

Real Estate Analysis Report

Office Investment Risks in Tokyo and Other Cities

~Asking Office Rents Contradict Cap Rates~

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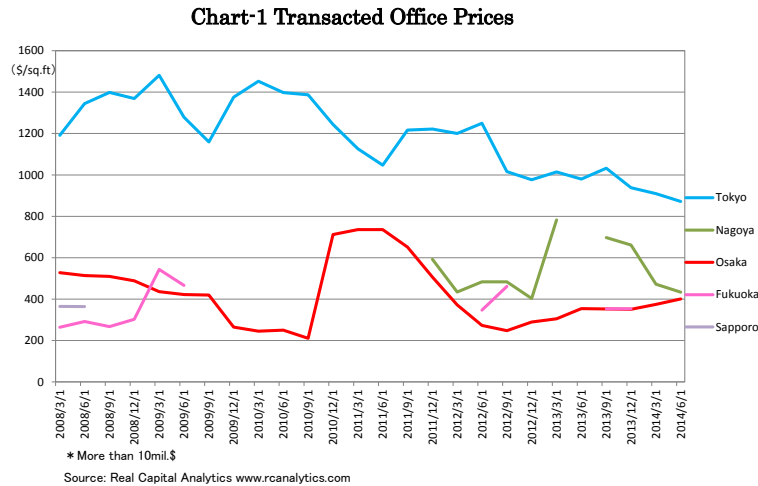
Summary

- Property prices in Tokyo are much higher than in other cities. Tokyo's high property prices are sustained not only by expensive office rents, but also low Cap Rates.
- On the other hand, common perceptions in the office leasing market are different. Actually, the volatility of asking office rents in Tokyo is apparently higher than those in other cities, which contradicts the risk profile indicated by Cap Rates.
- Contracted office rents and profitability analysis, however, reveal sizable risks in local cities not recognized from asking rents, and confirm the relatively low-risk profile of Tokyo. As a great number of companies are based in Tokyo, qualitative factors may also justify the relatively low-risk profile, such as acceptable liquidity both in the leasing and investment markets, which cannot be easily expected in local cities.

1. Gaps between Tokyo and Other Cities

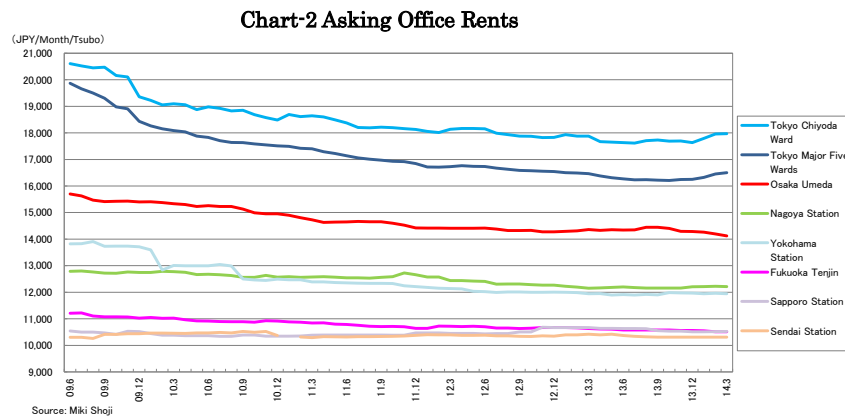
(i) Transacted Prices

Tokyo is dominantly powerful both in politics and the economy in Japan. Properties in central Tokyo are traded at higher prices than any other place across the country. Office transaction prices per square foot in Tokyo have been more than double of those in other cities, though there has been much decline since the global financial crisis (Chart-1).



(ii) Rents

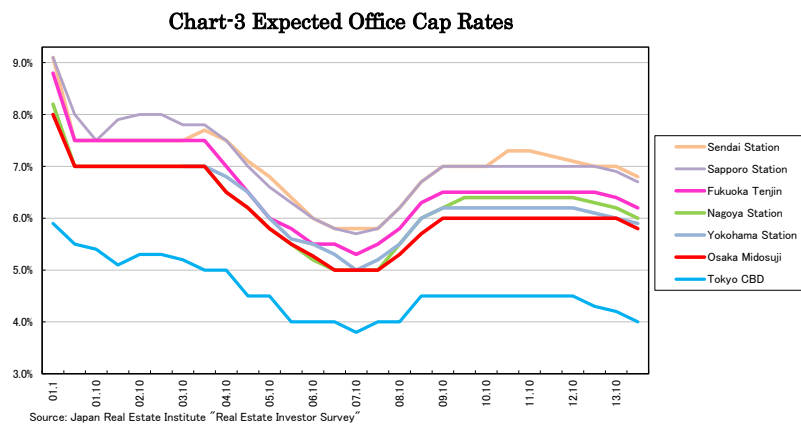
One of the main reasons for Tokyo's high property prices is expensive rents. Based on asking office rent data provided by Miki Shoji, office rents in Tokyo have always been higher than those in other cities by a wide margin (Chart-2). Building owners can set high asking rents in Tokyo based on the fact that a great number of corporations with good capacity to pay have been based there.



(iii) Cap Rates

Simply speaking, property prices are calculated from annual net operating income divided by capitalization rate, the so-called Cap Rate. Properties in Tokyo enjoy not only higher

rents and net operating incomes but also advantageous Cap Rates. Based on investors' expected Cap Rates as surveyed by Japan Real Estate Institute, Cap Rates in Tokyo have been categorically lower than those of other cities (Chart-3). This means investors appraise Tokyo as a low-risk market and require additional risk premiums when investing in properties in other cities.



2. Asking Office Rents Contradict Cap Rates

On the other hand, common perceptions in the office leasing market are different. General expectations are that office rents in Tokyo increase earlier and by a larger degree than those in other cities during office cycle upturns, and similarly, decline more rapidly and deeply during downturns. Actually, asking office rents in Tokyo had surged dynamically during the fund boom up until 2008, and dropped unmercifully during the global financial crisis in 2008 and 2009 (Chart-4).

The standard deviations of the rent changes also show that office rents in Tokyo have been much more volatile than those in other cities (Chart-5), which contradicts the risk profile indicated by investors' Cap Rates.

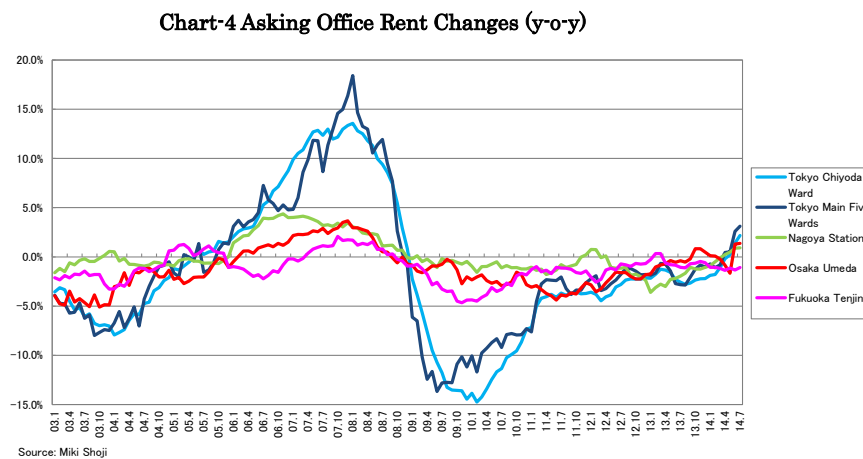
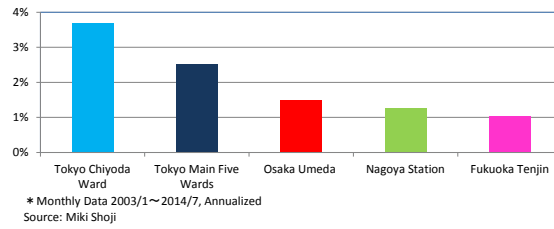


Chart-5 Standard Deviation of Asking Office Rent Changes



3. Revealing Risks in Local Cities

(i) Contracted Office Rents

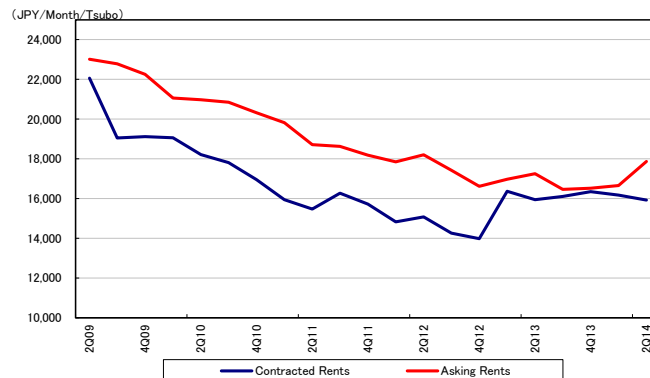
Asking office rent data is published monthly and is one of the most popular and influential data available on the Japanese office market. However, contracted office rent data is also available, though published quarterly. Changes in contracted rents can be negotiated even with asking rents remaining the same. Contracted rents are a more realistic indicator of the volatility of cash flows and property values than asking rents.

For example, contracted rents surged quickly and reflected a withdrawal of deep discounts in the first quarter 2013, while asking rents posted only a slight recovery (Chart-6).

The standard deviations of the contracted rent changes indicate that the volatility of contracted rents overwhelms that of asking rents; furthermore, contracted rents in Tokyo have been less volatile than those in other cities (Chart-7). This suggests Tokyo embraces less risks than other cities, which is the opposite of what asking rents indicate.

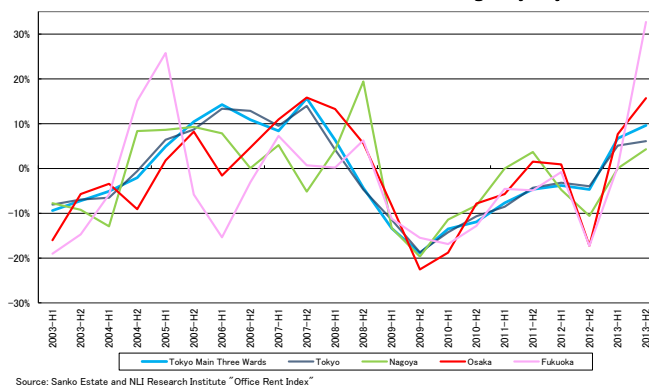
In local cities where the number of tenants and building owners is not sizable, it is easy to negotiate rents face-to-face. Asking rents matter a lot in Tokyo, as tenants compare numerous asking rents when considering relocation. However, tenants can directly negotiate with the limited number of building owners in local cities while asking rents are sometimes left unadjusted. Actually, asking rents in local cities have fluctuated only slightly (Chart-4) and seemingly do not reflect real leasing activity.

Chart-6 Contracted Office Rents and Asking Office Rents



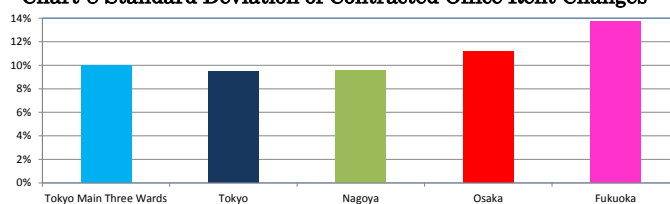
Source: Sanko Estate and NLI Research Institute "Office Rent Index"

Chart-7 Contracted Office Rents Changes (y-o-y)



Source: Sanko Estate and NLI Research Institute "Office Rent Index"

Chart-8 Standard Deviation of Contracted Office Rent Changes



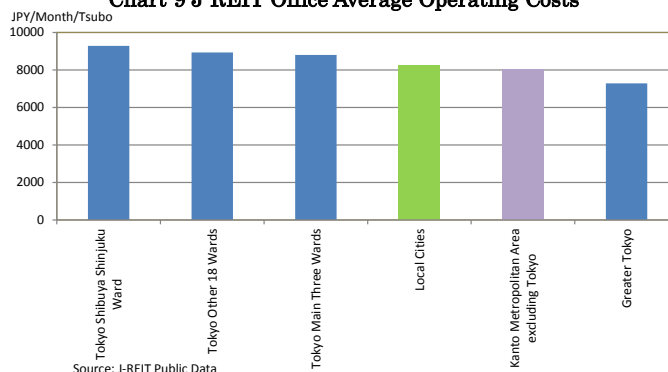
*Semiannual Data 2003H1~2013H2, Annualized
Source: Sanko Estate and NLI Research Institute "Office Rent Index"

(ii) Profitability

When considering investment risk, it is not sufficient to only check office rents¹ and it is better to look at costs and profitability.

Based on data on offices owned by J-REITs, there is little difference in average operating costs among cities (Chart-9). It is common throughout the world that the prices of commodities are noticeably different between capital and local cities, but such price gaps are not seen in Japan except for property-price-related items. By the same token, the area gaps on building operating costs can only be seen in certain taxes linked to property prices.

Chart-9 J-REIT Office Average Operating Costs



Source: J-REIT Public Data

Comparing model office buildings in major three cities with the supposition that 20% of the tenants are replaced semiannually at rents from the contracted rent indexes and with

¹ Another important factor for rental revenue is occupancy rate. Occupancy rates vary between Tokyo and other cities but volatilities by city do not differ much.

fixed operating costs at the J-REIT average, the profitability differed significantly. The model office building in Tokyo had a better profitability with a 57% NOI margin, while Osaka and Fukuoka had lower rates of 35% and 23%, respectively (Chart-10).

The volatility of rents had a larger impact on NOI in Osaka and Fukuoka than in Tokyo because they have lower margins based on more reasonable rents and mostly the same costs. The standard deviations of NOI changes turned out to be 6.2% in Tokyo, 8.9% in Osaka and 11.9% in Fukuoka.

Chart-10 Model Office Profitability and Volatility

	Remaining Rent (JPY/Month/Tsubo)	Operating Cost (JPY/Month/Tsubo)	NOI (JPY/Month/Tsubo)	NOI (%)	NOI St. Deviation
Model A Tokyo	14,900	6,366	8,534	57.3%	6.2%
Model B Osaka	8,456	5,338	2,918	35.3%	8.9%
Model C Fukuoka	6,966	5,338	1,628	23.4%	11.9%

* as of 2013H2. St. Deviation from Semiannual Data 2003H1~2.13H2 (Annualized)
Source: J-REIT public data, Sanko Estate and NLI Research Institute "Office Price Index"

The contracted office rents and profitability analysis revealed sizable risks in local cities not recognized from asking rents, and confirmed the relatively low-risk profile of Tokyo. As a great number of companies are based in Tokyo, qualitative factors may also justify the relatively low-risk profile, such as acceptable liquidity both in the leasing and investment markets, which cannot be easily expected in local cities.

4. Final Note

The contracted office rents and profitability analysis confirmed that office investment risks in Tokyo are smaller than in other cities. However, compared with other traditional assets such as equities and bonds which have daily transacted prices, many property issues remain unanalyzed by data.

The property industry has long been trying to invite new sources of investment such as Japanese pension funds. It is critically important to prepare diverse market data so that institutional investors can compare properties with other assets and appropriately control investment risk.

Since the J-REIT inception in 2001, various kinds of property market data have been provided and the transparency of the property market has progressed. Now that transacted price data is available for residential properties,² capital return calculation as equities and bonds is possible. Moreover, MLIT is also preparing a transacted price index for commercial properties. Hopefully the property investment market will become more active as the infrastructure of the property market matures.

² The TSE Home Price Index based on repeat sales method became available in 2012.

³ This report includes data from various sources and NLI Research Institute does not guarantee the accuracy and reliability of such data. In addition, this report is intended only for providing information, and the opinions and forecasts herein are not intended to make or break any contracts.