Real Estate Analysis Report

Japanese Property Market Quarterly Review, Third Quarter 2016

~Inbound Demand Peaks Out Affecting Retail Stores and Hotels~

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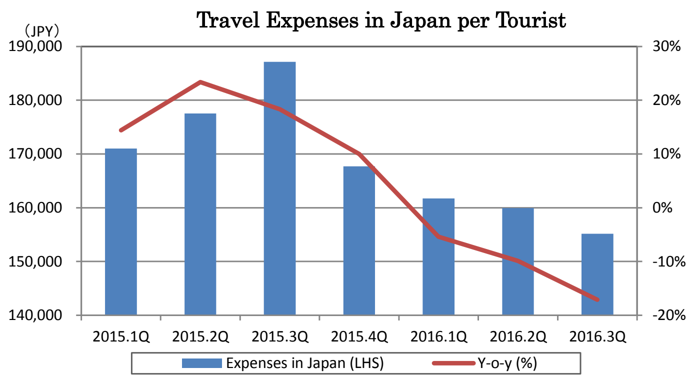
Summary

- Japanese real GDP maintained a positive q-o-q growth for the third consecutive quarter. Housing starts of apartments for lease have grown strongly. The average residential land price in the Tokyo metropolitan area has shown a leveling off.
- Tokyo grade-A office rents have rebounded in a downward trend from the third quarter 2015. Tokyo residential rents have still been on a rising trend, though at a slower pace.
- Foreign visitor arrivals continue to grow at a pace of about +20% y-o-y, however, consumption by foreign visitors in Japan has shrunk significantly. Retail sales have declined, pulled by shrinking duty-free sales in department stores. The increase of foreign visitors has no longer driven hotel demand. The logistics leasing market has faced huge supply both in the Tokyo and Osaka metropolitan areas.
- The TSE REIT Index did not change much while waiting for the comprehensive review of the Bank of Japan's policies. Despite aggressive acquisitions by J-REITs, other investors have reduced their activities drastically.



*Excluding flight expenses to Japan
Source: Japan Tourism Agency

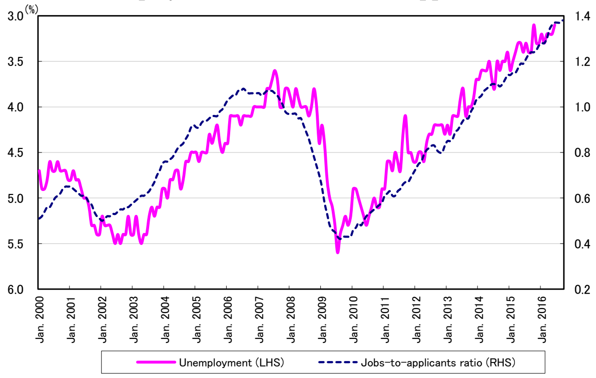
1. Economy and Housing Market

Japanese real GDP maintained a positive q-o-q growth for the third consecutive quarter. However, domestic demand has been weak on the whole and GDP growth in the third quarter was mostly attributed to the increase of net exports driven by IC exports to Asia for new smartphone models and resilient automobile exports to the U.S.

Positive GDP growth is expected to continue for the moment backed by the recovery in private consumption given the good employment environment (Chart-1), though net exports will not be reliable affected by uncertain global economic conditions. In the BOJ Tankan Survey in the third quarter of 2016, the D.I. of all three categories, large manufacturers, large non-manufactures and large property industry companies, are forecasted to maintain certain positive degrees in the fourth quarter (Chart-2).

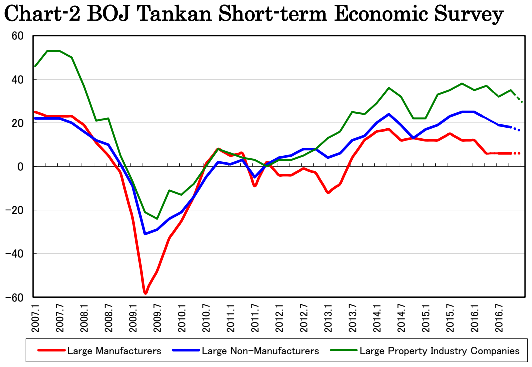
NLI Research Institute revised its Japanese GDP growth forecast up by 0.2% to +0.9% for the fiscal year 2016 and forecasts +0.7% for 2017, reflecting the latest numbers from the Cabinet Office.

Chart-1 Unemployment rate and Jobs-to-Applications Ratio



Source: MIC "Employment Report", MHLW "Job introduction」

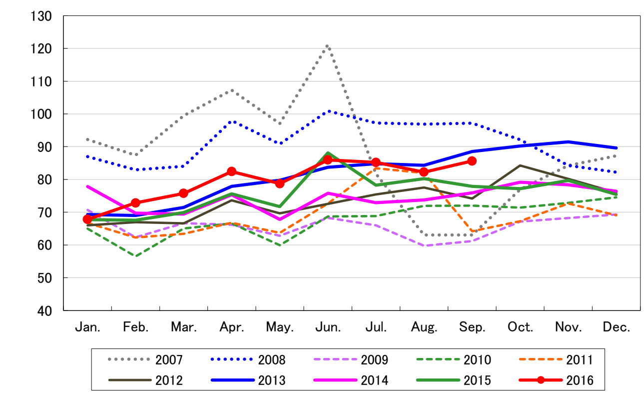
Chart-2 BOJ Tankan Short-term Economic Survey



Source: BOJ "Tankan Survey"

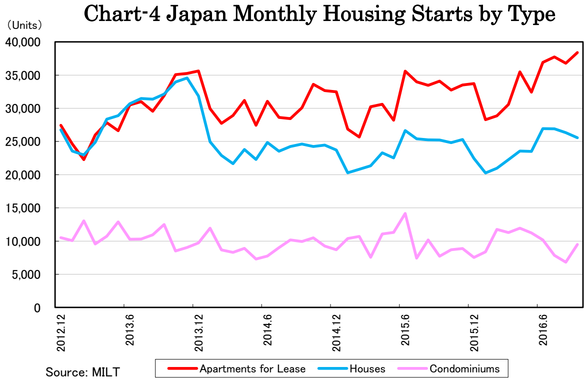
Housing starts posted a positive y-o-y growth for the third consecutive month to 85,622 units in September (Chart-3). Housing starts of apartments for lease have grown strongly (Chart-4) backed by insistent demand from individual land owners to save on inheritance tax, and additionally pushed by aggressive banking loan activities and stabilizing construction costs (Chart-5). However, housing starts of condominiums remain under the 10-year average and those of houses have peaked out with the anticipated rush demand disappearing following the postponement of the consumption tax hike originally scheduled for April 2017.

Chart-3 Monthly Housing Starts



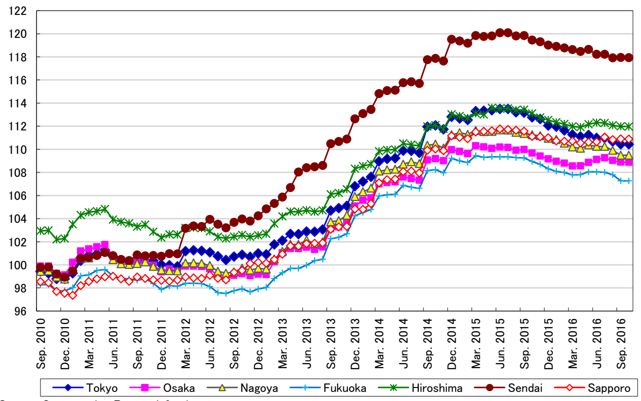
Source: MLIT

Chart-4 Japan Monthly Housing Starts by Type



Source: MILT

Chart-5 Construction Costs Indices

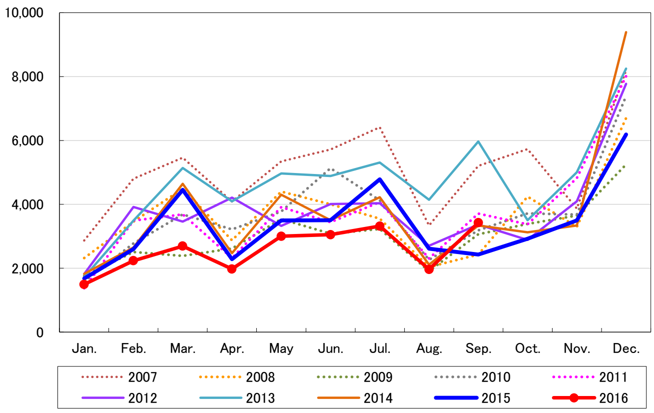


Source: Construction Research Institute

New condominium units sold in the Tokyo metropolitan area posted a positive y-o-y growth for the first time in ten months to 3,424 units in September (Chart-6). It looks like sizable projects originally targeting the rush demand before the consumption tax hike sold well. However, most of the sold projects are located outside of Tokyo, as units sold in Kanagawa prefecture increased by 50.9% y-o-y.

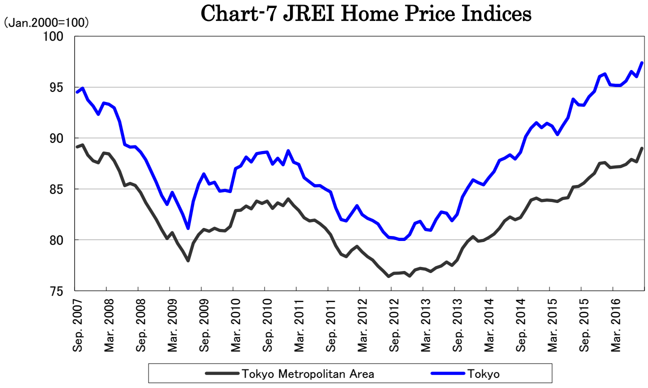
Condominium prices in the secondary market continued to rise as the average unit price in the Tokyo metropolitan area rose by 5.7% y-o-y to 31.3 million JPY in September, according to Real Estate Information Network Systems. Furthermore, Japan Real Estate Institute Home Price Indices, the repeat sales method index, also continued to rise (Chart-7).

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



Source: Real Estate Economic Institute

Chart-7 JREI Home Price Indices



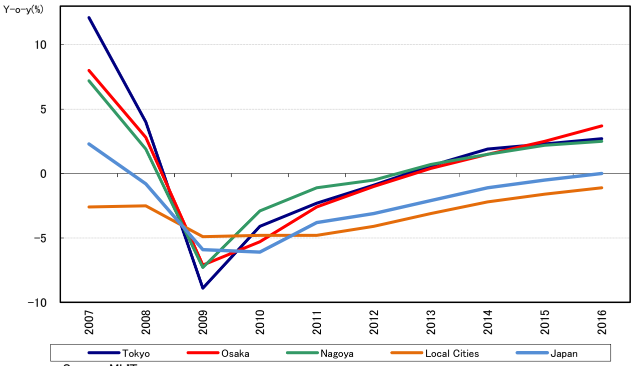
Source: Japan Real Estate Institute "Home Price Indices"

2. Land Prices

Regarding "Kijun Chika," national land prices as of July 1, 2016 by MLIT, the average commercial land price remained unchanged y-o-y for the first time since 2007 (Chart-8). Those in the three major metropolitan areas of Tokyo, Osaka and Nagoya accelerated, appreciating by 2.9% y-o-y from 2.3% in the previous year, and those in local cities alleviated, declining by 1.1% y-o-y from 1.6% in the previous year.

However, regarding residential and industrial land, land price appreciations in the three metropolitan areas could not compensate for decline in local cities. Thus, decline continued in the average national land price for all usage at 0.6% y-o-y.

Chart-8 "Kijun Chika" Commercial Land Prices

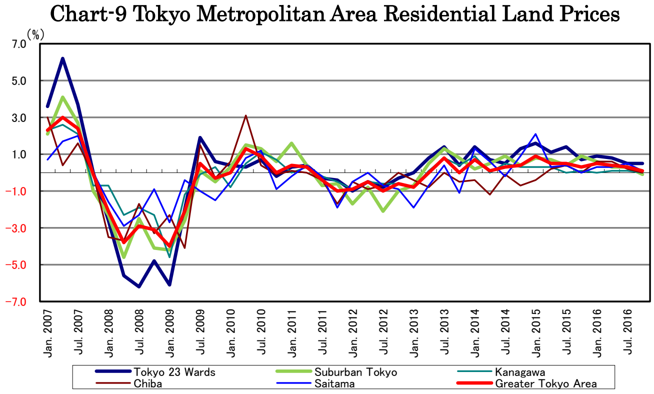


Source: MLIT

Despite the improving y-o-y numbers for land prices, q-o-q numbers have already shown a leveling off. According to Nomura Real Estate Urban Net, the average residential land price in the Tokyo metropolitan area was largely unchanged, posting 0.1% q-o-q growth (Chart-9). Though residential land prices in the Tokyo 23 wards maintained appreciation of 0.5% q-o-q, those in the surrounding prefectures; Kanagawa, Saitama and Chiba, have sidelined, and those in greater Tokyo even declined by 0.5% y-o-y.

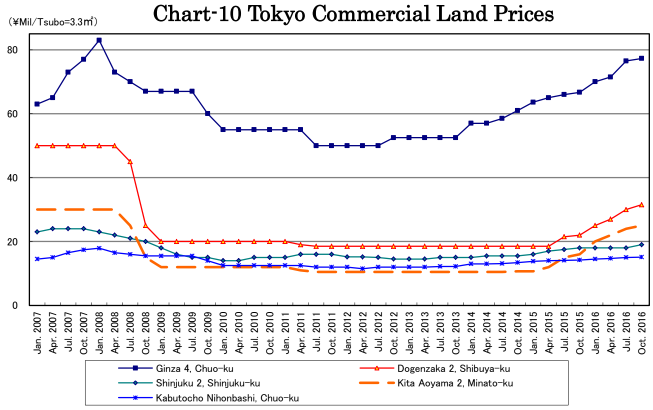
Among commercial land prices in the center of Tokyo, those in Ginza have noticeably appreciated, recovering to the level seen in 2008 (Chart-10). However, those in Osaka have remained far from the peak in 2007 (Chart-11).

Chart-9 Tokyo Metropolitan Area Residential Land Prices



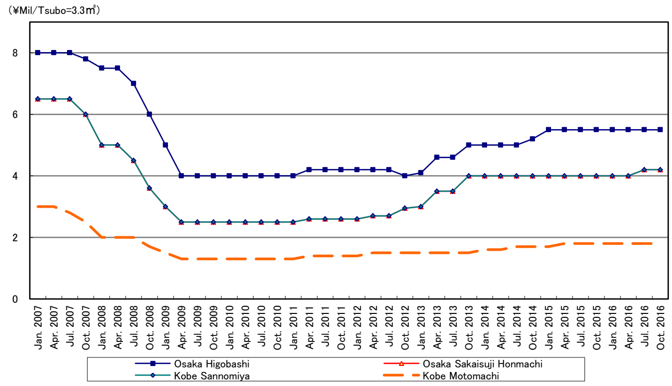
Source: Nomura Real Estate Urban Net

Chart-10 Tokyo Commercial Land Prices



Source: Nomura Real Estate Urban Net

Chart-11 Osaka and Kobe Commercial Land Prices



Source: Nomura Real Estate Urban Net

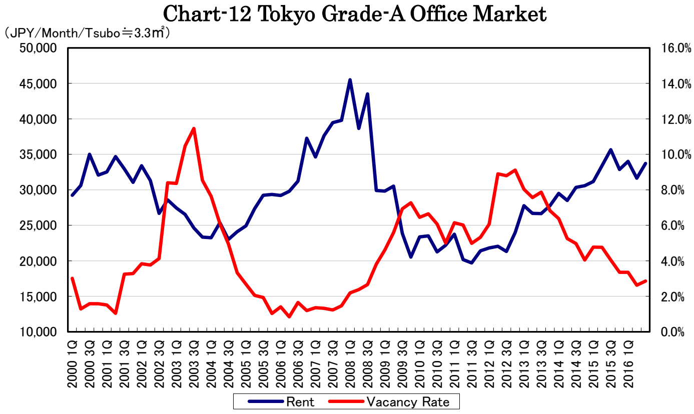
3. Sub-sectors

1) Office

Vacancy rates of Tokyo grade-A[1] offices and very large-sized offices in the Tokyo major three wards deteriorated by 0.3% and 0.5% q-o-q to 2.9% and 2.6% respectively in the third quarter, (Chart-12) affected by the completion of Sumitomo Fudosan Roppongi Grand Tower with about a 60% occupancy rate. The office rent index of Tokyo grade-A offices grew by 6.5% q-o-q to 33,703 JPY, however, and appears to be rebounding in a downward trend from the third quarter 2015.

The new grade A office supply affected the grade B office market as well, deteriorating vacancy rates by 0.1% q-o-q to 2.65% and pushing the rent index to decline by 0.4% q-o-q to 19,273 JPY (Chart-13).

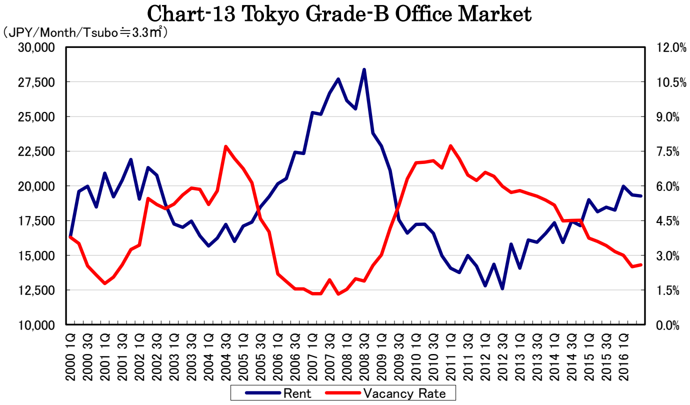
Chart-12 Tokyo Grade-A Office Market



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

[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 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.

Chart-13 Tokyo Grade-B Office Market

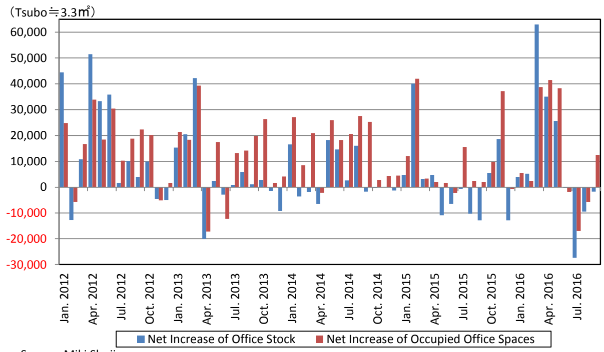


Source: Vacancy Rate･Sanko Estate, Rent･Sanko Estate and NLI Research Institute

Occupied office space increased substantially in the first half of 2016 (Chart-14) with several skyscrapers completing at fully leased or at high occupancy rates. However, new demand has disappeared with little supply since June, which suggests the improvement of vacancy rates was not brought by strong office demand but by decrease of the office stock.

The current grade-A office demand mainly relies on moves relating to group consolidations. Companies considering group consolidation do not have to move immediately and tend to wait for the next supply swelling from 2018. Thus, even at very low vacancy rates, office rents have declined in advance of vacancy rate increase.

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



Source: Miki Shoji

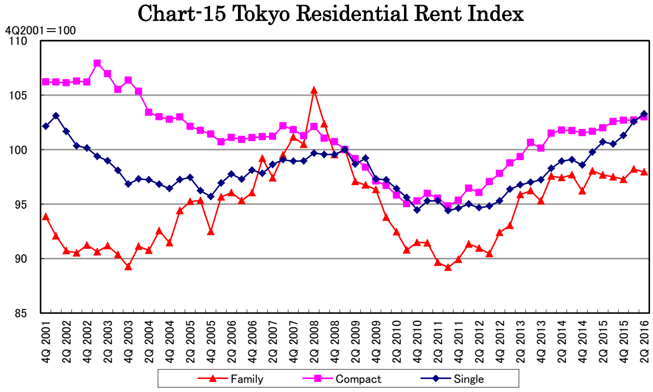
2) Residential Rent

Tokyo residential rents have still been on a rising trend, though at a slower pace, since 2014. Contrary to family and compact type residential rents rising at a milder pace, single type rents which had underperformed before have recently accelerated and risen (Chart-15).

In the center of Tokyo, residential rents in Chiyoda ward where rents had increased overwhelmingly for years have shown a noticeable decline (Chart-16).

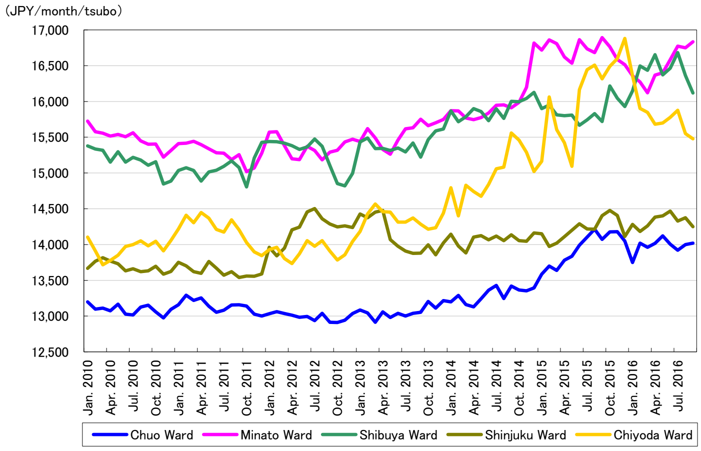
Regarding the Tokyo luxury residential market, rents have fluctuated and vacancy rates stopped improving (Chart-17). The number of foreign residents in Tokyo increased for the third consecutive year in 2015, however, the number in Minato ward increased by only 1.6% y-o-y compared with 8.6% overall for Tokyo in July.

Chart-15 Tokyo Residential Rent Index



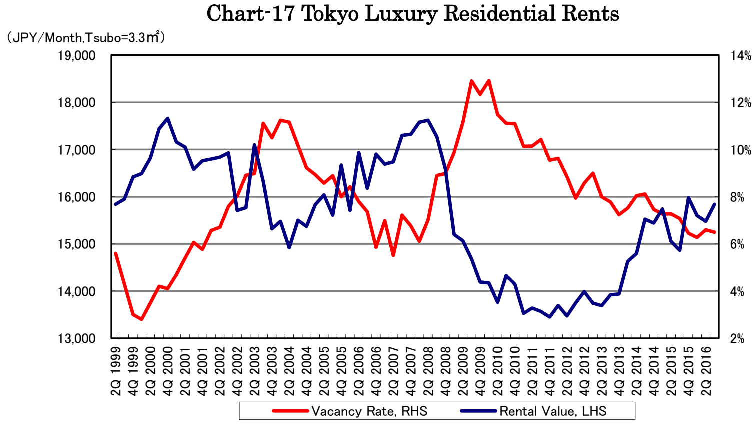
Source: Mitsui Sumitomo Trust Research Institute Co. Ltd. and At Home Co. Ltd.

Chart-16 Residential Rents in Tokyo Five Wards



Source: Leasing Management Consulting

Chart-17 Tokyo Luxury Residential Rents



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

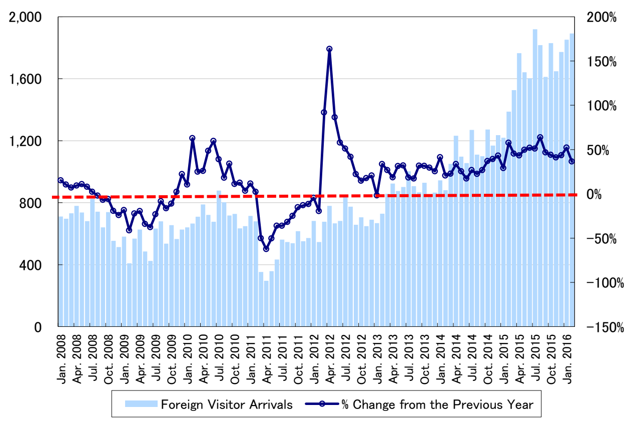
3) Retail, Hotel and Logistics

Foreign visitor arrival numbers have still grown at the pace of about +20% y-o-y in 2016 (Chart-18), increasing by 19% to 1.9 million in September, and 18 million for the year in 2016.

Visitor arrivals from South Korea increased the most at 42.8% y-o-y in September as a result of the recent launch of new airline routes. Visitor arrivals from ASEAN nations have also maintained strong growth such as Indonesia by 38.5% y-o-y, the Philippines by 31.3% and Thailand by 30.0%. Visitor arrivals from the U.S. and Canada also increased significantly by 26.9% and 24.8%, pushed by promotions for Japan.

However, visitor arrivals from China in September decelerated noticeably to a mere +6.3% y-o-y, affected by the cancellation of cruise ships due to typhoons, however, visitor arrivals from China in 2016 have increased by 30.5% y-o-y already reaching 5 million in September.

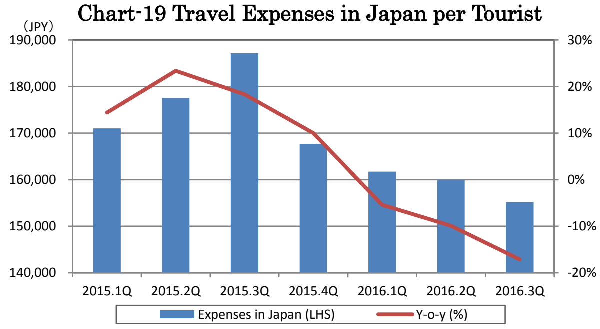
Chart-18 Monthly Foreign Visitor Arrivals



Source: Japan National Tourism Organization (JNTO)

Despite the continuous increase of visitor arrivals, consumption by foreign visitors in Japan has shrunk significantly, declining by 17.1% y-o-y in the third quarter (Chart-19). This trend is visible not only among visitors from China, for whom its government has required an abstention from luxury spending, but also visitors from many countries.

Chart-19 Travel Expenses in Japan per Tourist



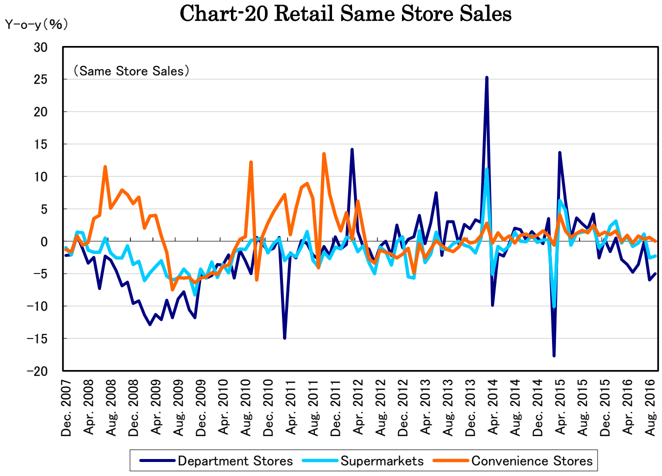
*Excluding flight expenses to Japan
Source: Japan Tourism Agency

Affected by the weakened inbound consumption demand, retail sales shrank by 1.9% y-o-y in September. Same store sales of department stores shrank by 5.0% for the seventh consecutive month in September and those of supermarkets and convenience stores also shrank by 2.3% and 0.01% y-o-y, respectively (Chart-20).

Duty free sales in department stores shrank significantly by 10.1% y-o-y for the sixth consecutive month in September, though the number of foreign customers still increased by 15.9% y-o-y.

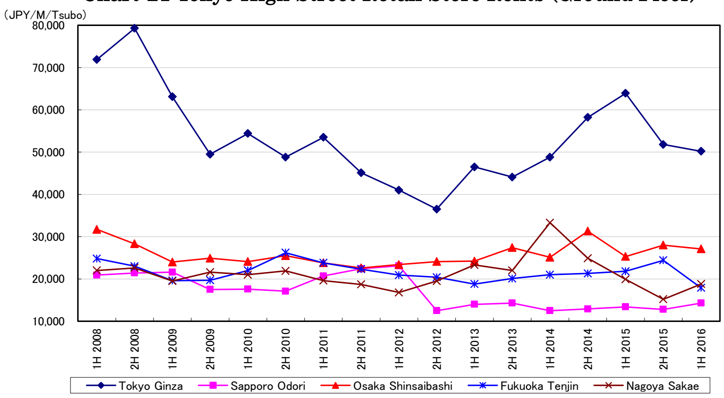
Affected by weakening retail sales, retail store rents have also adjusted since the latter half of 2015, in particular in Ginza where many luxury brand stores are located (Chart-21).

Chart-20 Retail Same Store Sales



Source: Ministry of Economy, Trade and Industry

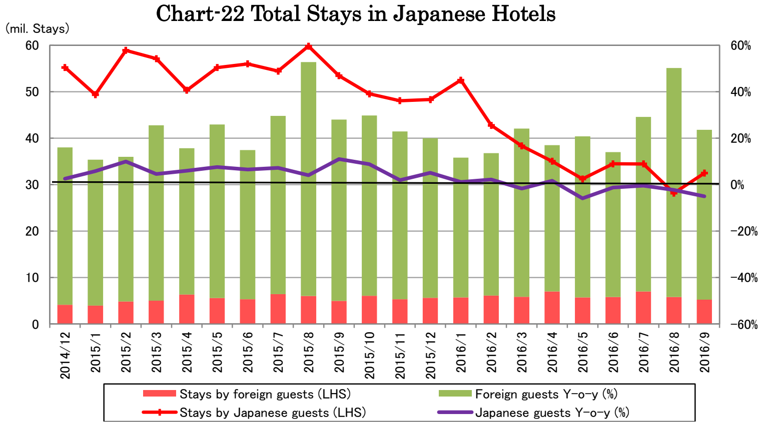
Chart-21 Tokyo High Street Retail Store Rents (Ground Floor)



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

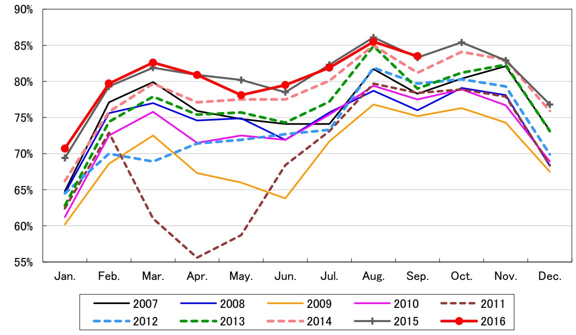
Despite the increase in foreign visitor arrivals, the number of hotel stays in Japan has recently shrunk, and even worse, the number of foreign guests shrank in August (Chart-22). Now that the increase in the number of foreign visitors is no longer driving hotel demand, it has become difficult for hotel occupancy rates to surpass the high figures of last year (Chart-23). RevPAR of hotels in Japan declined by 1.7% y-o-y to 14,224 JPY in August, suggesting raising room rates has not been easy. RevPAR of luxury and high grade hotels have been declining and those of budget hotels have not grown enough to compensate for the decline.

Chart-22 Total Stays in Japanese Hotels



Source: Japan Tourism Agency

Chart-23 Hotel Occupancy Rates

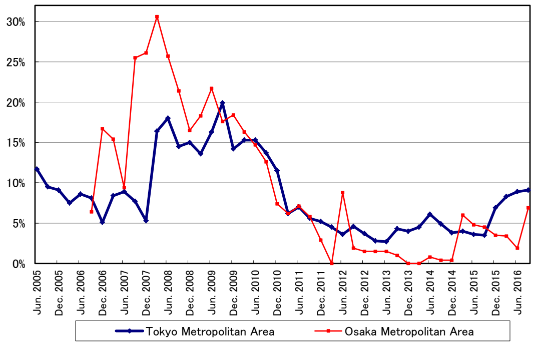


Source: Ohta Publications "Weekly HOTERES"

The logistics leasing market has been facing massive supply both in the Tokyo and Osaka metropolitan areas. Vacancy rates of large logistics facilities for multi-tenants in the Tokyo and Osaka metropolitan area deteriorated from 8.9% to 9.1% and from 1.9% to 6.9%, respectively (Chart-24).

Logistics facility demand has continuously emerged and absorbed new supply. However, vacancy rates in areas along with Ken-O-Do which is quite far from the center of Tokyo rose above 20% in the third quarter. Supply volume will be smaller for the time being, however, as another round of massive supply will come in the second quarter of 2017.

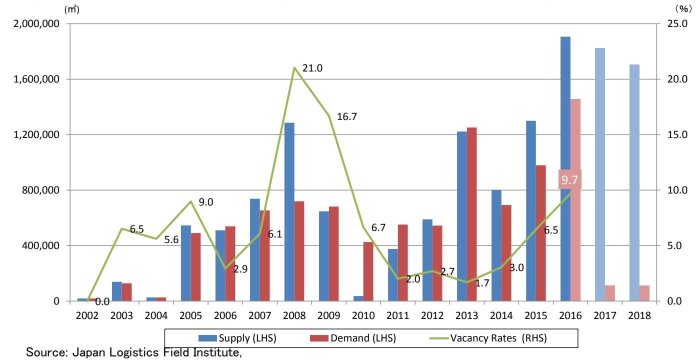
Chart-24 Logistics Facility Rents and Vacancy Rates (Large Sized Multi-Tenant-Use)



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

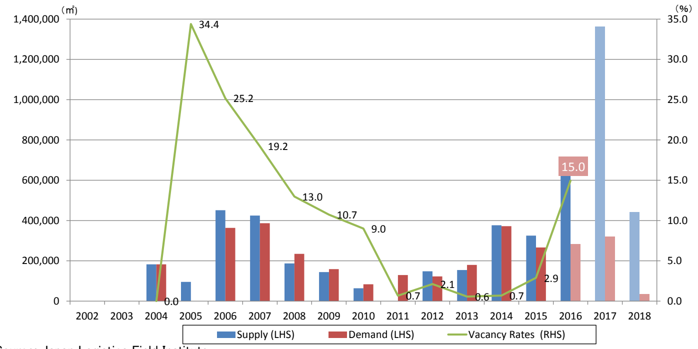
Supply volume will remain extraordinary large until 2018 (Chart-25, 26). Internet shopping is expected to grow continuously and create the logistics facility demand necessary to absorb the coming massive supply. However, considering that operating conditions such as securing labor has become increasingly difficult, tenants should be selective in location and specifications of logistics facilities. It will be often the case to see rents decline in specific areas as seen with Ken-O-Do.

Chart-25 Logistics Market in the Tokyo Metropolitan Area (Large Sized Multi-Tenant Use)



Source: Japan Logistics Field Institute,

Chart-26 Logistics Market in the Osaka Metropolitan Area (Large Sized Multi-Tenant Use)



Source: Japan Logistics Field Institute,

4. Property Investment and J-REIT Markets

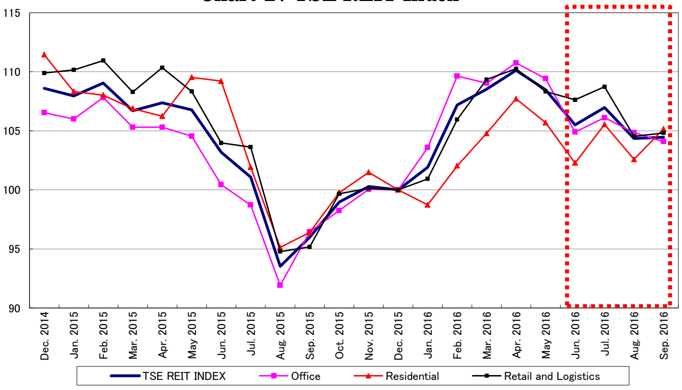
The TSE REIT Index did not change much in waiting for a comprehensive review of the Bank of Japan's policies on Sep. 21, producing a slight decline by 1.0% in the third quarter. The office sector declined by 0.8%, residential rose by 2.8% and others – including retail and logistics – declined by 2.6% (Chart-27). At the end of September, the J-REIT market value was 11.7 trillion JPY, while the price to NAV ratio was 1.2 times and the dividend yield was 3.5%, with a 3.6% yield spread on 10-year JGBs.

J-REITs acquired properties amounting to 526 billion JPY in the third quarter, totaling 1.46 trillion JPY for September in 2016 (Chart-28). Four REITs were newly listed and two REITs disappeared in mergers, bringing the number of J-REITs to 56.

Dividends of J-REITs have been increasing based on asset acquisitions, funding cost control and NOI increase of existing office buildings. NOI of office buildings owned by

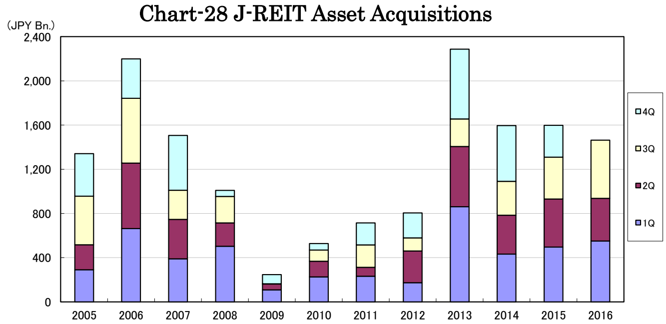
J-REITs increased by 2.4% a year, 0.8% y-o-y in the latter half of 2015 and 1.6% in the former half of 2016. Nippon Building Fund REIT, the largest office J-REIT, says that the NOI of existing buildings will increase at least for a year. As offices account for 40% of J-REIT portfolios, dividends of J-REITs will keep growing for a while.

Chart-27 TSE REIT Index



Source: Tokyo Stock Exchange

Chart-28 J-REIT Asset Acquisitions

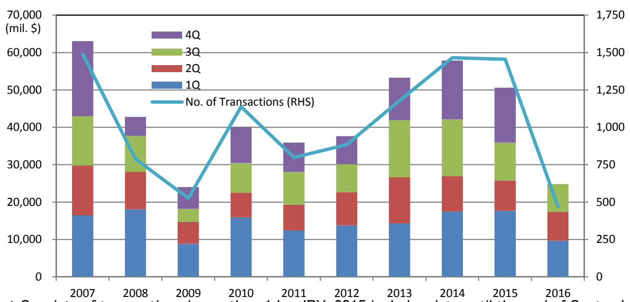


*Assets of new J-REITs are included at IPO
Source: NLI Research Institute

Despite aggressive acquisitions by J-REITs (Chart-28), other investors reduced their activities drastically. The transaction volume has remained much smaller compared with those in 2014 and 2015 when the yearly volume exceeded 50 billion USD (Chart-29).

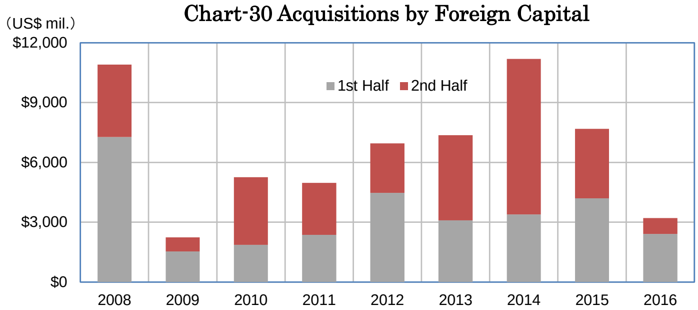
Foreign investors acquired a shrinking volume of Japanese properties (Chart-30). Due to the termination of JPY depreciation Japanese assets appear no longer particularly cheap. Furthermore, under the negative interest rate policy, competition among Japanese investors to acquire assets has been increasingly tough.

Chart-29 Property Transaction Volume in Japan



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

Chart-30 Acquisitions by Foreign Capital



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Source: Real Capital Analytics www.rcanalytics.com

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