Real Estate Analysis Report

Japanese Property Market Quarterly Review, Third Quarter 2015

~Markets Steady but Some Weaknesses Creeping In~

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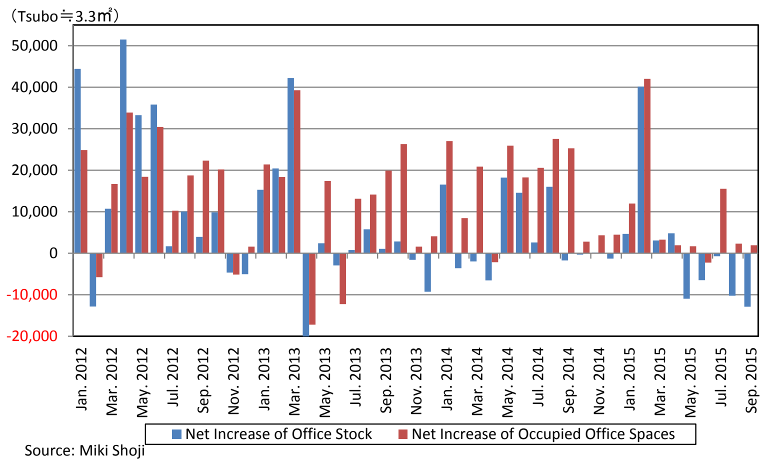
Summary

- Japanese economic recovery has not been obvious from the negative q-o-q GDP growth in the second quarter. Housing starts have been recovering as the construction cost increase has finally lost steam. Land prices in the three major metropolitan areas continued appreciating.
- The Tokyo grade-A office market has strengthened further, however, weakness in office demand has become noticeable over the whole market. Tokyo residential rents have been on the increase, but the luxury category has corrected.
- Retail stores and hotels are benefiting from the increase in foreign visitors. In particular, hotels are enjoying very high occupancy rates and have raised their room rates. The logistics facility market is about to face significant supply.
- The TSE REIT Index declined by 7.0% in the third quarter. Though J-REITs have accelerated asset acquisitions this year, the entire transaction volume in the property investment market has fallen short of that in 2014.

Net Increase of Office Stock and Occupied Office Spaces in Tokyo Five Wards



Source: Miki Shoji

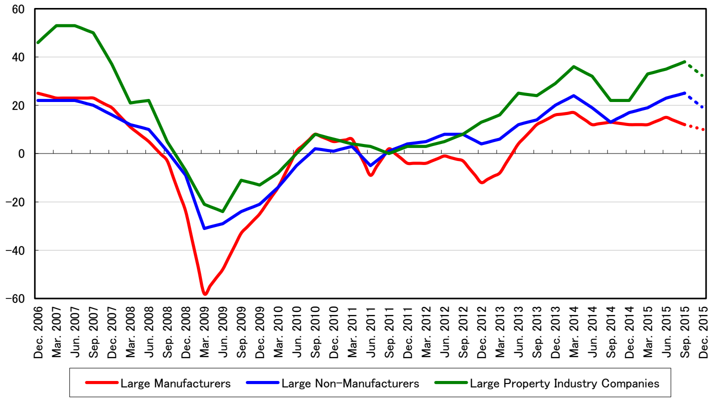
1. Economy and Housing Market

Japanese economic recovery has not been obvious from the negative q-o-q GDP growth in the second quarter on the back of uncertain Chinese business conditions. Although earnings results have been strong so far, corporations have not actively invested in equipment, which resulted in the sixth consecutive month of national trade deficit in September. Real consumption expenditure also shrank again by 0.4% y-o-y in September after a temporal 2.9% y-o-y rebound in August.

In the BOJ Tankan Survey in the third quarter of 2015, the current business confidence D.I. of large non-manufacturers and property industry companies improved from 23 to 25 and from 35 to 38, respectively. However, the D.I. of large manufacturers deteriorated ahead of the others from 12 to 10, and all three categories are forecasted to deteriorate noticeably in the fourth quarter (Chart-1).

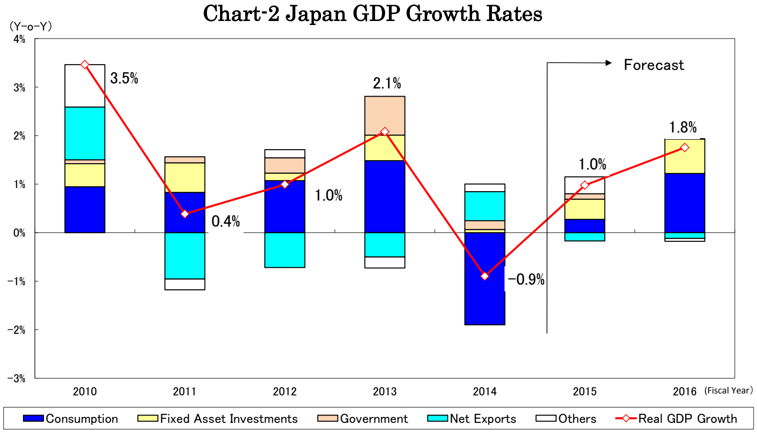
NLI Research Institute reduced its Japanese GDP growth forecast by 0.1% to +1.0% for 2015 and forecasts +1.8% for 2016, reflecting the weaker than expected recent economic conditions (Chart-2).

Chart-1 BOJ Tankan Survey



Source: BOJ "Tankan Survey"

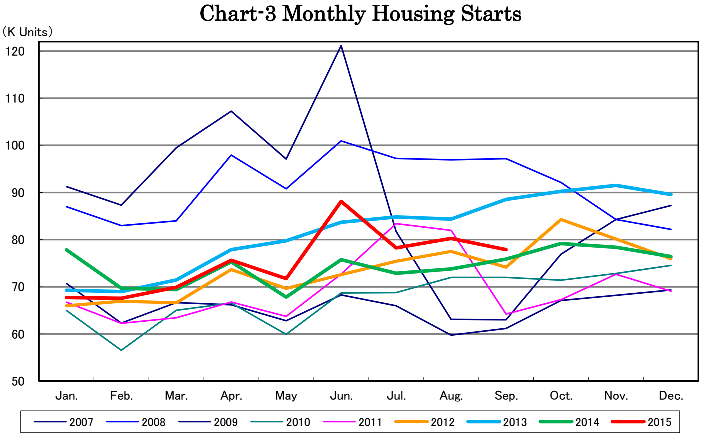
Chart-2 Japan GDP Growth Rates



Source: Economic and Social Research Institute, Cabinet Office, Government of Japan "Quarterly Estimate of GDP"
NLI Research Institute "Weekly Economist Letter" September, 2015.

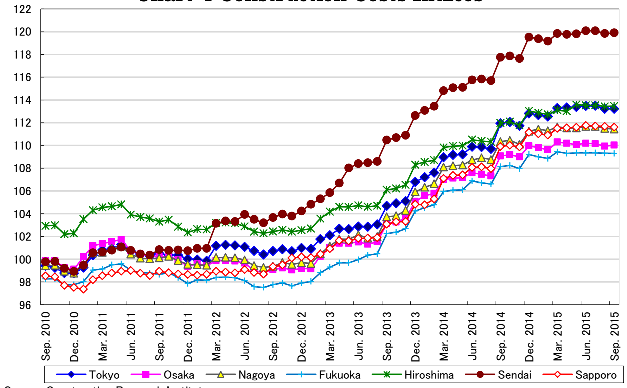
Housing starts posted a positive y-o-y growth for the fifth consecutive month to 77,872 units in September (Chart-3). Housing starts declined throughout 2014 suppressed by surging construction costs and the raised consumption tax rate. However, the construction cost increase has finally lost steam this year and housing starts have been recovering (Chart-4). Especially housing starts of apartments for lease have reached the peak volume that was seen in 2013 (Chart-5), reflecting the insistent demand by individual land owners to save on inheritance tax.

Chart-3 Monthly Housing Starts



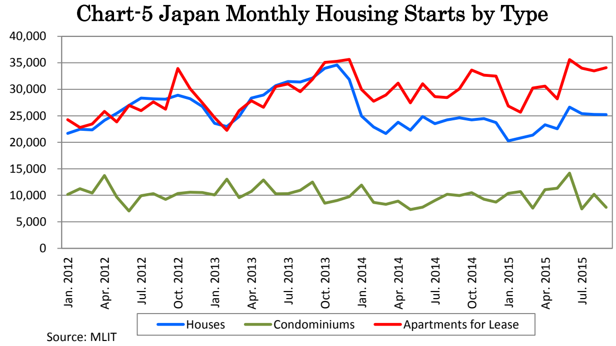
Source: MLIT

Chart-4 Construction Costs Indices



Source: Construction Research Institute

Chart-5 Japan Monthly Housing Starts by Type



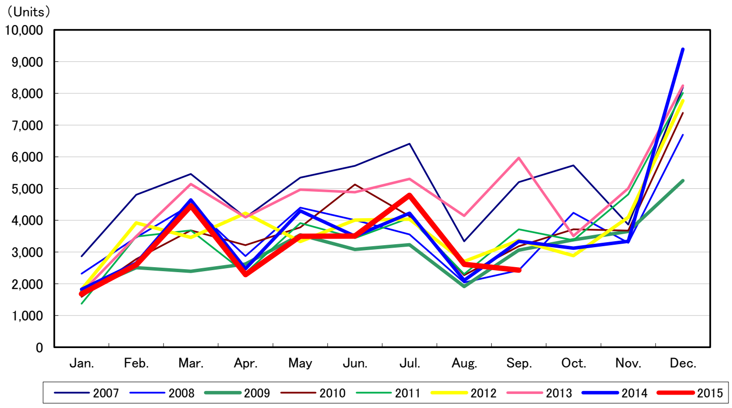
Source: MLIT

New condominium units sold in the Tokyo metropolitan area decreased by 27% y-o-y to 2,430 units in September following temporal increases in July and August (Chart-6). It looks like the pace of the rise in condominium prices overwhelms the growth in household income, and the sales number is struggling to grow.

Condominium prices in the secondary market continued to rise as Japan Real Estate Institute Home Price Indices in the Tokyo metropolitan area surged until August (Chart-7). According to Real Estate Information Network Systems, the average unit price in the secondary condominium market still rose in September by 3.6% y-o-y to 27 million JPY.

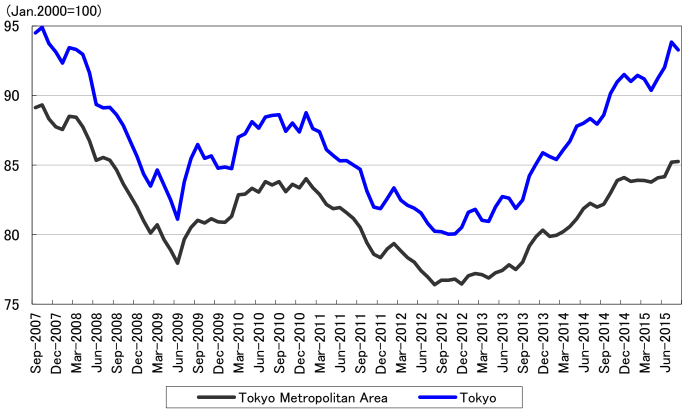
After being scarce due to high offering prices in 2014, the transaction volume of condominiums posted the fifth consecutive month of y-o-y growth in August, however, shrank again by 5.9% y-o-y in September (Chart-8).

Chart-6 Monthly New Condominium Units Sold (Tokyo Metropolitan Area)



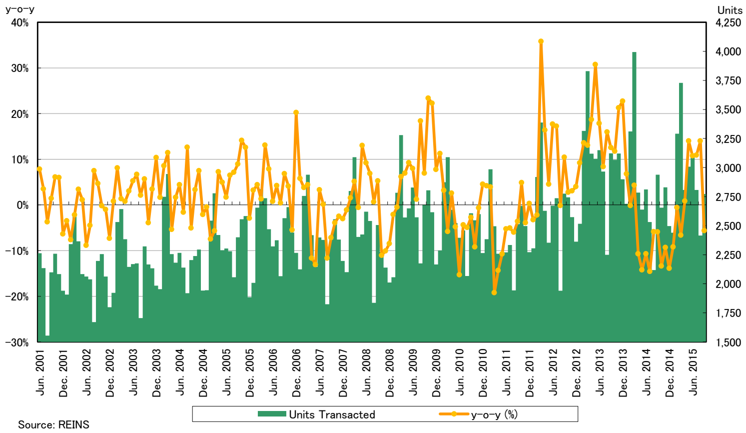
Source: Real Estate Economic Institute

Chart-7 JREI Home Price Indices



Source: Japan Real Estate Institute "Home Price Indices"

Chart-8 Secondary Condominium Transactions (Tokyo Metropolitan Area)



Source: REINS

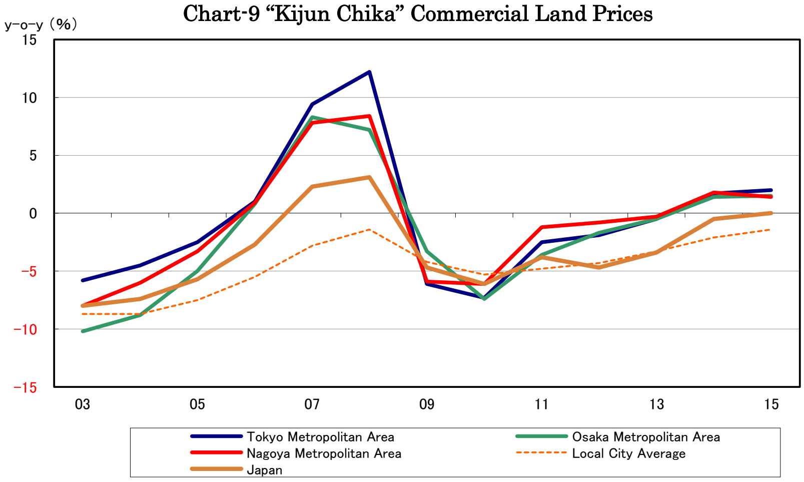
2. Land Prices

Regarding "Kijun Chika," national land prices as of July 1, 2014 by MLIT, land prices in the three major metropolitan areas of Tokyo, Osaka and Nagoya appreciated for the second consecutive year, with commercial and residential land prices posting 1.8% and 0.4% y-o-y respectively (Chart-9). However, land prices in other local cities still continued declining, with commercial and residential land prices posting -1.4% and -1.1% y-o-y respectively (Chart-9). The recovery in the three major metropolitan areas finally brought the declining of the national average commercial land price to a stop for the first time since 2008.

According to Nomura Real Estate Urban Net, the average residential land price in the Tokyo metropolitan area appreciated for the eighth consecutive quarter, posting 0.3% q-o-q growth (Chart-10). Residential land prices in the Tokyo 23 wards and greater Tokyo still rose by 0.7% and 0.9% q-o-q respectively, however, it looks like those in the surrounding prefectures of Kanagawa, Saitama and Chiba have already faced difficulties in rising.

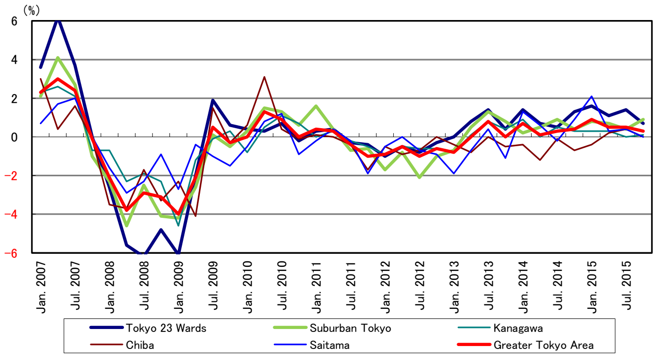
Among commercial land prices in the center of Tokyo, those in Ginza appreciated noticeably recovering to the level seen in 2008 (Chart-11).

Chart-9 "Kijun Chika" Commercial Land Prices



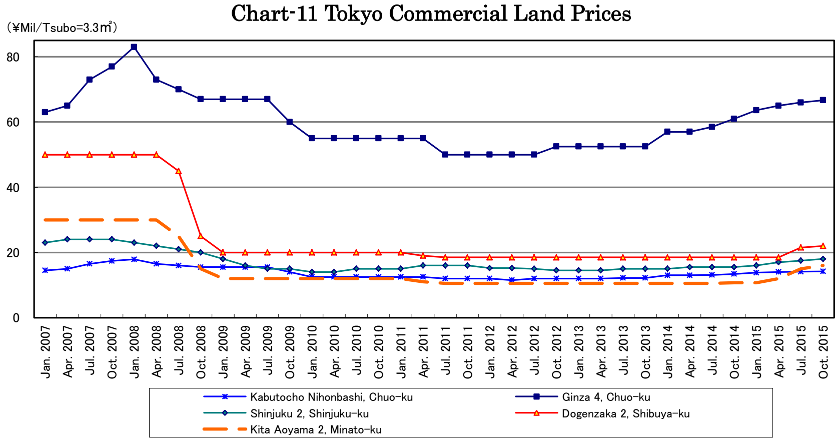
Source: MLIT

Chart-10 Tokyo Metropolitan Area Residential Land Prices



Source: Nomura Real Estate Urban Net

Chart-11 Tokyo Commercial Land Prices



Source: Nomura Real Estate Urban Net

3. Sub-sectors

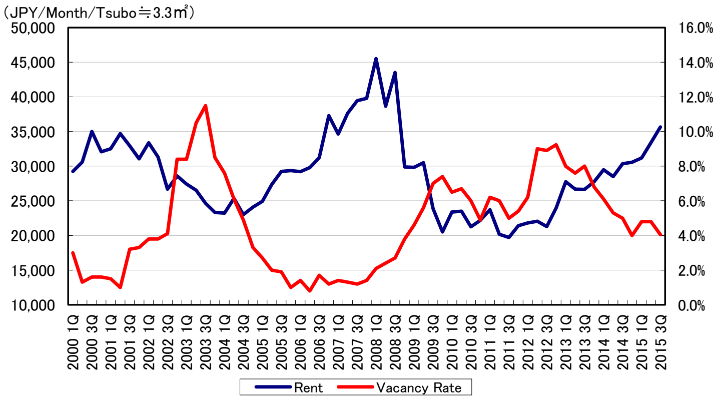
1) Office

Vacancy rates of Tokyo grade-A[1] offices and very large sized offices in the Tokyo major three wards improved by 0.8% and 0.3% q-o-q to 4.0% and 3.7%, respectively, in the third quarter (Chart-12). Moreover, the rising of Tokyo grade-A office rents accelerated, even at a high level, as the office rent index of Tokyo grade-A offices grew by 6.8% q-o-q to 35,652 JPY.

On the other hand, Tokyo grade-B office rents rose only mildly, even though the vacancy rates have improved to a very low level (Chart-13). It seems the market polarization has become increasingly noticeable these few years and more corporate tenants tend to focus on grade-A offices.

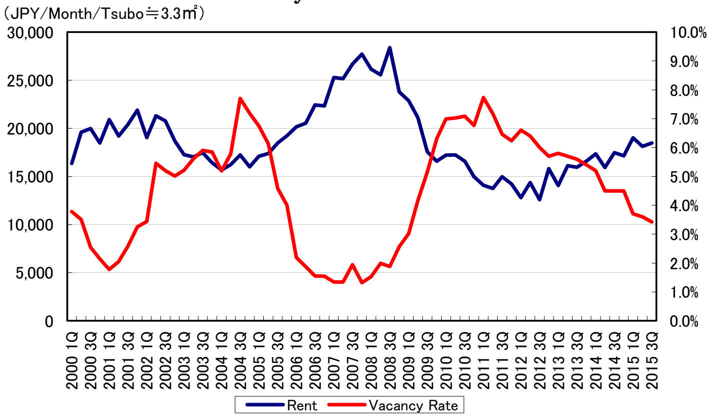
[1] Higher-spec buildings within the very large sized category by Sanko Estate Grade-A-Office Guidelines, urban area Tokyo five wards, main office areas and other specially integrated areas, with total floor areas of more than 33,000 m², main floor sizes of more than 990 m², building age of 15 years 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.

Chart-12 Tokyo Grade-A Office Market



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

Chart-13 Tokyo Grade-B Office Market

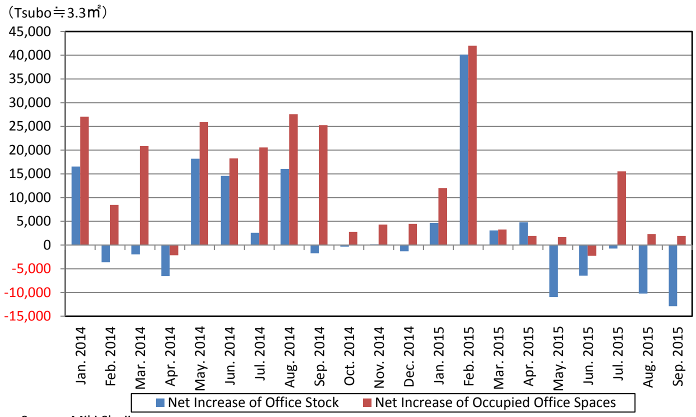


Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

The recent improvement of office vacancy rates has been based on the decrease in office stock, which is apparently different from when it was driven by increasing occupied spaces in 2013 and 2014 (Chart-14). The weak demand has also been noticeable in the new building market. Vacancy rates of new office buildings have outnumbered the peak in 2012 when new building supply swelled significantly (Chart-15). The supply volume this year has been much less than that which was seen in 2012, however, weak demand has made it difficult for new buildings to secure tenants before completion.

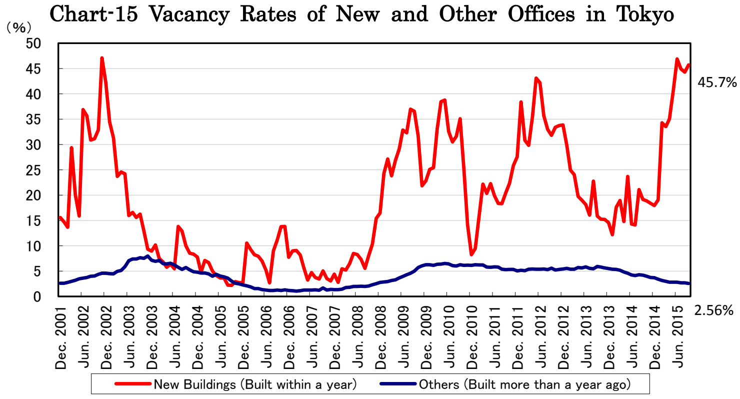
Though the low vacancy rates and rising rents are still explaining the strong market, the office demand has weakened affected by the equity market fluctuation from the end of August. From now on, considering the uncertain business conditions in China, the US interest rate hike and the raising of the domestic consumption tax, it has become increasingly difficult to expect the trend in rising office rent to continue.

Chart-14 Net Increase of Office Stock and Occupied Office Spaces in Tokyo Five Wards



Source: Miki Shoji

Chart-15 Vacancy Rates of New and Other Offices in Tokyo



Source: Sanko Real Estate

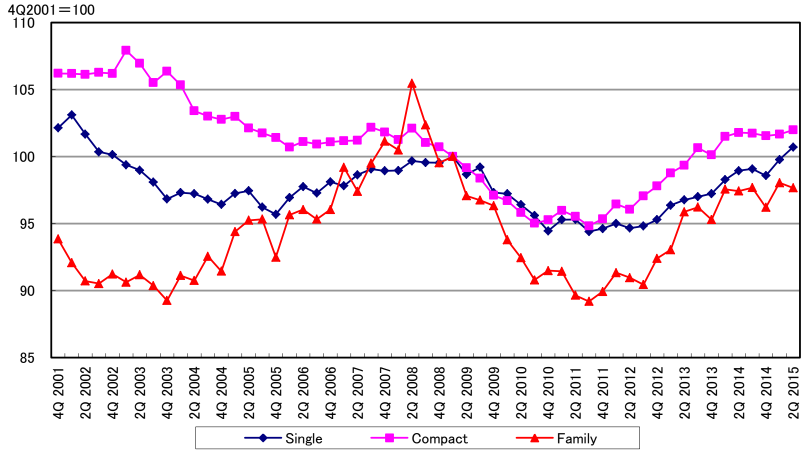
2) Residential Rental

Tokyo residential rents have been on a rising trend, though at a slower pace, since 2014. Contrary to family and compact type residential rents increasing at a milder pace, single type rents which had underperformed before have recently accelerated rising (Chart-16).

Rents are on the increase in central Tokyo, especially in Chiyoda and Chuo wards, though those in Shibuya and Shinjuku wards have been struggling to grow (Chart-17).

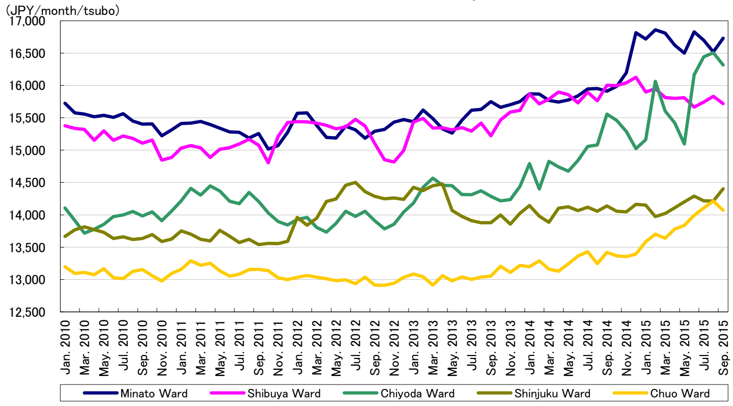
Regarding the Tokyo luxury residential rents in Minato, Setagaya and Shibuya wards, rents in Shibuya ward declined continuously after corrections in all three wards in the second quarter (Chart-18). Though the number of foreign residents in Tokyo increased for the third consecutive year in 2014 and is still increasing this year with 440k in October increasing from 417k and 433k in January and July respectively, increasing global business risks can have an effect on the luxury residential market.

Chart-16 Tokyo Residential Rent Index



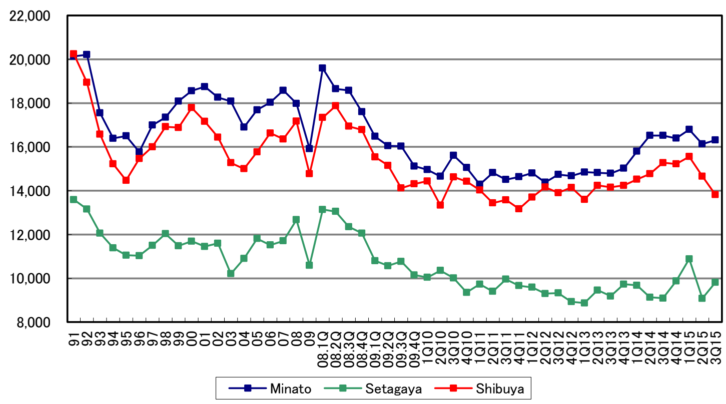
Source: Mitsui Sumitomo Trust Research Institute Co. Ltd. and At Home Co. Ltd.

Chart-17 Residential Rents in Tokyo Five Wards



Source: Leasing Management Consulting

(JPY/M. Tsubo≒3.3㎡) Chart-18 Tokyo Luxury Residential Rents



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

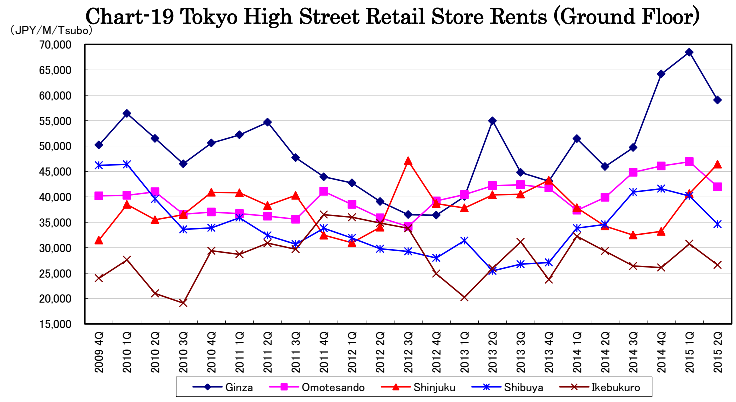
3) Retail, Hotel and Logistics

Despite retail store rents having shown some corrections (Chart-19), retail sales have been stable. The retail sales index by MLIT grew by 0.7% m-o-m to 104.6, posting the fifth consecutive month of positive growth, though some weakness has been noticed on automobiles, durable goods like air-conditioners and fuel products.

Same store sales of department stores and convenience stores grew for the sixth consecutive month posting a 1.8% and 1.3% y-o-y growth, respectively, in September (Chart-20).

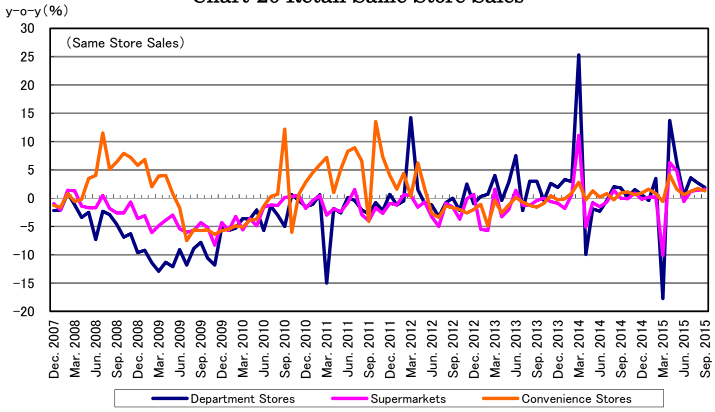
Department stores are especially benefiting from significant growth of duty free sales targeting foreigners. According to the Japan department store association, the number of foreign customers grew by 131.8% y-o-y and sales to foreign customers grew by 80% in September posting the thirty-second consecutive month of positive y-o-y growth.

Chart-19 Tokyo High Street Retail Store Rents (Ground Floor)



Source: Attractors Lab Co. and BAC Urban Project, Nikkei Real Estate Market Report

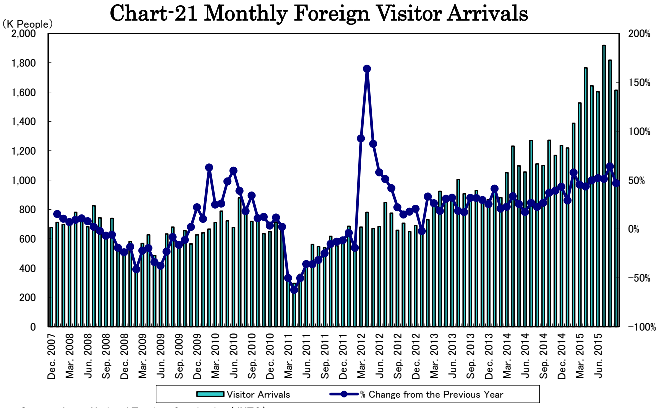
Chart-20 Retail Same Store Sales



Source: Ministry of Economy, Trade and Industry

Foreign visitor arrival numbers have accelerated increasing this year despite strong numbers in 2014, with a 46.7% y-o-y increase in September (Chart-21). The year to date number marked 14.48 million in September, which has already surpassed the total year number of 13.41 million in 2014. In particular, the number of Chinese visitors almost doubled, increasing by +99.6% in September. Considering active Chinese visitors during their long holiday season, the number in October should also be sizable.

Chart-21 Monthly Foreign Visitor Arrivals

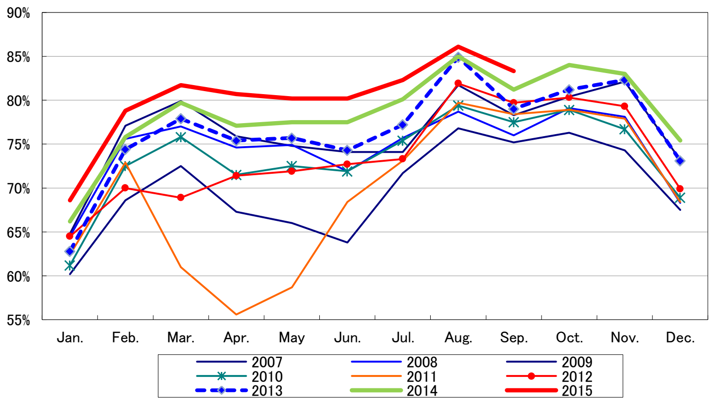


Source: Japan National Tourism Oganization (JNTO)

Hotels, which can benefit more from the foreign visitor increase than retail stores, have maintained the highest occupancy rates in recent years for every month this year (Chart-22).

According to Ota Publications, as hotel occupancy rates in Urayasu and Kyoto surpassed 95% in August and September, most hotel rooms were often fully reserved in many cities. Not only have occupancy rates increased but room-rates have also been raised, and according to STR Global, the RevPAR of Japanese hotels in August grew by +14.7% y-o-y to 16,455 JPY.

Chart-22 Hotel Occupancy Rates



Source: Ohta Publications "Weekly HOTERES"

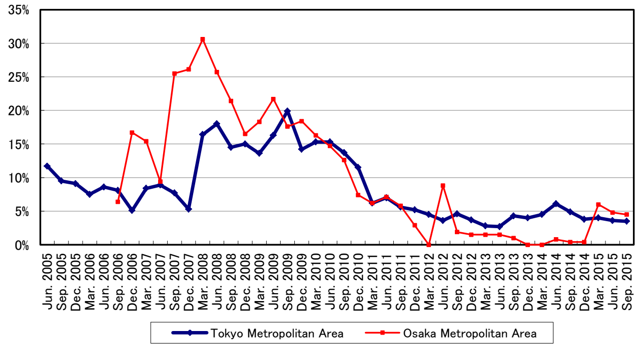
The logistics leasing market has been sustained by increasing demand. Vacancy rates of large logistics facilities for multi-tenants in the Tokyo and Osaka metropolitan area improved from 3.6% to 3.5% and from 4.8% to 4.5%, respectively (Chart-23).

Only one facility, Shinkiba Butsuryu Center, was completed in the Tokyo metropolitan area, and the modest supply pushed the vacancy rates down. On the other hand, a giant facility, GLP Naruohama with a GFA of 110,373m², was completed in the Osaka metropolitan area. However, strong demand absorbed the vacant spaces of new facilities completed in the first half of this year and the vacancy rates continued improving.

In the Tokyo metropolitan area, a gigantic volume of new supply is scheduled in the fourth quarter followed by a series of sizable new supply throughout 2016. Although strong demand is expected to absorb parts of the new supply, it seems that vacancy rates will continue to rise for the time being.

In the Osaka metropolitan area, no new supply is scheduled in the fourth quarter. However a sizable supply will come in the latter half of 2016 and vacancy rates will turn upward.

Chart-23 Logistics Facility Rents and Vacancy Rates (Large Sized Multi-Tenant-Use)



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

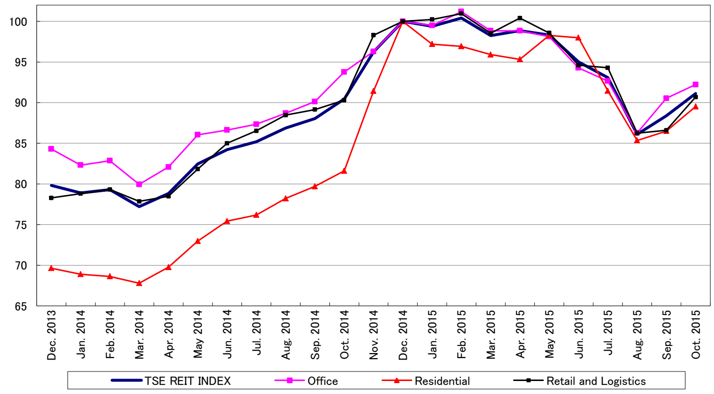
4. Property Investment and J-REIT Markets

The TSE REIT Index declined by 7.0% in the third quarter on the back of the uncertain business conditions in China and loosened liquidity by a series of public offerings. The office sector declined by 4.0%, residential by 11.7% and others – including retail and logistics – by 8.5% (Chart-24). At the end of September, the J-REIT market value was 10.0 trillion JPY, while the price to NAV ratio was 1.3 times and the dividend yield was 3.5%, with a 3.2% yield spread on ten year JGBs.

J-REITs acquired properties amounting to 340 billion JPY in the third quarter, totaling 1.2 trillion JPY in 2015. Despite high property prices making transaction activity difficult, the total acquisition amount has been larger than last year (Chart-25). Japan Senior Living Investment Corporation, as the third Japanese healthcare REIT, was listed with 14 assets of 28 billion JPY, bringing the number of J-REITs to 51.

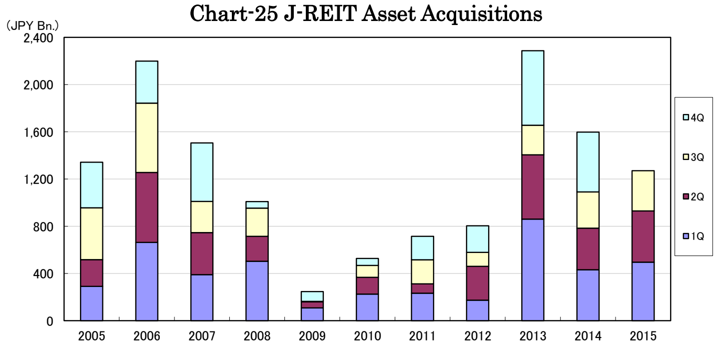
Net Operating Income of office buildings owned by J-REITs still declined by 0.9% h-o-h in the first half of 2015 even with rising office rents (Chart-26). Compared with the conditions when J-REIT's office NOI improved somewhat the last time from 2005 to 2008, the current pace of rent increase is slower, the areas where rents are rising are limited and J-REIT buildings have lost competitiveness to new buildings. Now that office demand has shown weakness, it has become more important for managers of J-REITs to work out how to improve the NOI of their office buildings regardless of the office rent trend.

Chart-24 TSE REIT Index



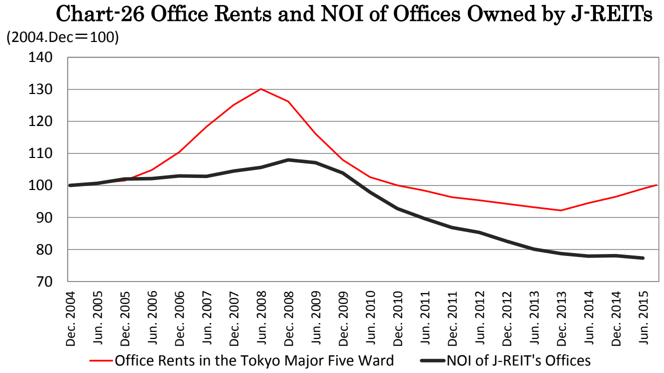
Source: Tokyo Stock Exchange

Chart-25 J-REIT Asset Acquisitions



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

Chart-26 Office Rents and NOI of Offices Owned by J-REITs

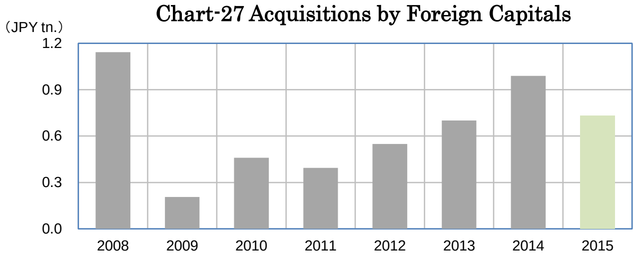


* Not including office buildings with less than 3 seasons of data
Source: Miki Shoji, J-REITs, NLI Research Institute

Transactions in the property investment market have been active this year as J-REITs have increased acquisitions (Chart-27). However, the total transaction amount this year has fallen short of that in 2014 when an exceptionally large amount of more than 5 trillion JPY in properties was transacted.

Foreign investors acquired Japanese properties aggressively at the beginning of this year including the case of Meguro Gajoen, however, the pace of acquisitions has since become more moderate. Considering the large amount acquired in the fourth quarter of 2014, the yearly amount acquired by foreign investors in 2015 will post a negative growth without very large acquisitions in the fourth quarter.

Chart-27 Acquisitions by Foreign Capitals



＊Consists of transactions larger than 1 bn JPY. 2015 includes data until the end of September.
Source: Real Capital Analytics www.rcanalytics.com

