NLI Research Institute February 19, 2015

Real Estate Analysis Report

Japanese Property Market Quarterly Review, Fourth Quarter 2014

~J-REITs Soar for Third Year and Office Demand Expands~

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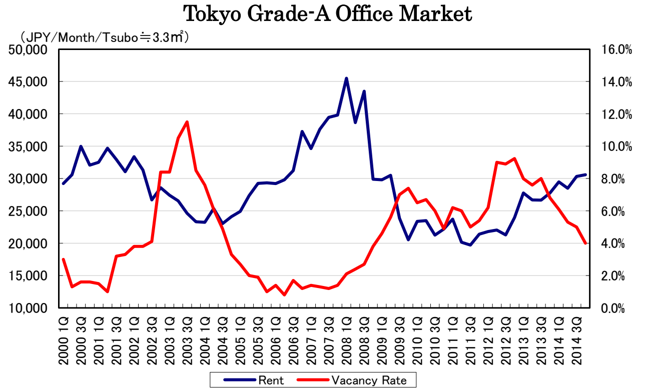
Summary

- Following negative GDP growth numbers in the second and third quarters, the government decided to suspend the next consumption tax hike and the Bank of Japan prepared additional monetary loosening measures. Despite the recent recovery in corporate activity and labor markets, the housing market remains stagnant. Housing starts decreased for the first time in five years and both new condominium sales and secondary condominium transactions shrank in 2014. On the other hand, land price appreciation expanded from the three major metropolitan areas to other cities.
- Office vacancy rates in Tokyo have improved significantly pushed by strong demand, and office rents have also been on an ascending trend. Residential rents in Tokyo have gradually been rising. Foreign visitor arrivals increased by 29% to 13.4 million in 2014, resulting in the maintaining of very high hotel occupancy rates. Logistics vacancy rates have been stable at a very low level.
- The TSE REIT Index rose by 25.3% in 2014 for the third consecutive year of significant appreciation. J-REITs acquired property assets of 1.6 trillion JPY and market value expanded to 10.5 trillion JPY with 49 J-REITs listed. Property investments have been active, with transaction volumes exceeding 4 trillion JPY for the second consecutive year.

Tokyo Grade-A Office Market



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

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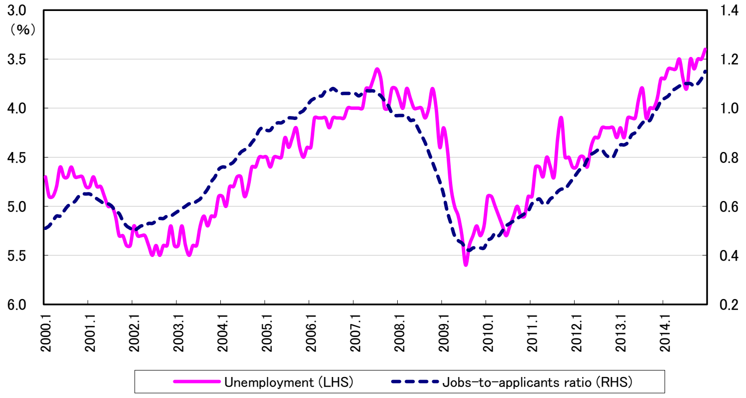
1. Economy and Housing Market

Japan's GDP growth rate turned negative in the second and third quarters unexpectedly, and the government decided to suspend the next consumption tax hike originally scheduled in October 2015. The Bank of Japan also decided to prepare additional monetary loosening measures to evade the deflation securely. Thus, corporate activity has gradually become active and the unemployment rate improved by 0.1% to 3.4% in December, with the jobs to applications ratio at 1.15 times, which is the highest in 23 years (Chart-1).

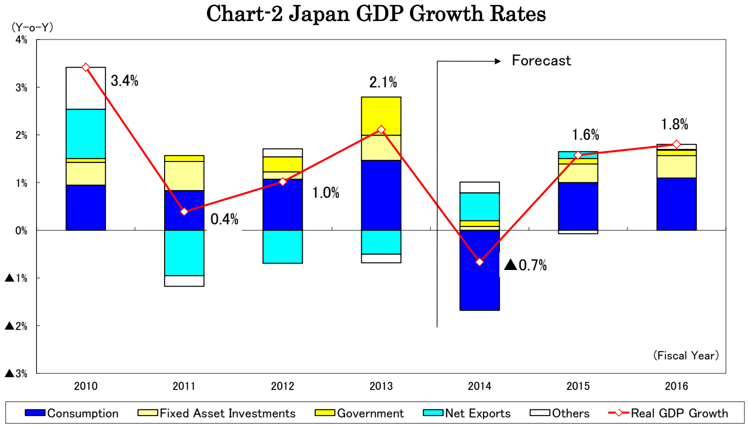
NLI Research Institute cut its GDP growth rate forecast by 1.0% to -0.7% for 2014 and forecasts +1.6% and +1.8% for 2015 and 2016 respectively. Though depletion is inevitable in 2014, it is expected that JPY depreciation and low oil prices will lift GDP growth rates in 2015 and 2016 to a higher level than that of Japan's potential sustainable growth (Chart-2).

Chart-1 Labor Market



Source; MIC "Employment Report" 、MHLW "Job introduction"

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" December 8, 2014.

Housing starts, sales and transactions have remained stagnant. Housing starts shrank by 14.7% y-o-y to 76.4k units in December for the tenth consecutive month of negative y-o-y growth (Chart-3). The number declined by 9.0% y-o-y to 8,920k units for the whole year in 2014 for the first time in five years (Chart-3).

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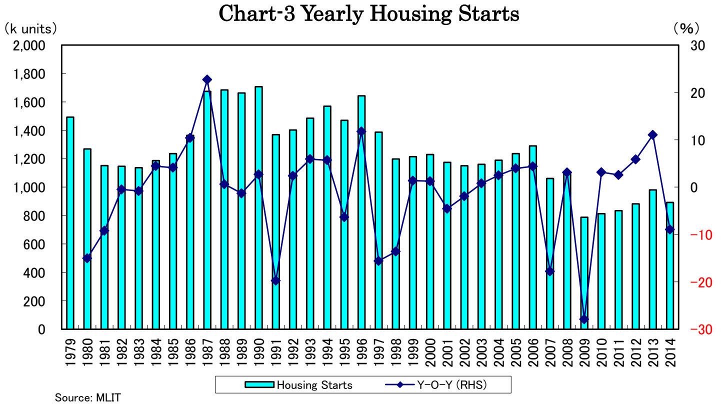
New condominium units sold in the Tokyo metropolitan area also decreased significantly by 20.5% y-o-y to 44,193 units in 2014 for the first time in three years. Real Estate Economic Institute forecasts 45,000 units in 2015 (Chart-5). It is anticipated that the housing market will recover supported by lower mortgage interest rates and broader exemptions for parents from gift taxes.

According to Real Estate Information Network Systems, the transaction volume in the secondary condominium market in the Tokyo metropolitan area shrank by 12.2% y-o-y to 7,982 units in the fourth quarter and by 7.2% to 33.8k units in 2014 (Chart-5).

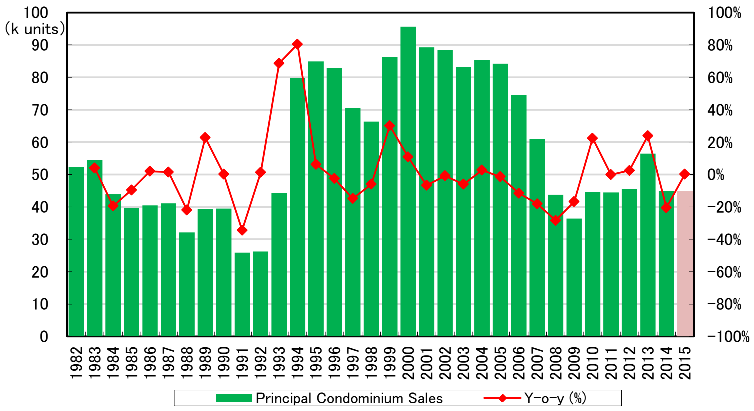
On the other hand, Home Price Indices[1] in the Tokyo metropolitan area appreciated m-o-m for the third consecutive month and y-o-y for the eighteenth consecutive month in November (Chart-6).

Chart-3 Yearly Housing Starts



Source: MLIT

Chart-4 New Condominium Units Sold in the Tokyo Metropolitan Area



*Not includng resort condominums. 2014 and 2015 numbers are forecasts.
Source: Real Estate Economic Institute

[1] Japan Real Estate Institute publishes Home Price Indices, succeeding the former TSE Home Price Indices by the Tokyo Stock Exchange.

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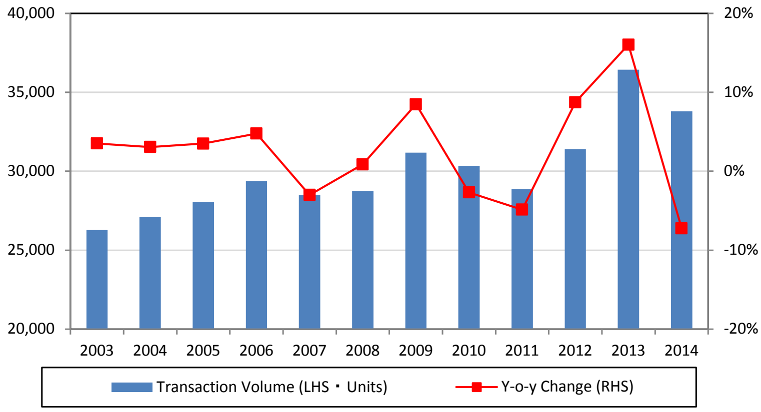
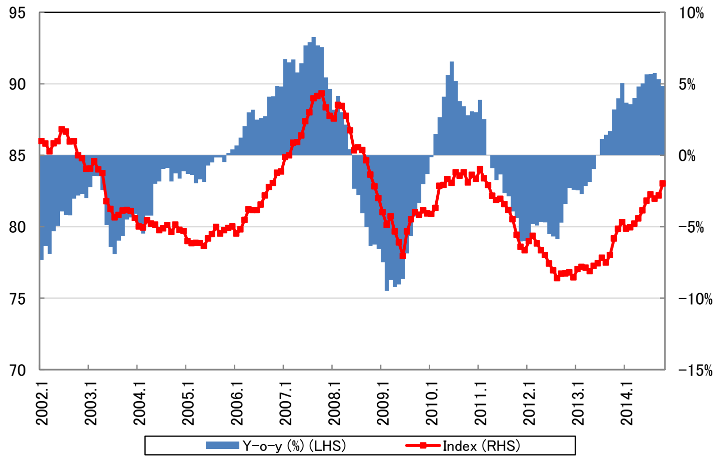
Chart-5 Transaction Volumes in Secondary Condominium Market



Source: REINS East Japan

Chart-6 Home Price Indices



Sources: Japan Real Estate Institute

2. Land Prices

Land price appreciation has expanded into rural cities from the three major metropolitan areas of Tokyo, Osaka and Nagoya, supported by strong demand for commercial property investment and residential development based on the loosening monetary policy.

In "Chika Look Report 4Q 2014[2]" by MLIT, no monitoring points recorded land price depreciations for the first time, with 89% of monitoring points in Tokyo, 77% in Osaka, 100% in Nagoya, 69% in rural cities and 83 % nationwide recording price appreciations (Chart-7).

According to Nomura Real Estate Urban Net, residential land prices in the Tokyo metropolitan area appreciated by 0.9% q-o-q for the seventh consecutive quarter of appreciation (Chart-8). Residential land prices in the Tokyo 23 wards, greater Tokyo, Kanagawa and Saitama prefecture rose by 4.2%, 2.5%, 0.9% and 4.5% q-o-q, respectively, while those in Chiba prefecture dropped by 2.4% q-o-q (Chart-8).

[2] Actually, it was for the 3Q of fiscal 2014 ending March 2015.

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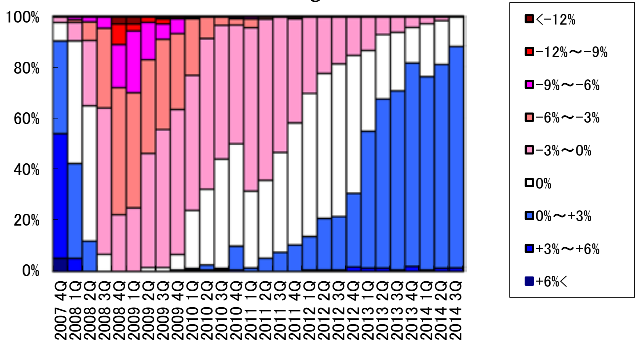
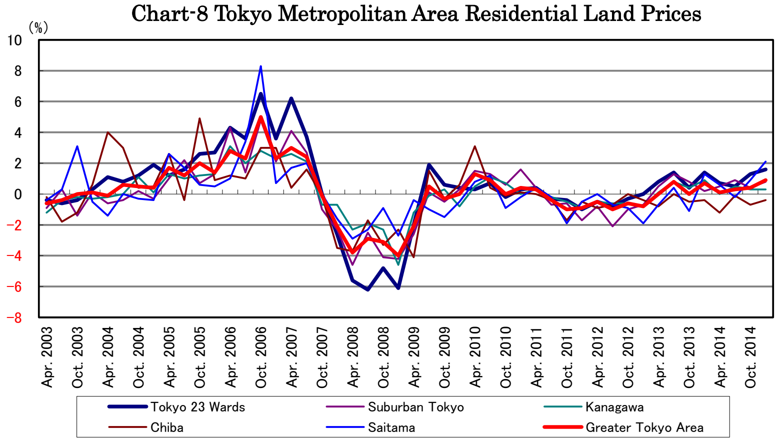
Chart-7 Land Price Changes Nationwide



Source: MLIT "Chika Look Report"

Chart-8 Tokyo Metropolitan Area Residential Land Prices



Source: Nomura Real Estate Urban Net

3. Sub-sectors

1) Office

With strong office demand, vacancy rates of very large sized offices in the Tokyo three wards improved by 0.5% q-o-q to 3.99%, below 4.0% for the first time in five years (Chart-9). Moreover, vacancy rates have also significantly improved in other major cities.

The rent index of Tokyo grade-A[3] offices rose by 0.8% q-o-q to 30,573 JPY in the fourth quarter for the second consecutive quarter. Although the index of grade-B offices declined by 1.9% q-o-q to 17,132 JPY in the quarter, it seems the overall office rents in Tokyo have been on an ascending trend.

While new office supply will increase by 26% y-o-y in 2015 according to Mori Building, it should be carefully followed to see whether the demand growth is large enough for the increasing supply.

[3] 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 and environmental friendliness.

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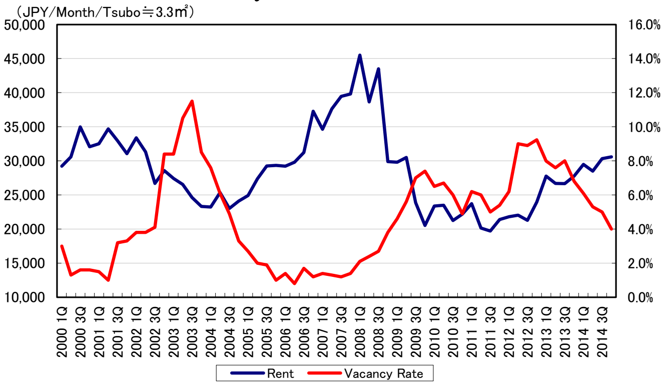
Chart-9 Tokyo Grade-A Office Market

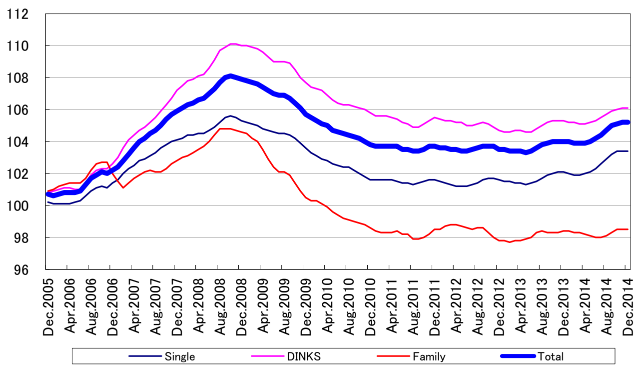


Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

2) Residential Rental

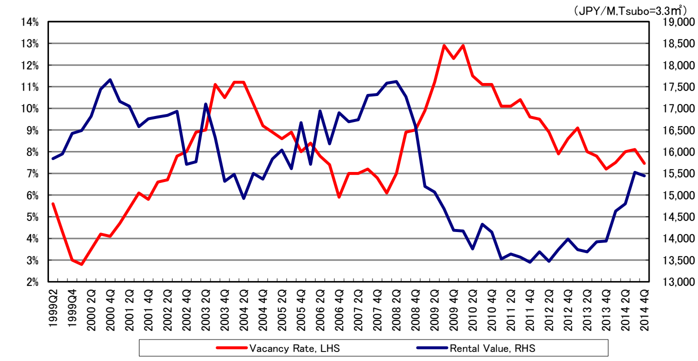
Residential rents in Tokyo rose for all types both q-o-q and y-o-y in the fourth quarter, with one-room type increasing by 1.3% y-o-y, DINKs type by 0.8% and family type by 0.1%. Tokyo luxury residential rents also rose by 10.8% y-o-y in December with vacancy rates improving significantly.

Chart-10 Tokyo Residential Rent Index



Jan 2005=100
Source: IPD・Recruit Residential Index

Chart-11 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.

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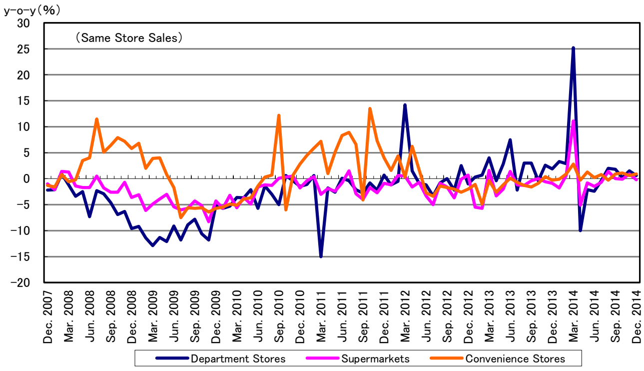
3) Retail, Hotel and Logistics

Retail sales grew by 0.7% y-o-y in December for the sixth consecutive month of positive growth, while same store sales grew by only 0.1% with department stores increasing by 0.6%, supermarkets decreasing by 0.2% and convenience stores increasing by 0.9% (Chart-12).

For the whole year in 2014, same store sales of department stores grew by 2.0% y-o-y for the third consecutive year of positive growth on the back of the asset effects from the equity market rally and expanding duty-free sales to foreign tourists. Same store sales growth of supermarkets and convenience stores also tuned positive, increasing by 0.3% and 0.7% y-o-y respectively in 2014.

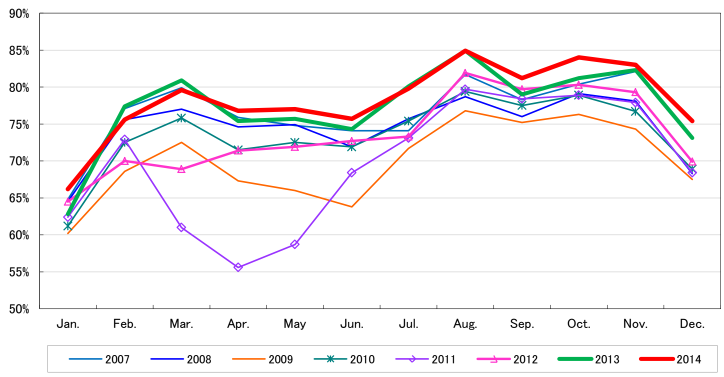
Nationwide hotel occupancy rates have been very high, improving by 2.3% y-o-y to 85.4% in December (Chart-13). Foreign visitor arrivals increased by 29% to 1.34 million in 2014 (Chart-14), accelerated by the JPY depreciation, loosened conditions on visa issuance for Southeast Asians, consumption tax exemptions for foreigners and various welcoming promotions. By nationality, Taiwanese, Koreans and Chinese accounted for 60% of the total, and Chinese especially increased dynamically by 83% y-o-y in 2014 (Chart-15). Consumption by foreign tourists swelled by 43% y-o-y to 2 trillion JPY, which has become one of the significant factors of Japanese consumption statistics.

Chart-12 Retail Same Store Sales



Source: Ministry of Economy, Trade and Industry

Chart-13 Hotel Occupancy Rates



Source: Ota Publication

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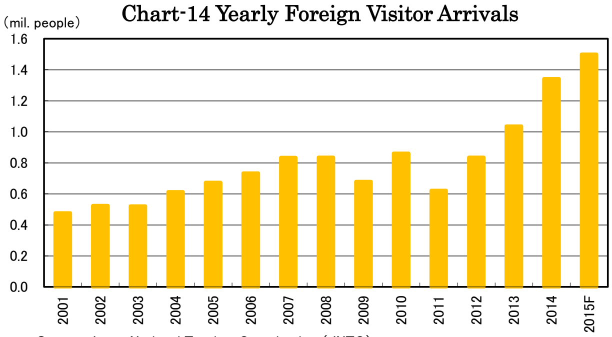
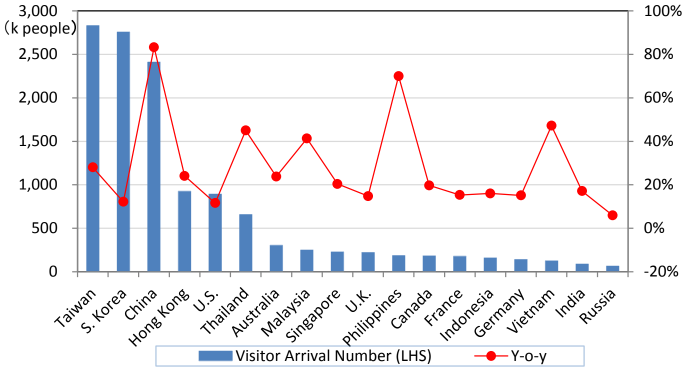
Chart-14 Yearly Foreign Visitor Arrivals



Source: Japan National Tourism Organization (JNTO)

Chart-15 Foreign Visitor Arrivals by Countries

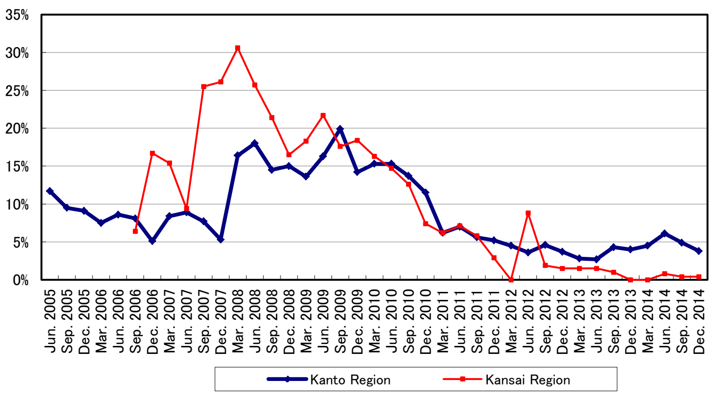


Source: Japan National Tourism Organization

According to CBRE, vacancy rates of large logistics facilities for multi-tenants in the Tokyo metropolitan area improved by 1.1% q-o-q to 3.8%, while those in the Osaka metropolitan area remained the same at a very low 0.4% (Chart-16). These very low vacancy rates are maintained by the strong demand for advanced logistics facilities on the back of the prevailing e-commerce. However, new supply in the Tokyo metropolitan area will become the largest ever in 2015, 40% more than 2014, and continue to be sizable in 2016, thus, it is anticipated that vacancy rates will reach 10% in 2016.

According to Ichigo Real Estate Service, logistics rents in the Tokyo metropolitan area rose slightly by 0.3% q-o-q to 4,000 JPY per tsubo in October.

Chart-16 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

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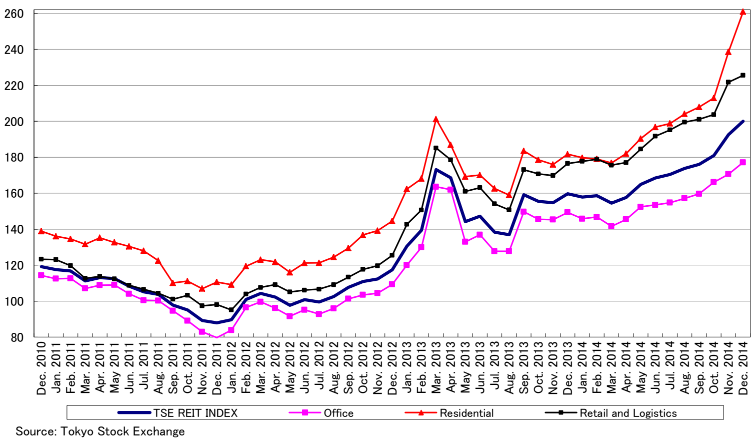
4. Property Investment and J-REIT Markets

The TSE REIT Index rose by 13.6% in the fourth quarter with a favorable equity market, lower interest rates and JPY depreciation based on loosening measures by the Bank of Japan. The residential sector paying relatively high dividends led the market, appreciating by 25.5% in the fourth quarter, while the office sector rose by 10.9% and other sectors – including retail and logistics – by 12.2% (Chart-17). At the end of December, the J-REIT market value was 10.5 trillion JPY, while the price to NAV ratio was 1.6 times and the dividend yield was 3.0% with a 2.7% yield spread on ten year JGBs.

The TSE REIT Index rose by 25.3% in 2014 for the third consecutive year of significant appreciation, following an increase by 33.6% in 2012 and by 35.9% in 2013. In particular, the index soared rapidly after the announcement by the Bank of Japan on October 31 to acquire an additional 60 billion JPY of J-REIT investment units amounting to 90 billion JPY for a year. The index renewed its record high for the first time since May 2007, before the global financial crisis.

J-REITs acquired property assets amounting to 1.6 trillion JPY in 2014, which was 30% less than in 2013 but still a very large amount. Some novel activities such as a healthcare REIT IPO and a foreign asset acquisition were notable in the market, though office and residential assets still accounted for 48% and 18% of the acquired assets (Chart-18). With six new J-REITs listed, the number of J-REITs increased to 49 with a total asset value of 12.6 trillion JPY. Under the current comfortable funding environment with J-REIT bond issues conditioned with eight years and 0.78% interest rates on average, J-REITs have increased their dividends by saving on financing costs.

Chart-17 TSE REIT Index



Source: Tokyo Stock Exchange

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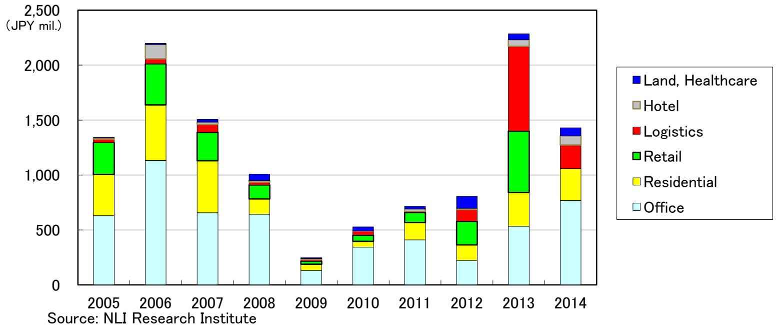
Chart-18 J-REIT Asset Acquisitions



Source: NLI Research Institute

Transactions in the property investment market have been active, as unlisted REITs and foreign investors have become aggressive. Transaction volumes reached 4 trillion JPY for the second consecutive year. Six cases of huge transactions of more than 100 billion JPY were notable and CAP rates shrank below 3% on some high-price deals.

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