NLI Research Institute February 17, 2017

Real Estate Analysis Report

Japanese Property Market Quarterly Review, Fourth Quarter 2016

~J-REITs Appreciate by 6% and Record Third Largest Yearly Acquisition Amount in 2016~

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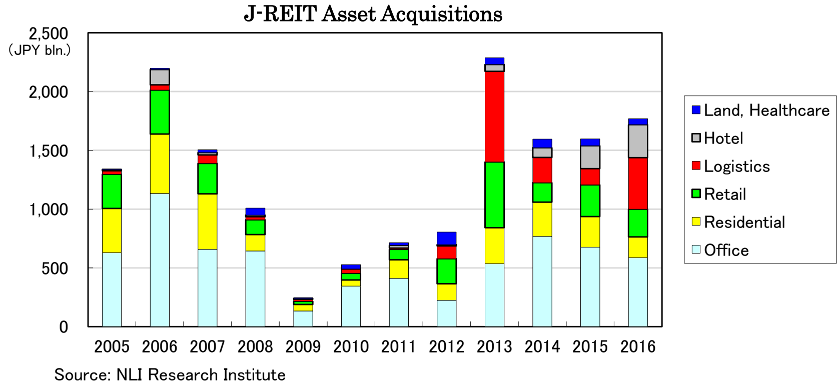
Summary

- While Japan's GDP growth rate was revised down in the third quarter, private consumption and private capital expenditure are expected to recover hereafter. The housing market has mostly been steady and housing starts increased by 6.4% y-o-y in 2016. However, new condominium sales volume has shrunk for the third consecutive year in the Tokyo metropolitan area, outnumbered by the secondary condominium transaction volume. Land prices continued to appreciate, however, those in Tokyo have already decelerated.
- While the vacancy rates of Tokyo grade-A offices remained low and stable, their rents have apparently peaked out. The residential rents in Tokyo have continued to rise. While foreign visitor arrivals grew by 22% to 24 million in 2016, total stays and consumption by foreigners in Japan have not grown as expected. The vacancy rates of logistics facilities will remain high in areas where glut of new supply appear.
- The TSE REIT Index rose by 6.2% in 2016 after declining in 2015. J-REITs acquired 1.7 trillion of assets in 2016, the third largest yearly amount in history, even in the shrinking investment market. The NLI Research Institute's "thirteenth property investment market survey" indicated that the market direction has become increasingly hard to read.



Source: NLI Research Institute

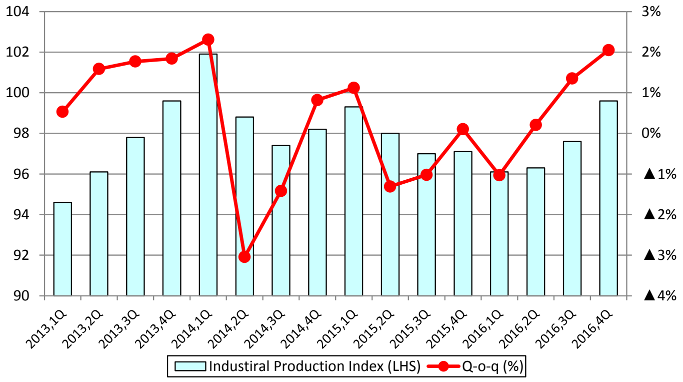
1. Economy and Housing Market

While Japan's GDP growth rate was revised down to 1.3% q-o-q in the third quarter, private consumption is expected to recover supported by better employment conditions and private capital expenditure is also expected to recover hereafter.

According to METI, the industrial production index rose by 2.0% q-o-q for the third consecutive quarter (Chart-1), posting as high a growth as in the first quarter in 2014 when the index was lifted by the rush in demand before the consumption tax hike.

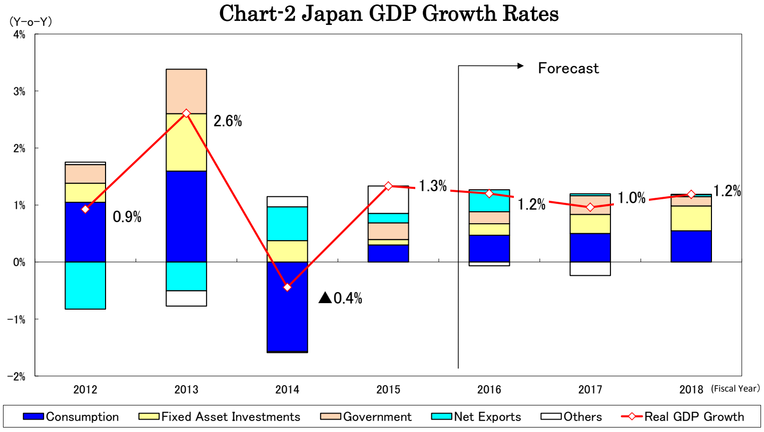
NLI Research Institute revised up its forecasts of GDP growth rates in December to +1.2%, +1.0% and +1.2% y-o-y for 2016, 2017 and 2018, respectively (Chart-2).

Chart-1 Industrial Production Index



Source: METI "Indices of Industrial Production"

Chart-2 Japan GDP Growth Rates



Source: Economic and Social Research Institute, Cabinet Office, Government of Japan "Quarterly Estimate of GDP", Taro Saito "Weekly Economist Letter" NLI Research Institute January 31, 2017

The housing market has mostly been steady excluding new condominium sales. Housing starts grew by 3.9% y-o-y to 78,406 units in December for the sixth consecutive month of positive growth, and by 6.4% y-o-y to 967k units for the whole year 2016. Housing starts of apartments for lease grew by 10.5% y-o-y for the fifth consecutive year of positive growth, accounting for 40% of total housing starts.

New condominium sales volume in the Tokyo metropolitan area decreased by 11.6% y-o-y to

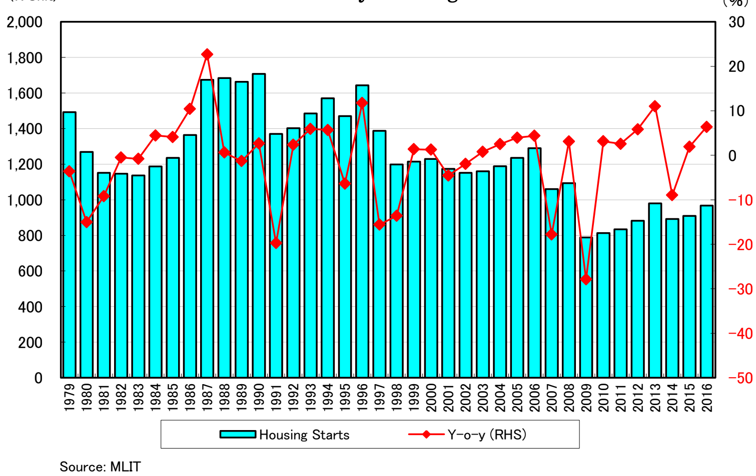
35,772 units in 2016, particularly declining by more than 20% in Tokyo. While the average unit price declined by 0.5% y-o-y to 54.9 million JPY, price per square meter still appreciated by 1.8% y-o-y to 793k JPY for the fourth consecutive year. Real Estate Economic Institute forecasts a 6.2% y-o-y increase of sales volume to 38,000 units in 2017 (Chart-4).

According to Real Estate Information Network Systems, the transaction volume in the secondary condominium market in the Tokyo metropolitan area increased by 11.1% y-o-y to 9,317 units in the fourth quarter and by 6.9% to 37.2k units, the largest ever, in 2016 (Chart-5), outnumbering the new condominium sales volume for the first time. The average transaction price rose by 5.4% y-o-y to 30.5 million JPY for the fourth consecutive year of appreciation.

However, housing prices have shown some weakness recently, as Japan Real Estate Institute's "Home Price Index," the secondary condominium price index in the Tokyo metropolitan area, has declined for the third consecutive month (Chart-6).

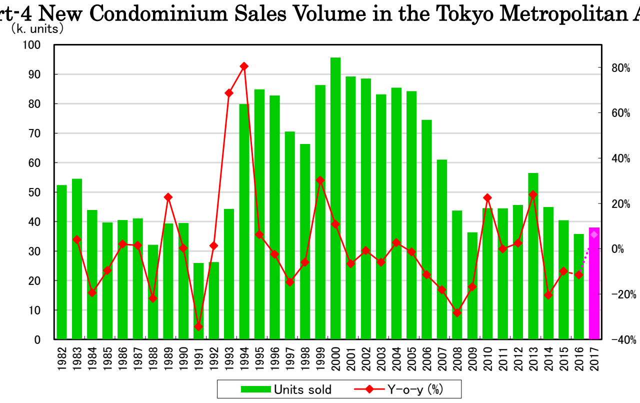
It is of concern that rising bond yields and strengthened regulatory measures will lift mortgage rates, and the tax authority is reviewing inheritance tax conditions to prevent luxury condominiums from being abused to minimize taxable bases.

Chart-3 Yearly Housing Starts



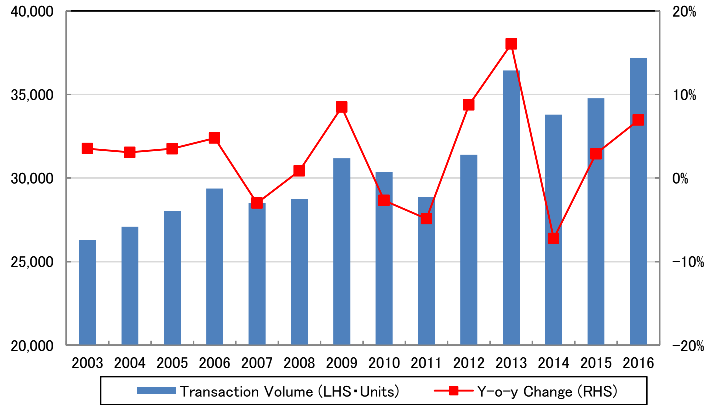
Source: MLIT

Chart-4 New Condominium Sales Volume in the Tokyo Metropolitan Area



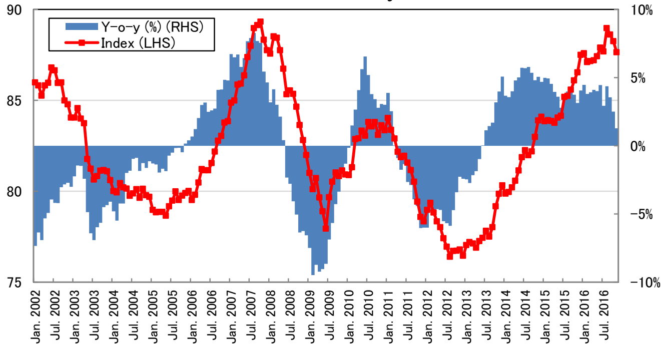
Source: Real Estate Economic Institute

Chart-5 Transaction Volumes in Secondary Condominium Market



Source: REINS East Japan

Chart-6 Home Price Index (Secondary Condominium Price)



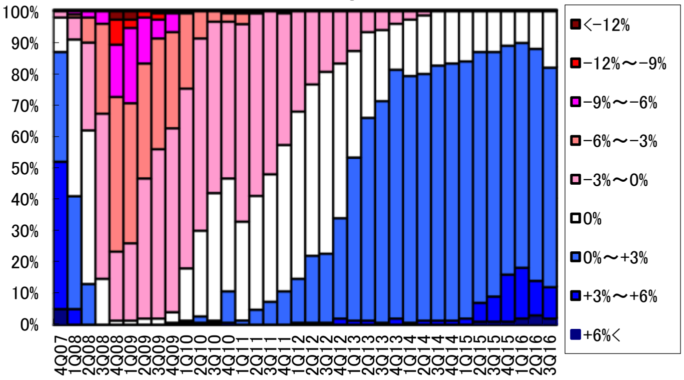
Sources: Japan Real Estate Instiitute

2. Land Prices

Land price appreciation has continued on the back of excess funds and progressing urban redevelopments. However, the stream has been lost in some areas. As shown in the MLIT's "Chika look report," the number of monitoring spots posting land price appreciation declined from 39 to 33 in the Tokyo metropolitan area (Chart-7). Despite this, the number in the Osaka metropolitan area remained high at 24 of all 25 monitoring spots, and all 9 monitoring spots in the Nagoya metropolitan area posted land price appreciation.

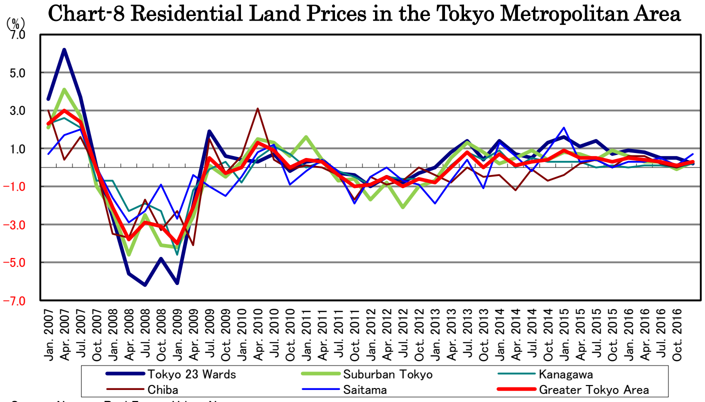
According to Nomura Real Estate Urban Net, residential land prices in the Tokyo metropolitan area appreciated by 0.3% q-o-q in the fourth quarter for the tenth consecutive quarter and by 1.2% y-o-y, led by those in Tokyo's 23 wards appreciating by 2.1% y-o-y (Chart-8).

Chart-7 Land Price Changes Nationwide



Source: MLIT "Chika Look Report"

Chart-8 Residential Land Prices in the Tokyo Metropolitan Area



Source: Nomura Real Estate Urban Net

3. Sub-sectors

1) Office

According to Miki Shoji, office vacancy rates in the five central wards of Tokyo improved by 0.14% to 3.61% and the average office rent rose by 4.8% y-o-y in December. While the office rents in Tokyo have risen at the pace of 4 or 5% y-o-y supported by low vacancy rates, office rents in local cities have risen at higher paces than in Tokyo with limited new supply (Chart-9).

The rent index of Tokyo grade-A[1] offices slightly rose by 0.2% q-o-q to 33,785 JPY per month per tsubo in the fourth quarter (Chart-10). As the rents apparently peaked out in the third quarter of 2015, finding new tenants for grade-A offices has recently become increasingly time-consuming. In the Mori Building's "2016 Survey of Office Needs in Tokyo 23 Wards," when asked of the reasons for plans to lease new office space, "Lower Rent" responses increased for the first time since 2010, following "To expand Business/ To Accommodate an Increase in Employees" responses ranking first.

[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.

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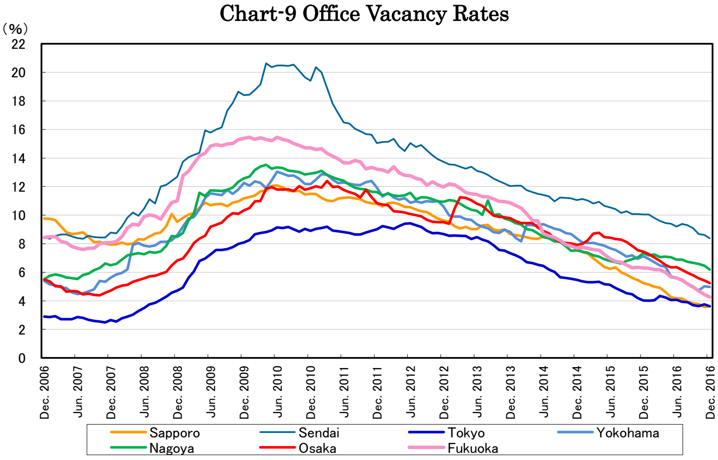
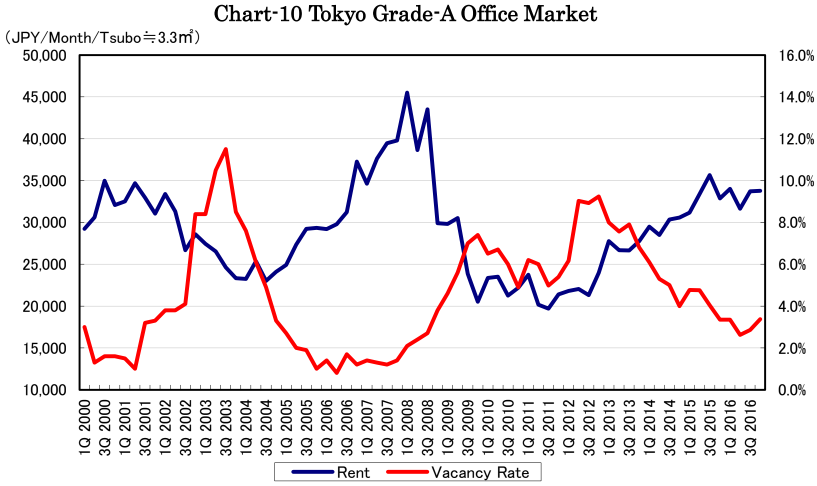
Chart-9 Office Vacancy Rates



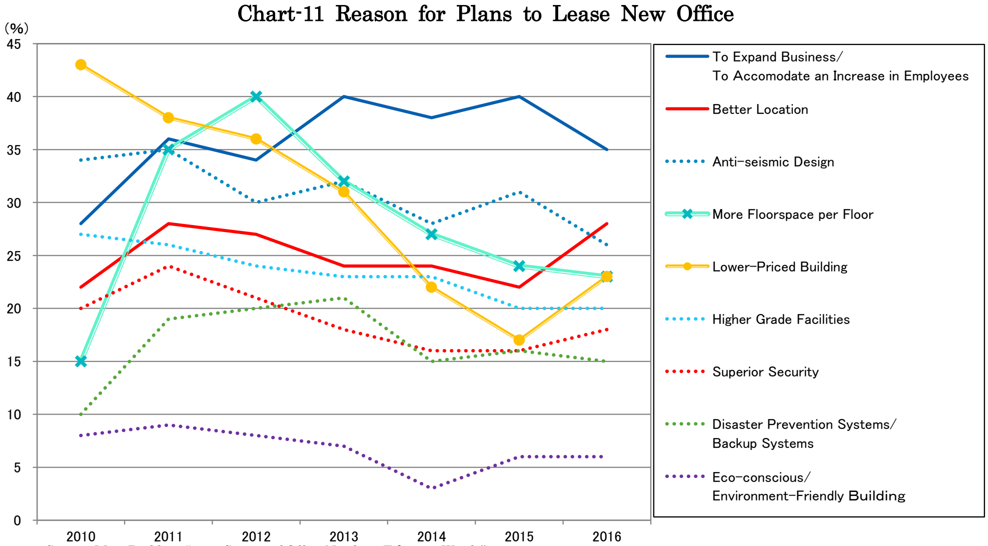
Source: Miki Shoji

Chart-10 Tokyo Grade-A Office Market



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

Chart-11 Reason for Plans to Lease New Office



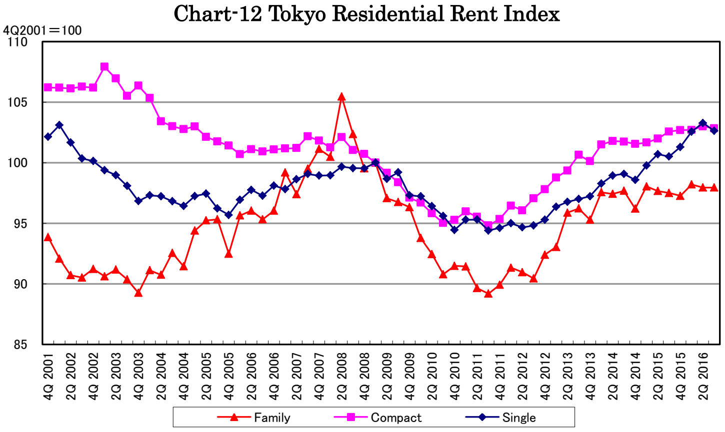
Source: Mori Building "2016 Survey of Office Needs in Tokyo 23 Wards"

2) Residential Rental

Though declining somewhat q-o-q in the third quarter, it appears residential rents in Tokyo's 23 wards have still been on the ascending trend, as single-type, compact type and family type rose by 2.1%, 0.3% and 0.5% y-o-y, respectively (Chart-12).

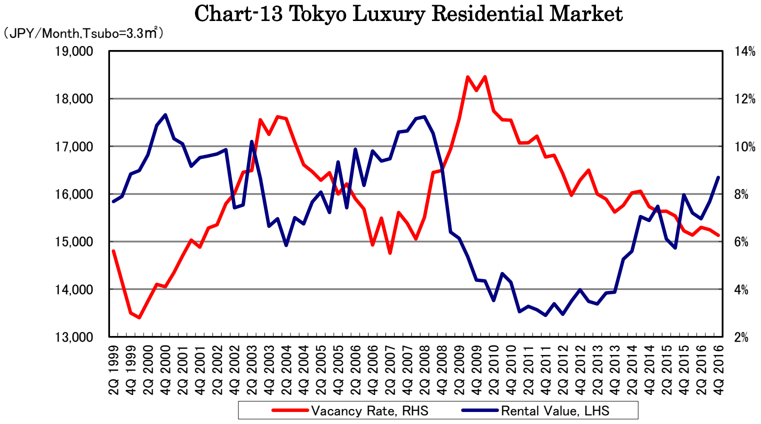
On the other hand, Tokyo luxury residential rents rose strongly by 2.3% y-o-y to 16,346 JPY per month per tsubo on the back of improving vacancy rates in December (Chart-13).

Chart-12 Tokyo Residential Rent Index



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

Chart-13 Tokyo Luxury Residential Market

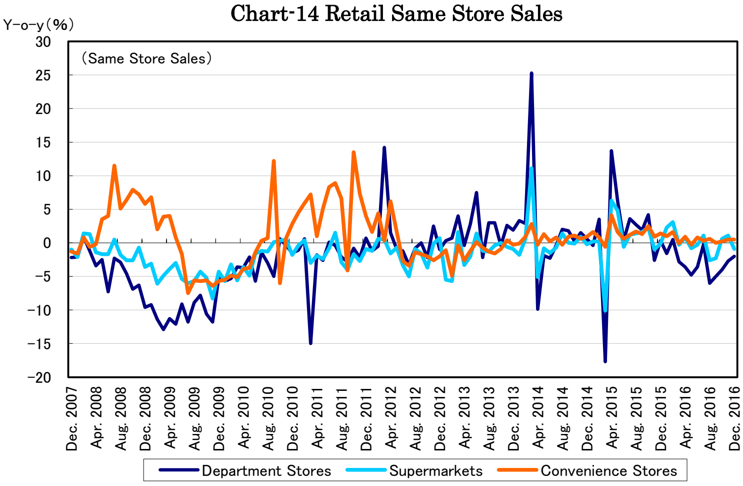


*Sample consists of contracts with more than 300K JPY/Month, tsubo rental value or 30 tsubo space.
Source: Ken Real Estate Advisors Ltd.

3) Retail, Hotel and Logistics

Same store sales of department stores shrank by 2.8% y-o-y, however, those of supermarkets and convenience stores increased by 0.2% and 0.4% y-o-y in the fourth quarter (Chart-14). For the whole year 2016, same store sales of department stores shrank by 2.9% y-o-y and those of supermarkets and convenience stores increased by 0.1% and 0.5% y-o-y, respectively. Stagnant apparel sales and normalizing inbound demand have impacted department stores, while supermarket stores and convenience stores have remained stable.

Chart-14 Retail Same Store Sales



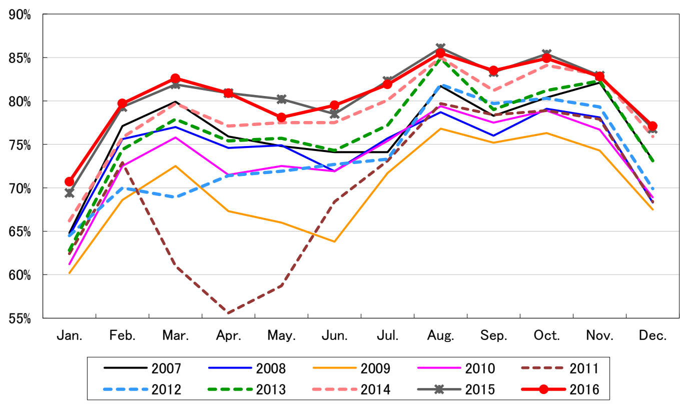
Source: Ministry of Economy, Trade and Industry

Occupancy rates of hotels in 61 cities across the nation increased by 0.3% y-o-y to 77.0% in December. Though remaining at high levels, occupancy rates posted negative y-o-y changes in several months during 2016 (Chart-15).

Foreign visitor arrivals increased by 22% to 24.03 million in 2016 for the fourth consecutive record-setting year (Chart-16). Visitor arrivals from 20 major countries excluding Russia posted record highs supported by several factors such as increased cruise services, active promotions to Japan and loosened visa issuance conditions. However, total stays by foreign visitors increased by only 8.5% (Chart-17) and consumption in Japan increased by 8.0% to 3.7 trillion JPY, with consumption per foreign visitor declining by 11% y-o-y to 156k JPY, particularly consumption per Chinese visitor shrinking by 18% y-o-y.

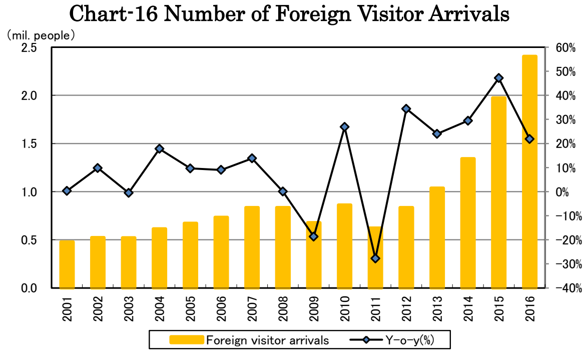
The recent JPY depreciation apparently supports the hotel demand. However, the development of legislation on private accommodations operated through Airbnb and other services and the increasing number of hotel developments will have a considerable impact on the hotel market.

Chart-15 Hotel Occupancy Rates



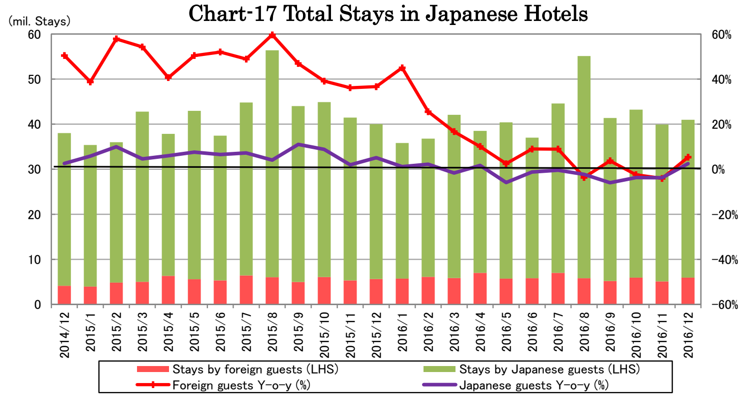
Source: Ohta Publications "Weekly HOTERES"

Chart-16 Number of Foreign Visitor Arrivals



Source: Japan National Tourism Organization (JNTO)

Chart-17 Total Stays in Japanese Hotels



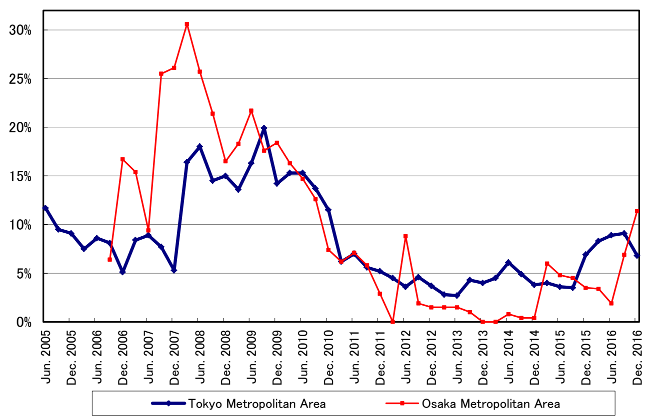
Source: Japan Tourism Agency

According to CBRE, vacancy rates of large logistics facilities for multi-tenants in the Tokyo metropolitan area improved by 2.3% q-o-q to 6.8%, while those in the Osaka metropolitan area deteriorated by 4.5% q-o-q to 11.4% (Chart-18).

The vacancy rates will remain high in areas where glut of new supply appear such as Ken-O-Do in the Tokyo metropolitan area and the bay-area in the Osaka metropolitan area, despite strong demand for advanced logistics facilities.

According to Ichigo Real Estate Service, logistics rents in the Tokyo metropolitan areas rose by 3.5% q-o-q to 4,140 JPY per month per tsubo in October.

Chart-18 Logistics Facility Rents and Vacancy Rates (Large Sized Multi-Tenant-Use)



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

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4. J-REIT and Property Investment Markets

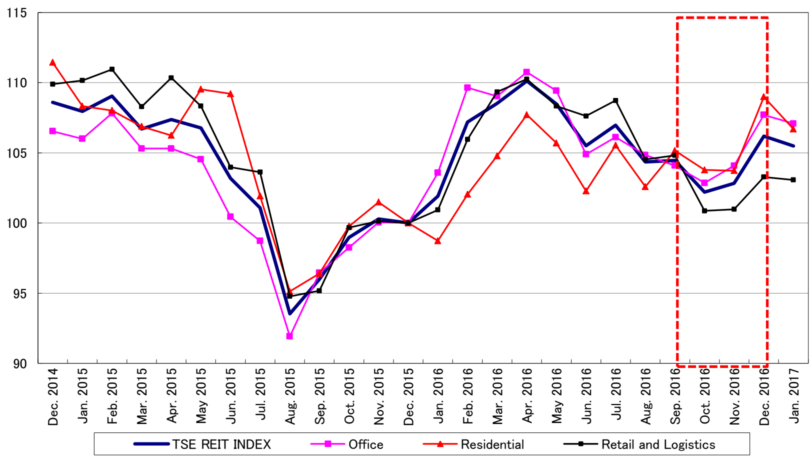
The TSE REIT Index rose by 1.7% q-o-q in the fourth quarter pulled up by the equity market rallying after the U.S. presidential election, despite having stagnated before the event. The office and residential sectors rose by 3.5% and 3.7% q-o-q respectively, while other sectors – including retail and logistics – declined by 5.1% (Chart-19). At the end of December, the J-REIT market value was 12.1 trillion JPY, while the price to NAV ratio was 1.2 times and the dividend yield was 3.5%, with a 3.5% yield spread on 0% of ten year JGBs.

The TSE REIT Index rose by 6.2% in 2016 after declining in 2015. Even affected by the significant events overseas such as the U.K. withdrawal from the EU and the U.S. presidential election, the financial results of J-REITs have steadily improved and supported the unit prices.

J-REITs acquired property assets amounting to 1.77 trillion JPY with seven IPOs in 2016 (Chart-20). The acquisition volume was 11% more than in 2015, posting the third largest yearly amount in history even when the entire market transaction volume shrank in Japan. J-REITs acquired an increasing number of logistics facilities and hotels noticeably, while the total acquisition volume of the traditional three sectors such as office, residential and retail decreased y-o-y, accounting for the lowest ever 56% of total volume. Besides that, acquisition volume in the five central wards of Tokyo accounted for only 23% of total volume, shrinking from 28% in 2015. Pursuing yield incremental acquisitions, J-REITs have shifted acquisition targets from central Tokyo to suburban areas and from core to sub categories.

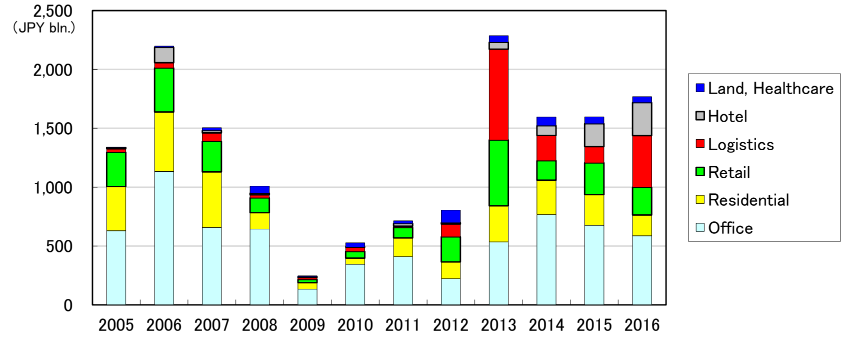
The funding environment has been comfortable with the average J-REIT bond issuance condition being 10 years and 0.51%.

Chart-19 TSE REIT Index



Source: Tokyo Stock Exchange

Chart-20 J-REIT Asset Acquisitions

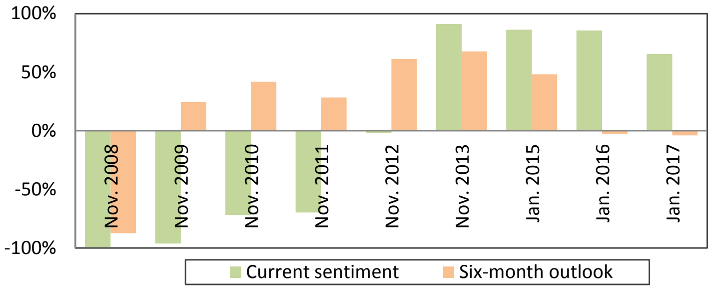


Source: NLI Research Institute

In the NLI Research Institute's "thirteenth annual property investment market survey,"[2] regarding the current sentiment, "Good" or "Somewhat good" responses overwhelmed "Bad" or "Somewhat bad" responses for the fourth consecutive year (Chart-21). However, regarding the six-month outlook, the market direction was unassertive with the small difference between the positives and negatives and "No change" responses accounting for two-thirds of responses.

Despite domestic economic conditions looking stable, with the uncertainty concerning policy measures by the new U.S. government and several elections scheduled throughout the EU, the market direction has become increasingly difficult to read.

Chart-21 Property Investment Market Sentiment and Outlook (DI)



* ("Good" or "Somewhat good") – ("Bad" or "Somewhat bad") for Current sentiment
("Better" or "Somewhat better") – ("Worse" or "Somewhat worse") for Six-month outlook
Source: NLI Research Institute, January 2017

[2] Mamoru Masumiya " Interest Rate Concerns Emerge, Property Prices Forecasted to Decline after Going Sideways～The Thirteenth Japanese Property Market Survey～ -" Real Estate Analysis Report, February 7, 2017

