NLI Research Institute May 18, 2016

Real Estate Analysis Report

Japanese Property Market Quarterly Review, First Quarter 2016

~Office Rents Rise Again, Foreign Visitor Arrivals Boost Hotels and Land Prices ~

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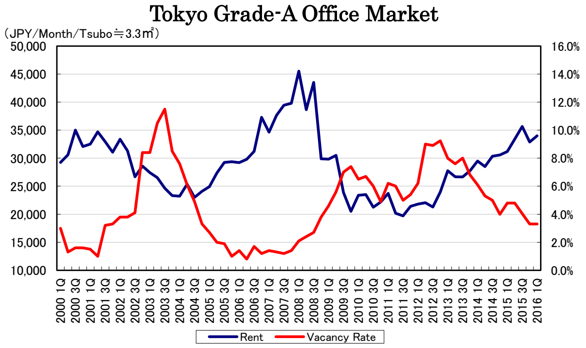
Summary

- Japan's real GDP grew only 0.7% with a lack of vigor in private consumption in 2015. While housing starts have recovered, the number of new condominium units sold are decreasing and the average price has been rising in the Tokyo metropolitan area. In "Kouji Chika" the average national land price appreciated y-o-y for the first time in eight years and the ratio of appreciating monitoring sites continuously increased.
- The rents of Tokyo Grade-A offices rose again in the first quarter after a dip affected by the large supply in the fourth quarter. Office vacancy rates remained low at 3.3%, however, finding a tenant seems time-consuming at the current high rent levels. Residential rents in Tokyo except Shibuya ward have apparently stopped rising. Foreign visitor arrivals in the past twelve months have reached 20 million since January and hotels have maintained high occupancy rates. Logistics vacancy rates rose on the large supply in the Tokyo metropolitan area despite healthy demand for large logistics facilities.
- The TSE REIT Index rose by 8.5% in the first quarter, affected by the decline of bond yields following the announcement of the negative interest rate policy by the Bank of Japan. The pace of property acquisition by J-REITs accelerated again after the significant slowdown in the fourth quarter.

Tokyo Grade-A Office Market



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

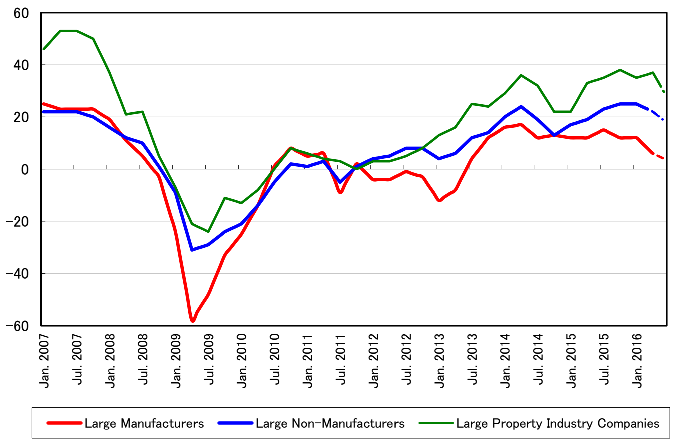
1. Economy and Housing Market

Japan's real GDP shrank by 0.3% y-o-y in the fourth quarter of 2015. While the employment situation has improved through labor shortages as a result of the declining and aging population, private consumption has been without vigor.

In the BOJ Tankan Survey, the current business confidence D.I. of large manufacturers and non-manufacturers deteriorated while that of the property industry improved a little, as it was expected to benefit from the negative interest rates. However, the three-month outlook declined noticeably in all categories (Chart-1).

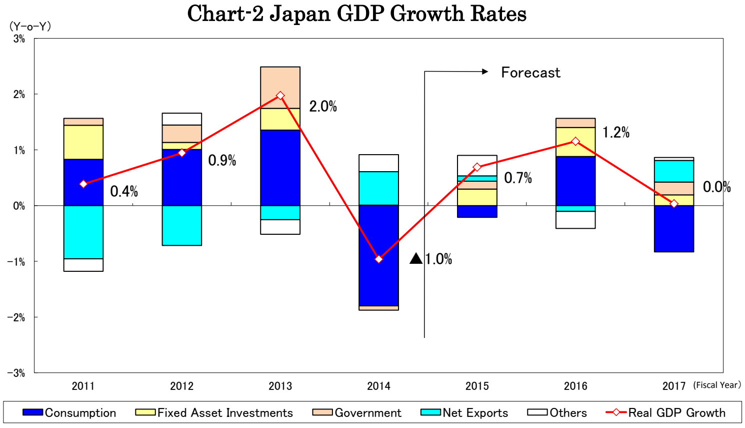
NLI Research Institute forecasted Japan's real GDP growth rates on March 8 at +0.7%, +1.2% and 0.0% for 2015, 2016 and 2017 respectively (Chart-2). These forecasts are based on the consumption tax rate hike scheduled in April 2017, and it is possible the numbers can be inflated in the case of postponement of the tax rate hike.

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" March, 2016.

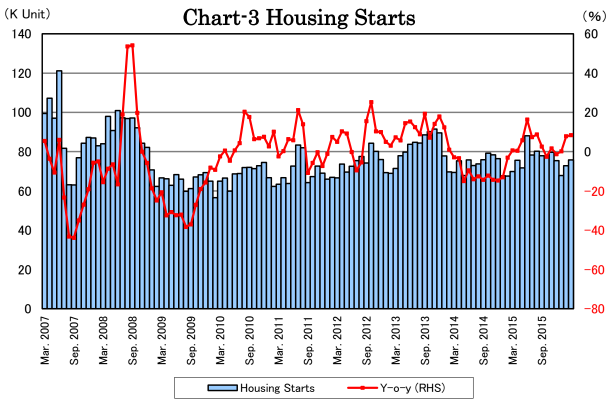
Housing starts have been growing y-o-y for the third consecutive month in 2016 after having recovered in 2015 from the stagnation following the consumption tax rate hike in April 2014 (Chart-3).

The number of new condominium units sold in the Tokyo metropolitan area shrank significantly in the first quarter to figures as small as those in 2009 just after the global financial crisis (Chart-4), and the fiscal year number for 2015 declined by 14.4% y-o-y. On the other hand, both average unit price and average price per tsubo appreciated y-o-y for the fourth consecutive fiscal year, led by luxury units in the center of Tokyo.

While new condominiums have been no longer affordable for most ordinary people, secondary condominiums have become increasingly popular. According to Real Estate Information Network Systems, the transaction volume in the secondary condominium market in the Tokyo metropolitan area increased by 3.4% y-o-y to 9,784 units in the first quarter, and the average price per square meter appreciated by 5.5% y-o-y to 477.8 k JPY (Chart-5).

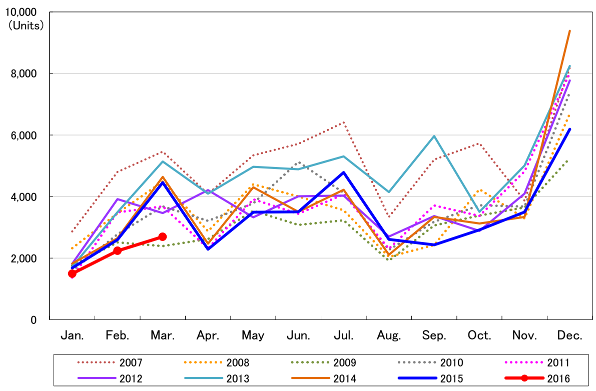
Construction costs have still remained high, despite having peaked out in the first half of 2015 (Chart-6). Although the prices for secondary condominiums should not be directly affected by construction costs, they have still appreciated significantly and are no longer considered reasonable.

Chart-3 Housing Starts



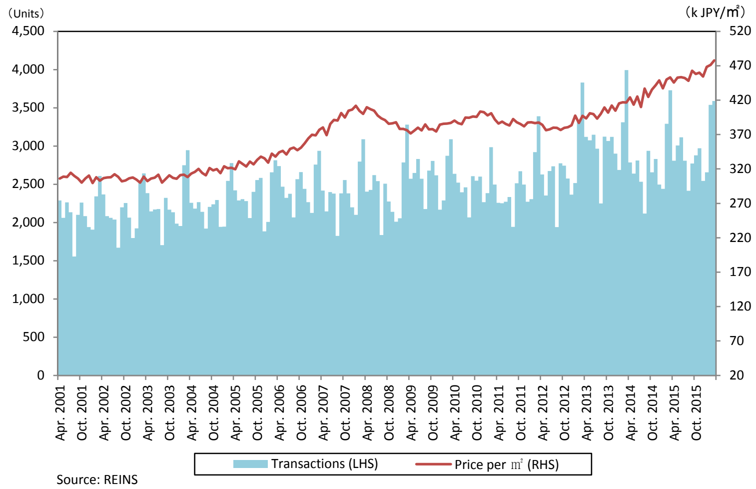
Source: MLIT

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



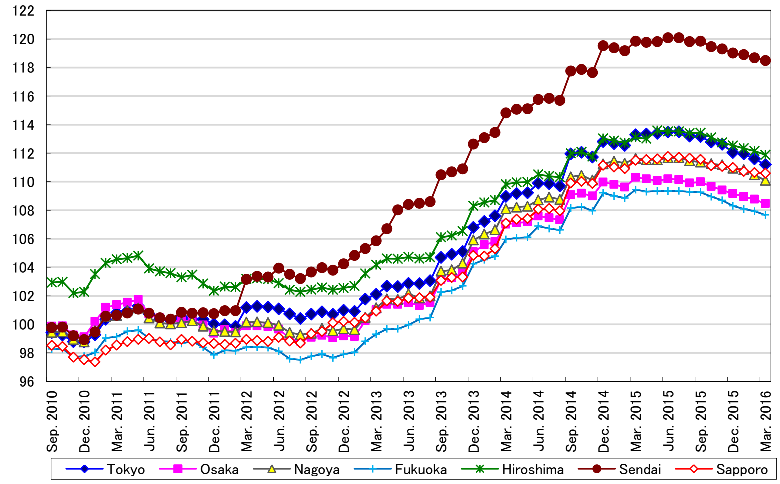
Sourc: Real Estate Economic Research Institute

Chart-5 Transaction Volumes and Prices of Secondary Condominiums



Source: REINS

Chart-6 Construction Cost Indices



Source: Construction Research Institute

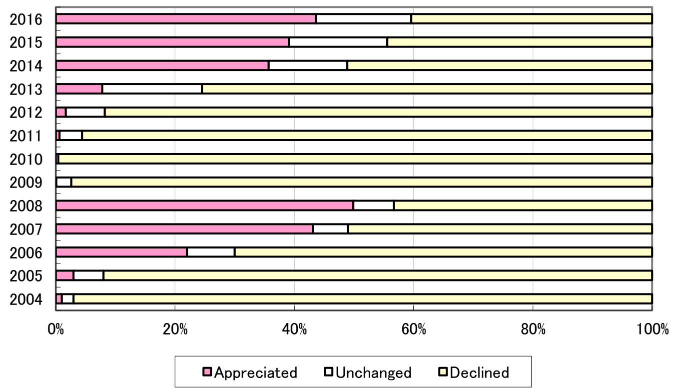
2. Land Prices

Regarding "Kouji Chika," national land prices as of January 1, 2016, the average national land price appreciated by 0.1% y-o-y for the first time in eight years. The ratio of depreciating monitoring sites decreased for both commercial and residential land. The ratio of depreciating monitoring sites for commercial land dropped below that of the previous peak in 2008. While the average land prices in the major three metropolitan areas and other four large cities, Sapporo, Sendai, Hiroshima and Fukuoka, posted positive growth, the average land price of all local areas still depreciated.

Commercial land prices in Osaka performed outstandingly, benefitting from inbound demand for retail stores, as Shinsaibashi and Dotonbori performed the best and the second best in Japan, appreciating by 45.1% and 40.1% y-o-y respectively.

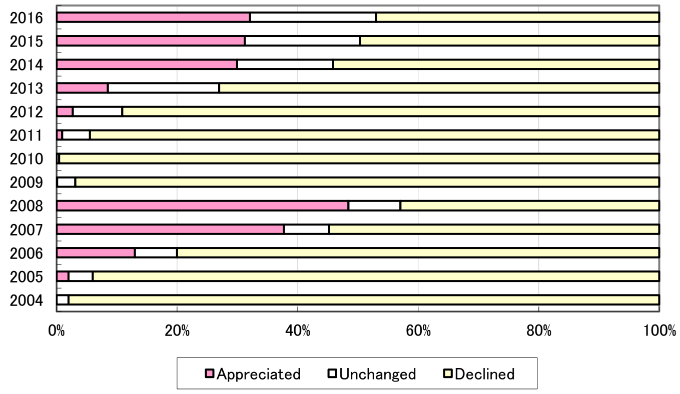
Residential land prices in areas popular among foreigners also performed well. Niseko in Hokkaido, a popular resort among Australians and Chinese, performed the best among residential land in Japan appreciating by 19.7% y-o-y.

Chart-7 Ratio of Price Change of Commercial Land Nationwide



Source: MLIT

Chart-8 Ratio of Price Change of Residential Land Nationwide



Source: MLIT

3. Sub-sectors

1) Office

The rent index of Tokyo grade-A[1] offices rose by 3.4% q-o-q and 9.1% y-o-y to 33,995 JPY per month per tsubo in the first quarter (Chart-9). Though constrained by large new supply in the fourth quarter, the increasing trend of office rents in Tokyo since 2012 still looks alive.

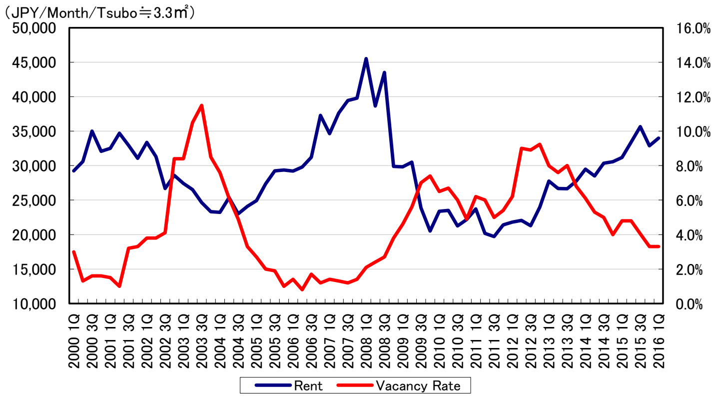
The vacancy rates of Tokyo grade-A offices remained unchanged at 3.3% in the first quarter, however, finding a tenant seems to have become time-consuming at the current high rents.

The rent index of Tokyo grade-B[2] offices also rose by 9.4% q-o-q to 19,971 JPY per month per tsubo and the vacancy rates improved to 3.0% for the fifth consecutive quarter (Chart-10). Office markets have been improving nationwide as vacancy rates in major local cities excluding Sendai continued to decrease (Chart-11).

[1] Higher-spec buildings within the very large sized category of the Sanko Estate Grade-A-Office Guidelines, urban area five wards of Tokyo, 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.

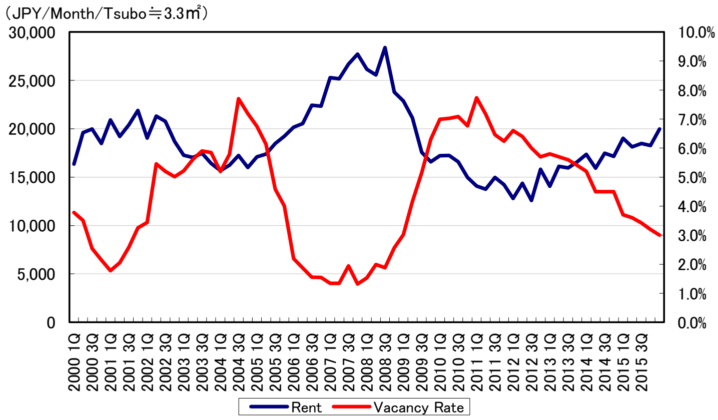
[2] Buildings with main floor sizes of more than 660 m² excluding Grade-A.

Chart-9 Tokyo Grade-A Office Market



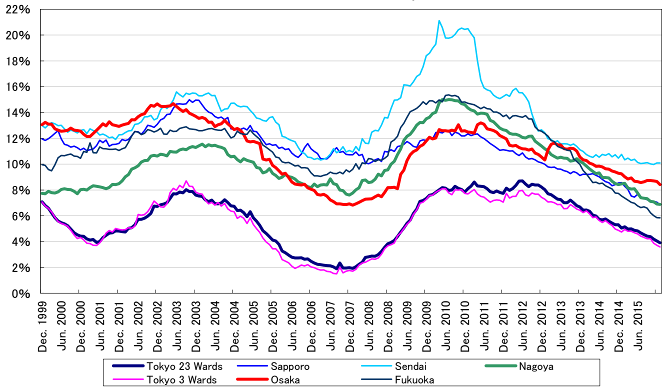
Source: Vacancy Rate・Sanko Estate, Rent・Sanko Estate and NLI Research Institute

Chart-10 Tokyo Grade-B Office Market



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

Chart-11 Office Vacancy Rates



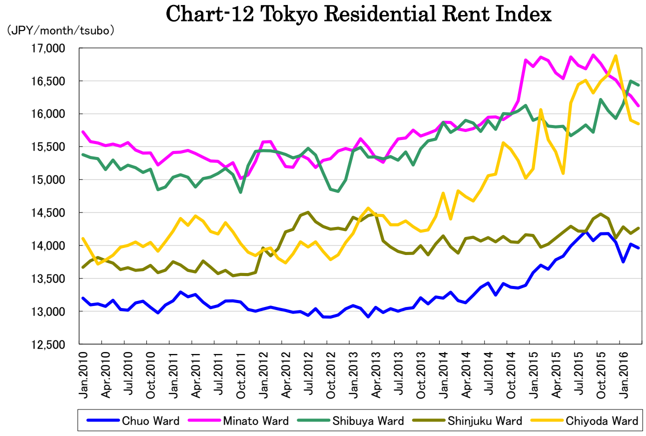
Source: Sanko Estate

2) Residential Rental

Residential rents in the five major wards of Tokyo have apparently stopped rising excluding Shibuya ward in 2016, terminating the rising trend since 2012 (Chart-12).

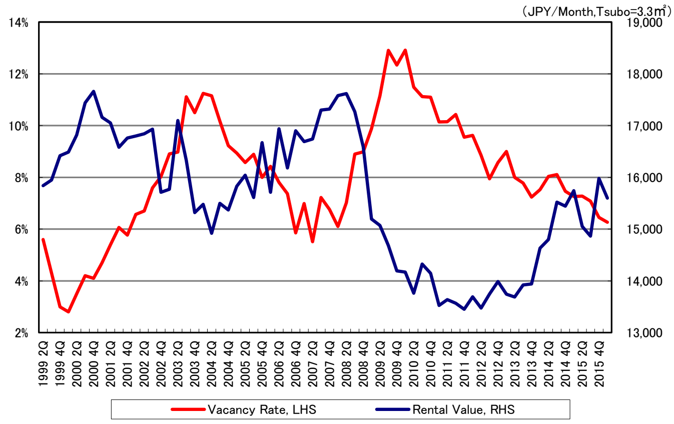
Vacancy rates of Tokyo luxury apartments decreased to 6.27% in the first quarter (Chart-13). The current rents at 15,601 JPY per tsubo per month is lower than those at 17,850 JPY in the first quarter 2008 when vacancy rates were at the same level. The current lower rents should be attributed to the smaller number of high-salaried expats.

Chart-12 Tokyo Residential Rent Index



Source: Leasing Management Consulting

Chart-13 Tokyo Luxury Residential Market



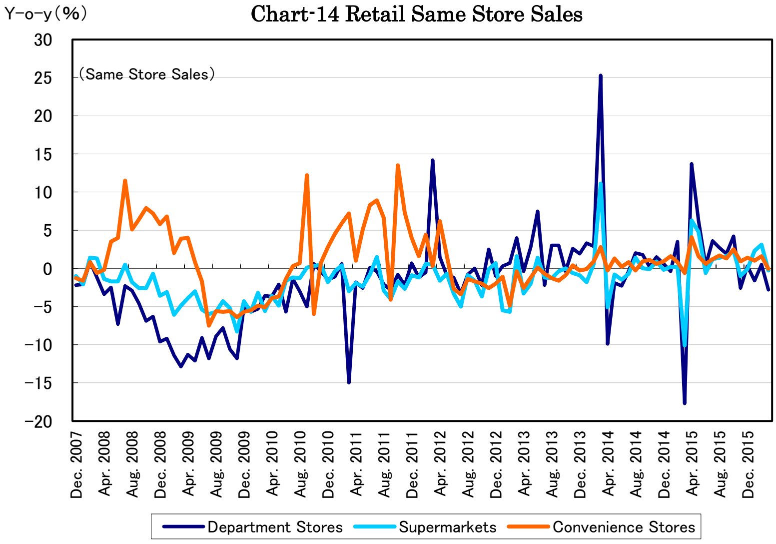
*Sample consists of contracts with more than 300K JPY/Month, tsubo rental value or 30 tsubo space.
Source: Ken Real Estate Advisors Ltd.

3) Retail, Hotel and Logistics

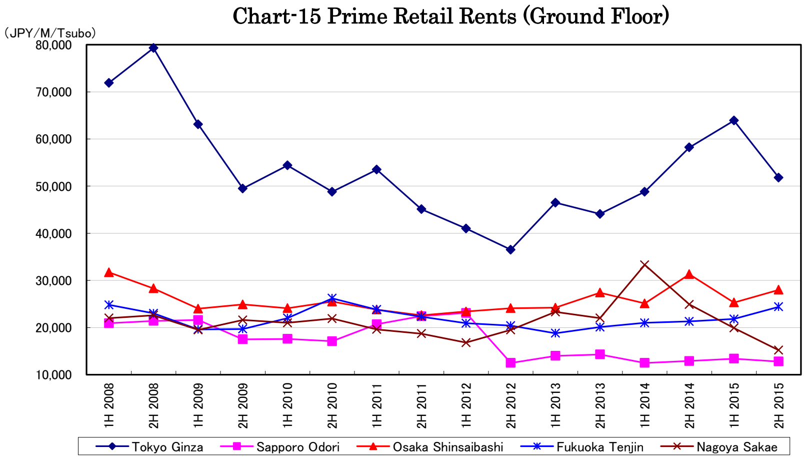
Same store sales of department stores, supermarkets and convenience stores remained stable shrinking somewhat y-o-y in March (Chart-14).

Prime retail rents in Tokyo Ginza dropped in the second half of 2015 though the rents still remained much lower than those of the previous peak in 2008.

Prime retail rents in other major local cities such as Shinsaibashi, Osaka and Tenjin, Fukuoka have been rising.



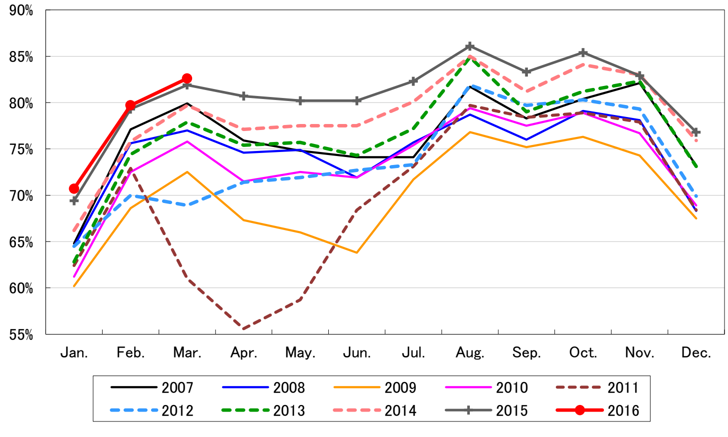
Source: Ministry of Economy, Trade and Industry



Source: Attractors Lab Co. and BAC Urban Project, Japan Real Estate Institute

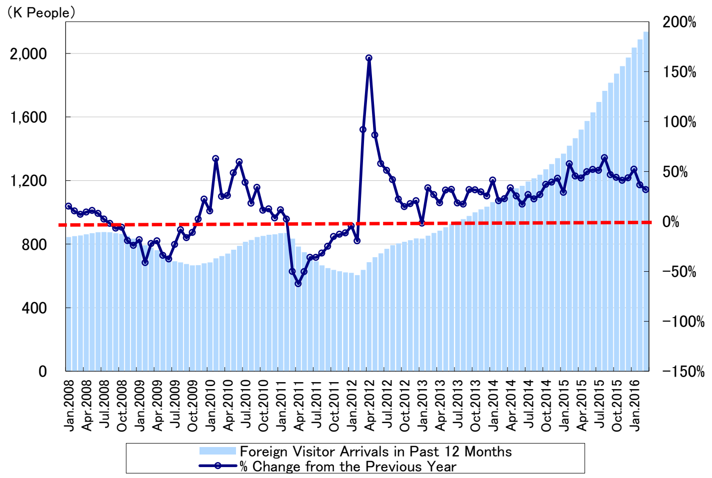
Foreign visitor arrivals in the past twelve months have reached 20 million people since January (Chart-16). The pace of increase accelerated in 2015 boosted by the JPY depreciation. Thanks to this trend, hotels have maintained high occupancy rates. Hotel occupancy rates in 61 cities nationwide improved by 0.7% y-o-y to 82.6% in March (Chart-17). Acquisitions of existing hotels and development of new hotels have both increased and transaction prices for hotels have been rising. The number and floor area of construction starts for hotels and ryokans increased by 34% and 40% y-o-y respectively in 2015, albeit still smaller than those from 2005 to 2008 (Chart-18).

Chart-16 Hotel Occupancy Rates



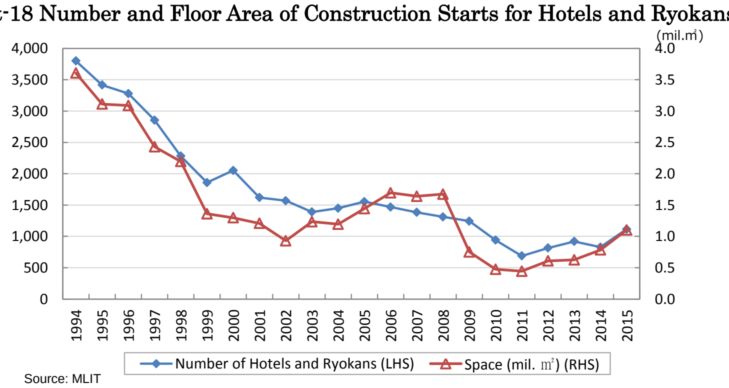
Source: Ohta Publications "Weekly HOTERES"

Chart-17 Foreign Visitor Arrivals in Past 12 Months



Source: Japan National Tourism Oganization (JNTO)

Chart-18 Number and Floor Area of Construction Starts for Hotels and Ryokans



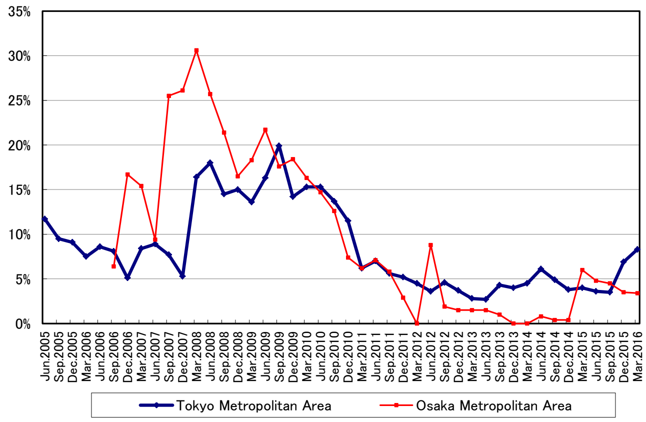
Source: MLIT

According to CBRE, the vacancy rates of large logistics facilities designed for multiple tenants in the Tokyo metropolitan area increased by 1.4% q-o-q to 8.3%, the highest since the fourth quarter of 2010 (Chart-19). New supply as large as 120 thousand tsubo overwhelmed healthy demand for large facilities, while vacancy rates of logistics facilities completed more than a year ago remained at 1.7%. The vacancy rates may increase further based on the continuous new supply as large as 130 thousand tsubo and 90 thousand tsubo expected in the second and the third quarter respectively.

The vacancy rates of large logistics facilities designed for multiple tenants in the Osaka metropolitan area decreased by 0.1% q-o-q to 3.4%. The vacancy rates will certainly increase in the second half, pressed by the largest ever 80 thousand tsubo of new supply expected in the third quarter.

Constrained by the massive supply, the average logistics rent should be lower in both the Tokyo and Osaka metropolitan areas. However, logistics rents have been rising and are expected to remain stable in specific areas where new facilities are rare and multiple consumer markets are accessible such as in areas along the Outer Ring Road and Kyoto.

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



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

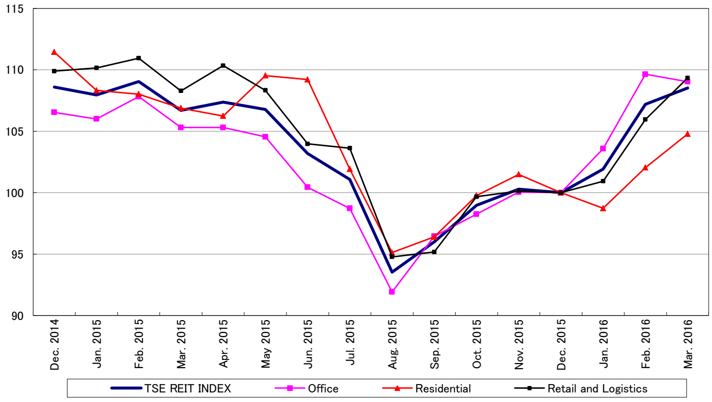
4. J-REIT and Property Investment Markets

The TSE REIT Index rose by 8.5% in the first quarter, affected by the decline of bond yields following the announcement of the negative interest rate policy by the Bank of Japan. The office sector rose by 9.0%, residential sector by 4.8% and other sectors – including retail and logistics – by 9.3% (Chart-20). At the end of March, the J-REIT market value was 11.7 trillion JPY, while the price-to-NAV ratio was 1.3 times and the dividend yield was 3.3% with a 3.3% yield spread on 0% of ten year JGBs.

J-REITs acquired properties amounting to 550 billion JPY in the first quarter increasing by 11% y-o-y (Chart-21). The pace of acquisition by J-REITs slowed down significantly in the fourth quarter, however, it has accelerated again. Lasalle Logiport REIT was listed with 8 assets valued at 161 billion JPY, and the number of J-REITs increased to 53.

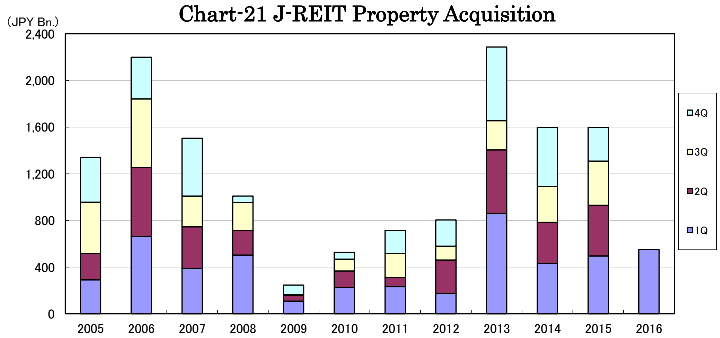
The negative interest rates can lead to incremental dividends of J-REITs. The average interest rate on existing debts of J-REITs is 1.2% and the current interest rate on a new debt for J-REITs is 0.7%. Considering that refinancing can reduce the average interest rate on debts of J-REITs by 0.5%, J-REITs can increase their dividends by 9%.

Chart-20 TSE REIT Index (Dec.2015=100)



Source: Tokyo Stock Exchange

Chart-21 J-REIT Property Acquisition



*Assets of new J-REITs are included at IPO
Source: NLI Research Institute

According to Nikkei Real Estate Market Information, foreign funds and J-REITs noticeably sold their properties at high prices in the first quarter. However, it looks like foreign funds sold only minor properties and intend to hold large-sized core assets. Japanese developers, construction companies and other sector companies have been noticed as main buyers, while foreign funds acquired only small properties shifting to the suburbs. As a representative deal, Nippon Tochi-Tatemono acquired two properties in Toranomon, Tokyo, where integrated redevelopment has been underway.

Under the negative interest rate policy, property investment yields can be even lower, however, prime properties are held tight and are seldom seen for sale. In order to secure certain investment yields, investors have to consider properties in suburban locations or non-core sectors.

