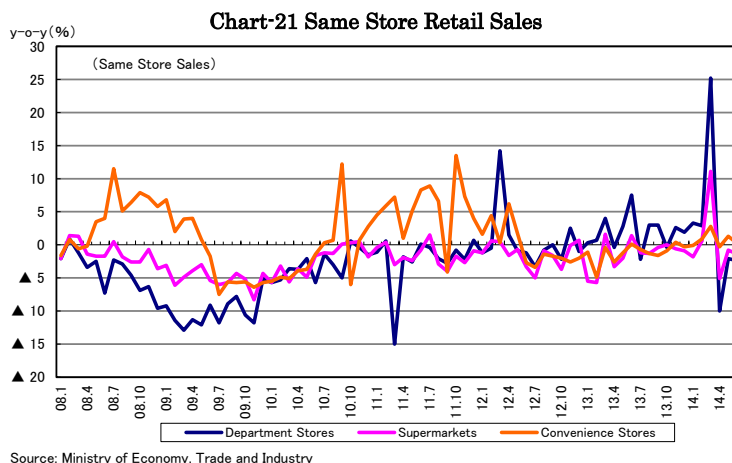
### 3) Retail, Hotel and Logistics

Retail sales declined by 1.8% y-o-y in the second quarter 2014, following a 6.6% growth in the first quarter before the consumption tax rate increase. However, the -0.4% and -0.6% y-o-y in May and June were not as bad as the -4.3% in April, following the +11.0% in March.

The same store sales of department stores and supermarkets declined by 4.7% and 2.4%, respectively, reversing significant 11% and 3.3% growth in the previous quarter, while those of convenient stores still increased by 0.4% following 1.2% modest growth in the previous quarter (Chart-21).

The reversal effect stood out for luxury goods, as sales of art works, jewelry and precious metals declined by 38.9% y-o-y in April, following an abnormal 113.7% growth in March.

Retail rents in Shinjuku and Shibuya finally tuned to a recovery in the first quarter, while those in Ginza maintained a recovery phase for several quarters (Chart-22).



The monthly numbers of foreign visitors to Japan have exceeded one million for the fourth consecutive month since March (Chart-23). The number for April of 1.23 million is especially noteworthy, as it is the first time since 1970 that visitors have outperformed the number of Japanese traveling overseas of 1.19million in April.

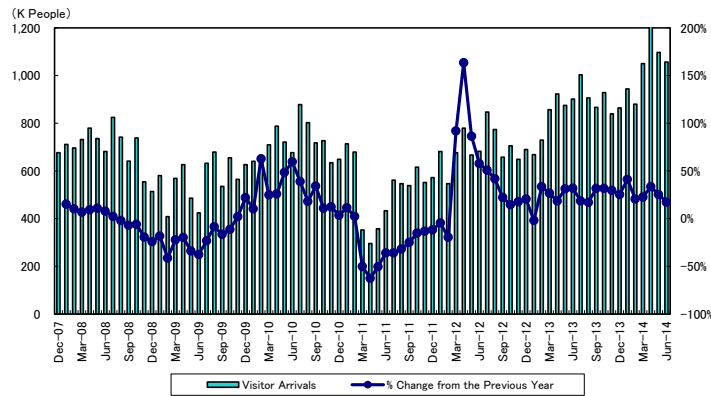
The visitor number for the first half of 2014 totaled 6.26 million and visitors from all countries, except South Korea, increased significantly such as China at +88.2% y-o-y, Thai at +63.8%, the Philippines at +62.9% and Malaysia at +62.5%. It seems that additional LCC routes, relaxed visa requirements for Southeast Asian visitors and various promotions all contributed to lift foreign visitor arrival numbers.

Supported by increasing foreign visitor numbers (Chart-24) and moderate room supply after the East Japan earthquake, hotel occupancy rates are higher than last year. While

foreign hotel brands such as Andaz Tokyo in Toranomon Hills have entered the Japanese market, the number of hotel rooms in Japan has decreased from 1.59 million in 2009 to 1.56 million in 2012 (Chart-25). Hotel construction figures remain around 800, much lower than the 1,500 seen before the global financial crisis in 2008.

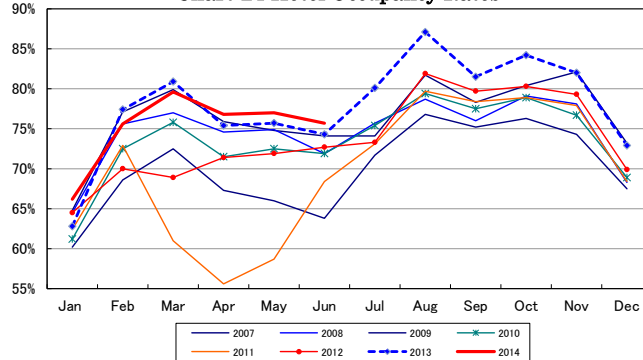
According to the Japan Tourism Agency, the number of Japanese and foreign tourists on overnight stays grew by 2.3 million y-o-y to 133.6 million in the first quarter, most of which were accounted for by foreigners growing by 2.5 million (Chart-26). However, Japanese tourists have become active in summer and strong demand for hotel rooms is expected for August.

**Chart-23 Foreign Visitor Arrival Number**



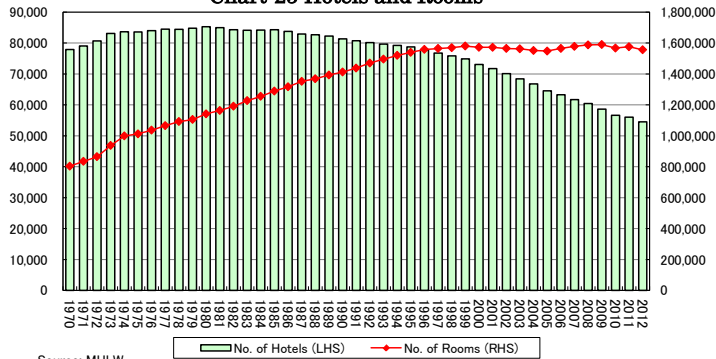
Source: Japan National Tourism Organization (JNTO)

**Chart-24 Hotel Occupancy Rates**

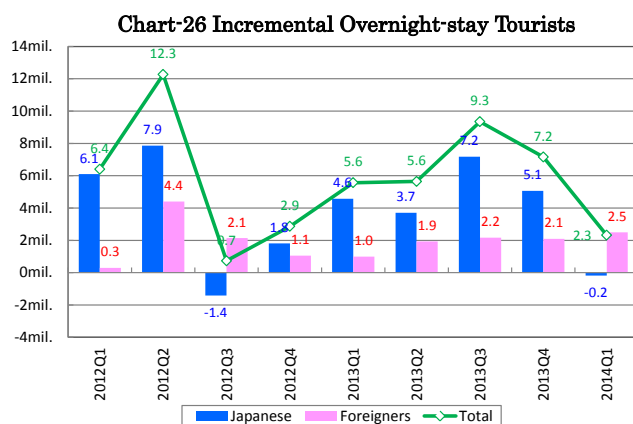


Source: Ohta Publications "Weekly HOTERES"

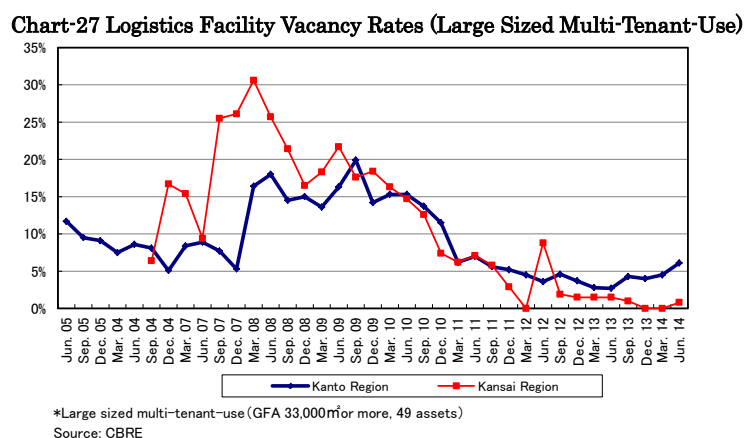
**Chart-25 Hotels and Rooms**



Source: MHLW



According to CBRE, the vacancy rates of large logistics facilities for multi-tenants in the Tokyo metropolitan area deteriorated by 1.6% to 6.1% with continuous large supply in the second quarter (Chart-27). However, demand for logistics facilities remains strong and rents in some areas have even been increasing. As a truck driver shortage and fuel costs increase, logistics facilities located close to Tokyo have been reviewed. Though vacancy rates are expected to stabilize in the latter half of 2014, they may again start to increase on the back of continuous supply in 2015.

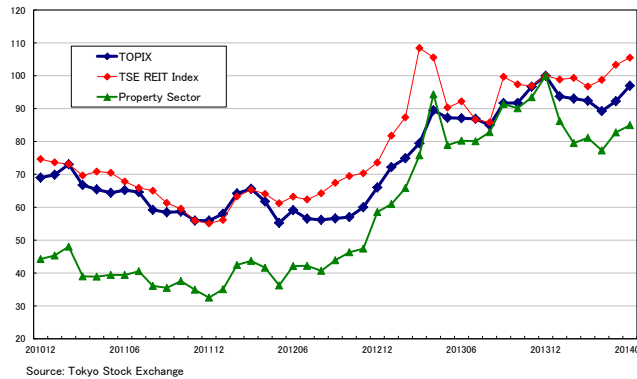


## 6. Property Investment and J-REIT Markets

The TSE REIT index temporarily recovered 1,600pt for the first time since May 2013 and finished at 1,598pt, rising by 9.1% q-o-q in the second quarter (Chart-28). J-REIT office, residential and retail/logistics sectors appreciated by 9.1%, 11.2% and 9.2% q-o-q respectively.

At the end of June, J-REIT market value was 8.4 trillion JPY, while the price to NAV ratio was 1.4 times and the dividend yield was 3.5% with a 2.9% yield spread on ten year JGBs.

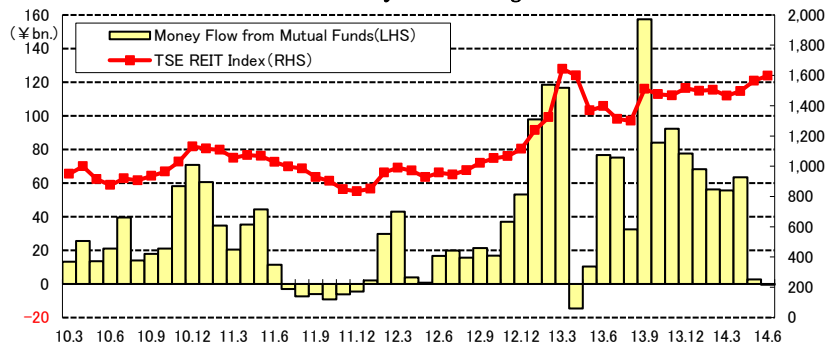
Chart-28 TSE REIT Index



Foreign investors actively invested in J-REITs totaling 62.2 billion JPY in the quarter, while money flow through domestic mutual funds, previously the biggest investor category, shrank rapidly (Chart-29).

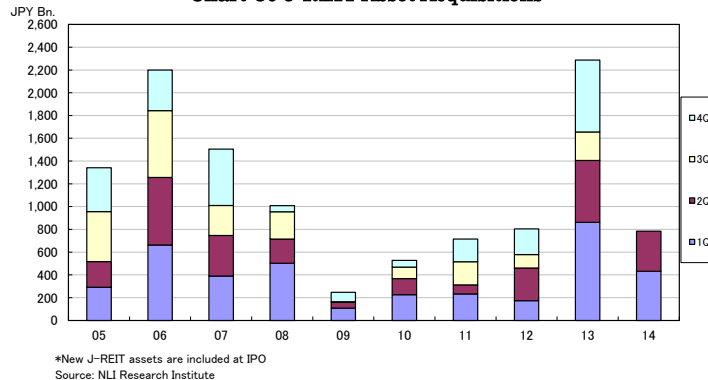
Market participants have been paying more attention to the Government Pension Investment Fund beginning to invest in J-REITs and whether other pension funds will follow suit.

Chart-29 J-REIT Money Flow through Mutual Funds



J-REITs acquired assets of value of 352 billion JPY in the second quarter, thus totaling 784 billion JPY in the first half of 2014, 44% smaller than the overwhelming volume in 2013 but as large as that in 2007 (Chart-30). Invesco Office J-REIT Inc. got listed with five assets valued at 78.6 billion JPY in June, and the number of J-REITs increased to 46.

Chart-30 J-REIT Asset Acquisitions



\* This report includes data from various sources and NLI Research Institute does not guarantee the accuracy and reliability of such data.

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