NLI Research Institute May 22, 2017

Real Estate Analysis Report

Japanese Property Market Quarterly Review, First Quarter 2017

~Focus on Coming Large Supply of Offices, Hotels and Logistics Facilities~

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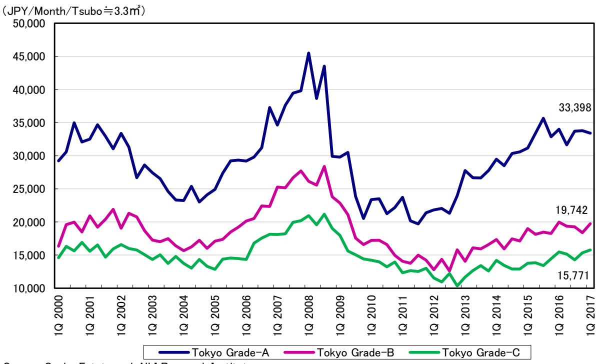
Summary

- Japan's real GDP grew for the fifth consecutive quarter and business conditions are expected to remain stable backed by the recovery of corporate earnings and capital expenditure. While housing starts have modestly grown y-o-y, concerns about loans for building apartments for lease and mounting inventories of new condominiums have also increased. While the average national land price appreciated y-o-y for the second consecutive year, the number of sites where land prices appreciated did not increase q-o-q in the first quarter.
- The rents of Tokyo Grade-A[1] offices declined 1.1% q-o-q in advance of large new supply starting from 2018. While hotel demand has been strong due to increasing foreign visitors, coming large new supply worries investors about certain areas and categories. Large new supply of logistics facilities has been considerably absorbed so far by strong demand.
- The TSE REIT Index declined by 4.3% in the first quarter. Despite the interest rate hike in the U.S., 10-year JGB yields have remained around 0% and debt funding conditions have been favorable.

Tokyo Grade-A, B and C Office Rent Index



Source: Sanko Estate and NLI Research Institute

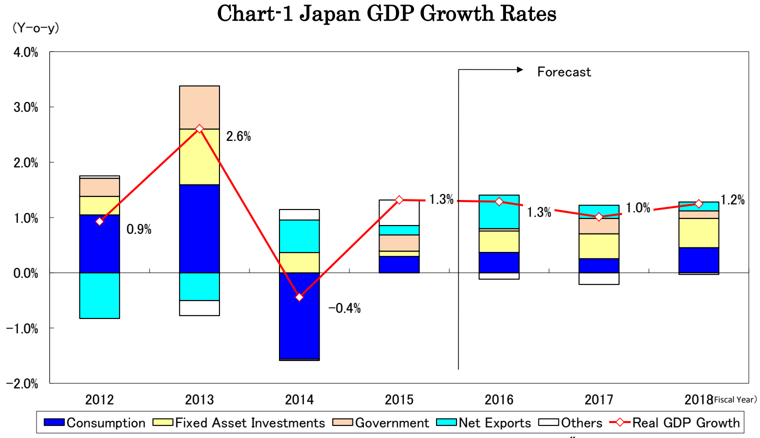
[1] Sanko Estate Grade-A Office Guidelines: Located in urban area Tokyo five wards, main office areas or other specially integrated areas, with total floor area of more than 33,000 m², main floor size of more than 990 m², building age of 15 years or less

1. Economy and Housing Market

Japan's real GDP growth rate was revised up by 0.1% to 0.3% q-o-q in the fourth quarter of 2016, which also raised the NLI Research Institute GDP growth rate forecast for 2016 by 0.1% to 1.3% y-o-y (Chart-1). The real GDP growth rate for the first quarter of 2017 was 0.5% q-o-q for the fifth consecutive month of positive growth, as business conditions are expected to remain stable backed by the recovery of corporate earnings and capital expenditure.

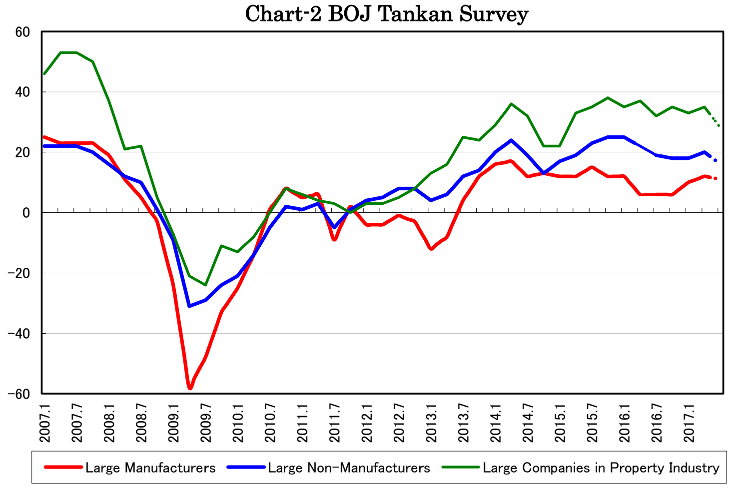
In the BOJ Tankan Survey, the current business confidence D.I. of both large manufactures and non-manufacturers improved (Chart-2). The D.I. of large companies in the property industry has remained above the 30-point level but the three-month forecast deteriorated to the 28-point level reflecting increasing uncertainty.

Chart-1 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 April 28, 2017

Chart-2 BOJ Tankan Survey



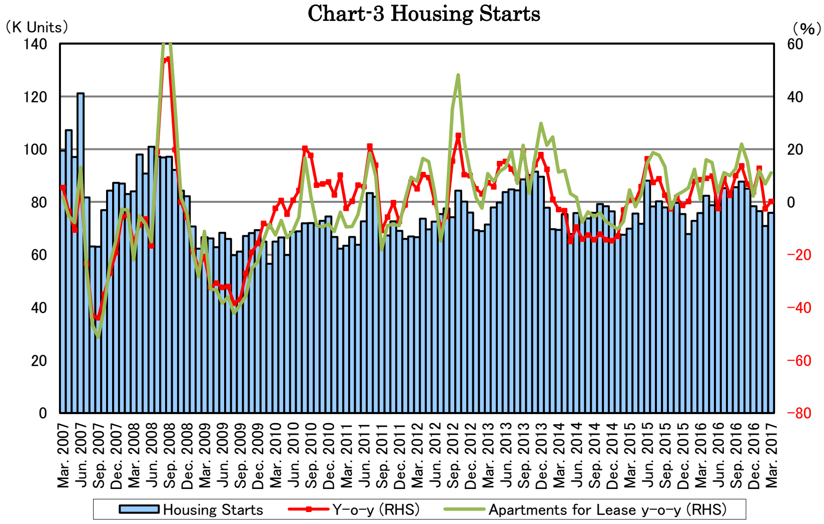
Source: BOJ "Tankan Survey"

Housing starts have modestly grown y-o-y led by apartments for lease (Chart-3). Regarding loans for building apartments for lease, the Financial Services Agency and the Bank of Japan intend to tighten controls over financial institutions.

The number of new condominium units sold in the Tokyo metropolitan area increased by 10% y-o-y to 7,102 in the first quarter, however, the contracted rate dropped below 70% and inventories have accumulated (Chart-4). New condominium prices have stopped rising and leveled off. Some developers have furnished their units for free to clear their inventories, which suggest that new condominium prices are about to decline.

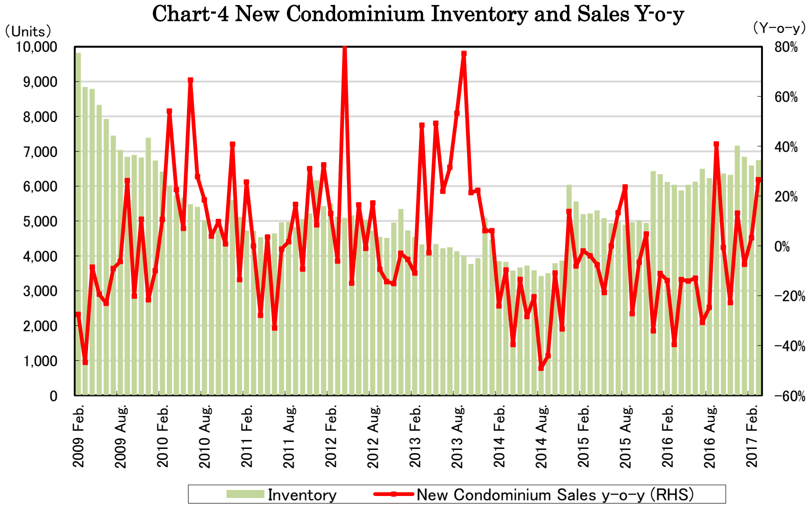
The transaction volume in the secondary condominium market in the Tokyo metropolitan area remained the same as last year. After rising for years, condominium prices have become too expensive for ordinary people looking for their own home (Chart-5), urging potential buyers to move to the residential leasing market.

Chart-3 Housing Starts



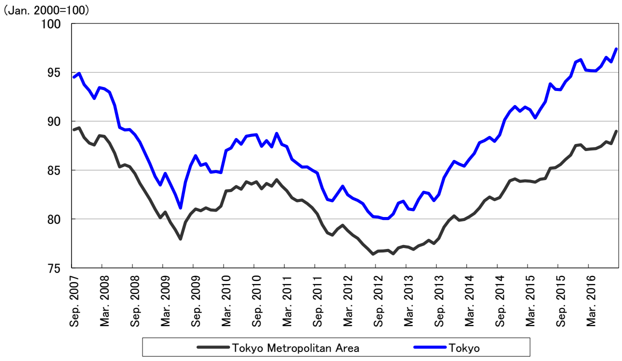
Source: MLIT

Chart-4 New Condominium Inventory and Sales Y-o-y



Source: Real Estate Economic Institute

Chart-5 Secondary Condominium Transacted Prices



Source: Japan Real Estate Institute "Home Price Indices"

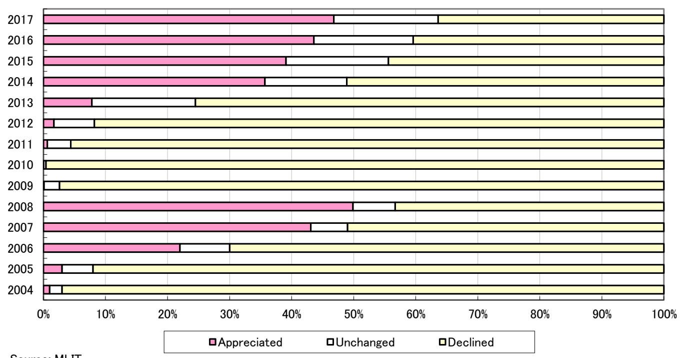
2. Land Prices

Regarding "Kouji Chika," national land prices, as of January 1, 2017, the average national land price appreciated by 0.4% y-o-y for the second consecutive year of positive growth following seven years of depreciation. The ratio of appreciating monitoring sites increased for both commercial and residential lands while that of depreciating monitoring sites decreased (Chart-6, 7). While the average land price in the major three metropolitan areas and four other large cities, Sapporo, Sendai, Hiroshima and Fukuoka, posted positive growth, the average land price of other local areas continued to moderately depreciate.

The six commercial sites that performed the best nationally all turned out to be in the Kansai area, with the top five sites located in Osaka and the sixth site in Kyoto. Strong demand for hotels and retail stores has lifted commercial land prices backed by the increase in foreign visitors, despite the noticeable shrink in spending volume per visitor. On the other hand, seven of ten residential sites that performed the best nationally turned out to be in Miyagi prefecture, suggesting a steady home demand in recovering areas affected by the Great East Japan Earthquake.

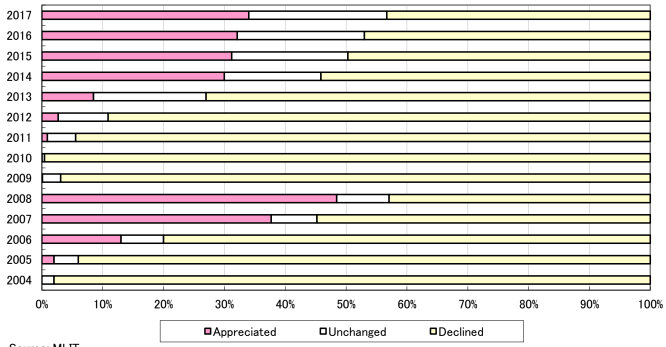
Regarding "Land Value Look Report" published quarterly by MILT, the number of sites with no land price change has increased since the third quarter of 2016 (Chart-8). It appears land price appreciation has lost steam as the land price of only one site with land price appreciation increased while sites with land price appreciation of more than 6% q-o-q disappeared in the fourth quarter.

Chart-6 Ratio of Price Change of Commercial Land Nationwide



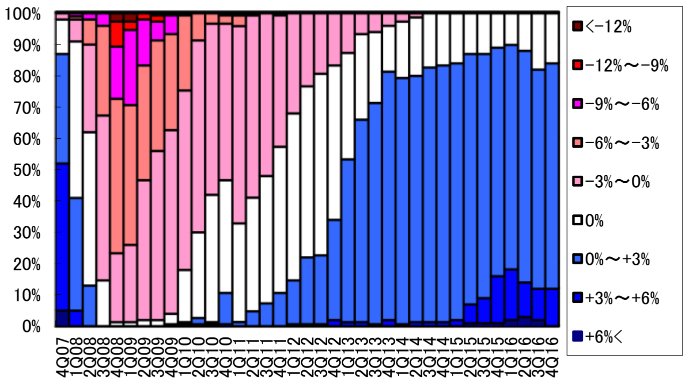
Source: MLIT

Chart-7 Ratio of Price Change of Residential Land Nationwide



Source: MLIT

Chart-8 Ratio of Price Change of Intensively Used Land Nationwide



Source: MLIT "Land Value Look Report"

3. Sub-sectors

1) Office

The rent index of Tokyo Grade-A offices declined by 1.1% q-o-q and 1.8% y-o-y to 33,398 JPY per month per tsubo in the first quarter (Chart-9). Grade-A office rents have been on a declining trend since peaking in the third quarter of 2015. Tenants have taken the initiative in leasing negotiations on the back of the 1.4 million square meters of new supply scheduled in 2018, even with current favorable business conditions and corporate earnings.

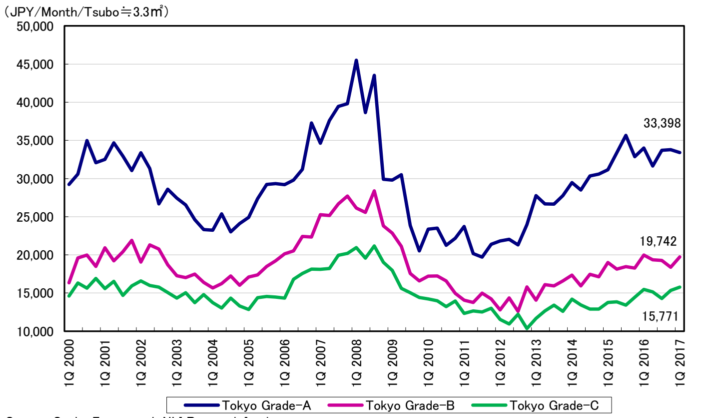
On the other hand, the rent index of Tokyo Grade-B[2] offices rose by 1.1% q-o-q and declined by 1.8% y-o-y while that of Tokyo Grade-C[3] offices rose by 1.1% q-o-q and 1.8% y-o-y. Grade-C office rents have been strong without direct influence by the glut of coming Grade-A supply. However, office rents of all grades have been much lower than those at the peak in 2008.

Vacancy rates of Grade-A offices deteriorated to 3.9% for the third consecutive quarter (Chart-10). On the contrary, vacancy rates of Grade-B and C have improved and have driven the rent increase.

[2] Offices with main floor size of more than 660 m^2 excluding Grade-A offices
[3] Offices with main floor size of more than 330 m^2 excluding Grade-A or B offices

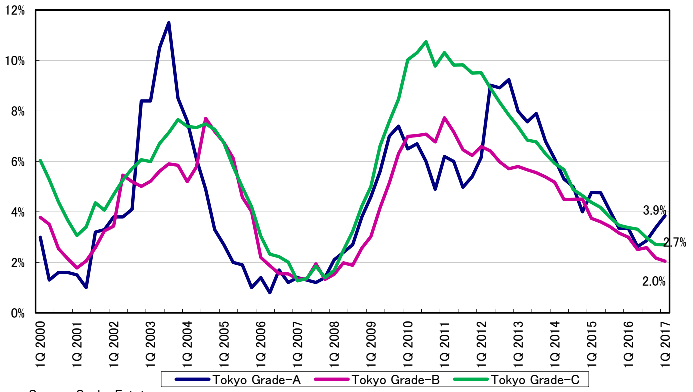
Office vacancy rates in major cities other than Tokyo have been improving supported by limited new supply excluding Yokohama, where some tenants moved to their own buildings, and Nagoya, where a landmark building was completed next to a JR station (Chart-11).

Chart-9 Tokyo Grade-A, B and C Office Rent Index



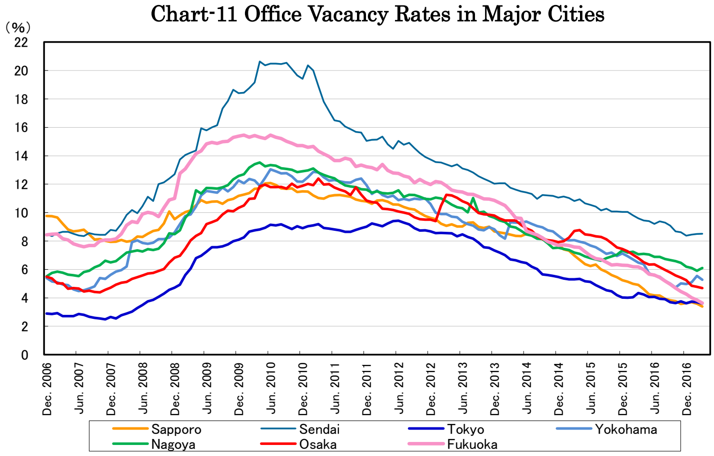
Source: Sanko Estate and NLI Research Institute

Chart-10 Tokyo Grade-A, B and C Office Vacancy Rates



Source: Sanko Estate

Chart-11 Office Vacancy Rates in Major Cities



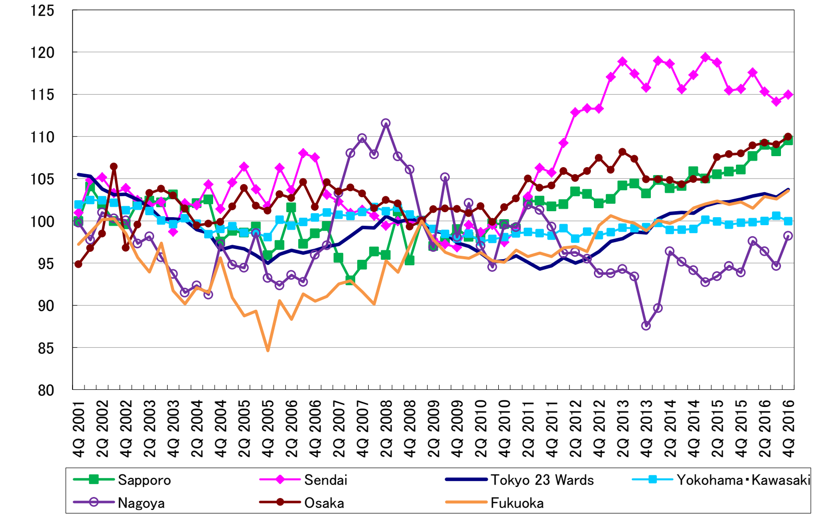
Source: Miki Shoji

2) Residential Rental

Residential rents in major cities have been on the rise (Chart-12). The residential rents in Tokyo rose again in the fourth quarter after declining once in the third quarter of 2016.

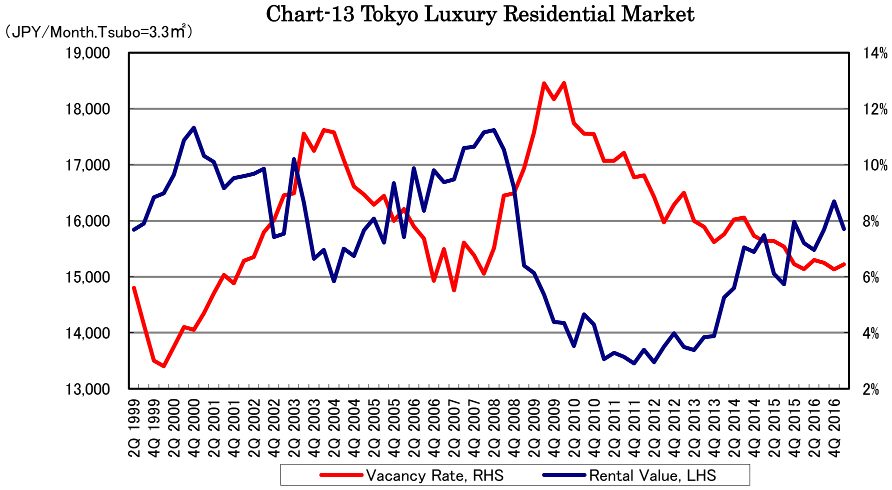
The vacancy rates of Tokyo luxury apartments have leveled off since the beginning of 2016 following several years of improvement (Chart-13). The luxury residential rents which still appear on the ascending trend also declined by 3.0% q-o-q to 15,853 JPY per tsubo per month in the first quarter of 2017. The rents have been much lower than those at the peak above 17,000 JPY per tsubo per month in 2008, suggesting the spending ability of potential tenants has drastically deteriorated.

Chart-12 Residential Rent Index in Major Cities



Source: Sumitomo Mitsui Trust Research Institute, At Home

Chart-13 Tokyo Luxury Residential Market



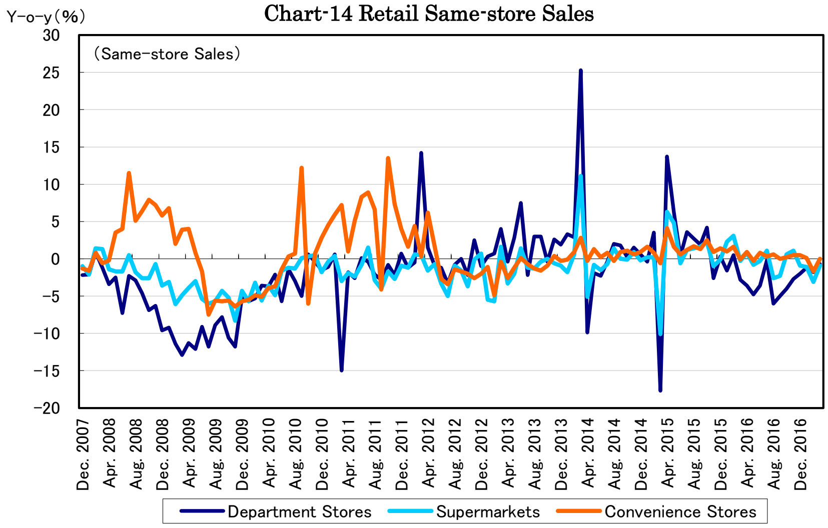
*Sample consists of contracts with more than 300K JPY/Month, tsubo rental value or 30 tsubo space.
Source: Ken Real Estate Advisors Ltd.

3) Retail

Same-store sales of department stores declined y-o-y for the thirteenth consecutive month, however, the pace of decline moderated in the first quarter (Chart-14). Those of supermarkets and convenience stores remained stable though shrinking somewhat y-o-y.

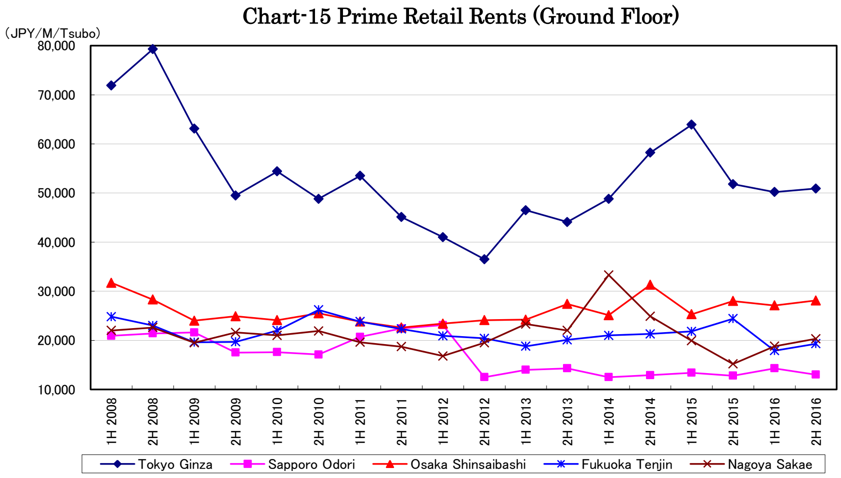
Prime retail rents in Tokyo Ginza remained mostly unchanged after declining from the peak in 2015 which was lower than that in 2008 (Chart-15). Prime retail rents in other major cities have been stable.

Chart-14 Retail Same-store Sales



Source: Ministry of Economy, Trade and Industry

Chart-15 Prime Retail Rents (Ground Floor)



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

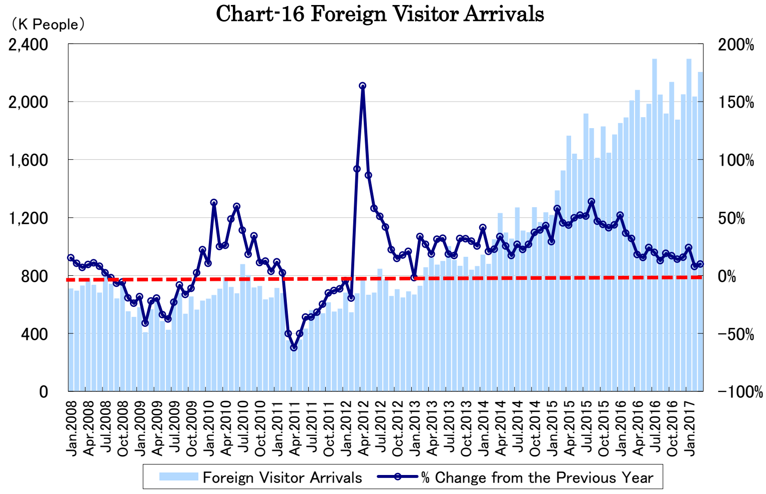
4) Hotel

Foreign visitor arrivals which have recently stimulated hotel demand still increased moderately (Chart-16). However, the total number of stays in accommodation facilities by foreign visitors has often posted negative y-o-y growth since October 2016 (Chart-17). One of the reasons may be "*Minpaku*," private residential units leased for short stays operated through Airbnb and others.

Hotel occupancy rates declined y-o-y in many cities, Yokohama and Nagoya in particular, in March (Chart-18). On the contrary, hotel occupancy rates in Fukuoka, Kyoto and Hiroshima increased y-o-y in March. Fukuoka often faces hotel shortages when live concerts are held, while Kyoto and Hiroshima have high reputations as global, sightseeing cities.

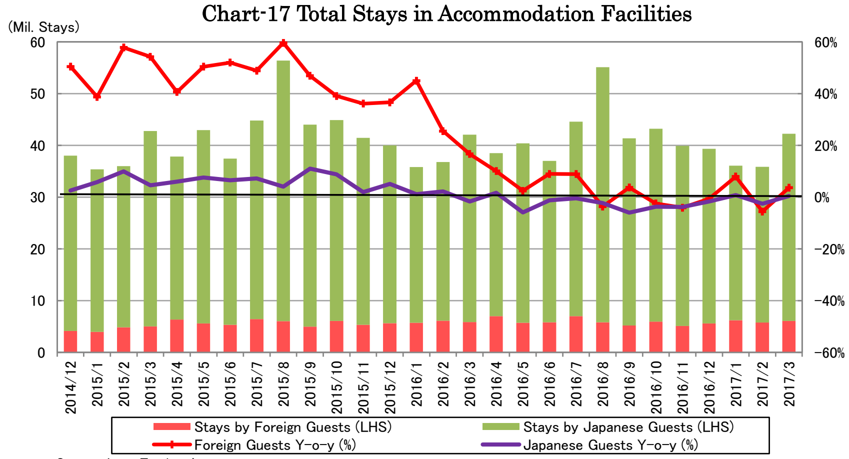
In Tokyo and Osaka, it appears expensive room rates in the city center have pushed tourists to choose to stay in the suburbs. However, hotel occupancy rates have been above the long-term average while hotel investment and development are also active. The number and space for construction starts of accommodation facilities increased by 40% and 86% y-o-y respectively in 2016 (Chart-19). Considering hotel demand has been diverted to *Minpaku* and the suburbs, increasing hotel developments can bring low occupancy rates in certain areas and categories. In hotel development and operation, targeting customers in appropriate categories is becoming increasingly important in order to secure demand.

Chart-16 Foreign Visitor Arrivals



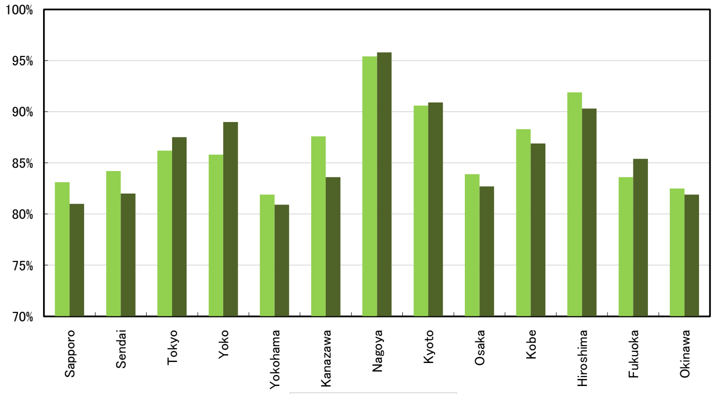
Source: Japan National Tourism Organization (JNTO)

Chart-17 Total Stays in Accommodation Facilities



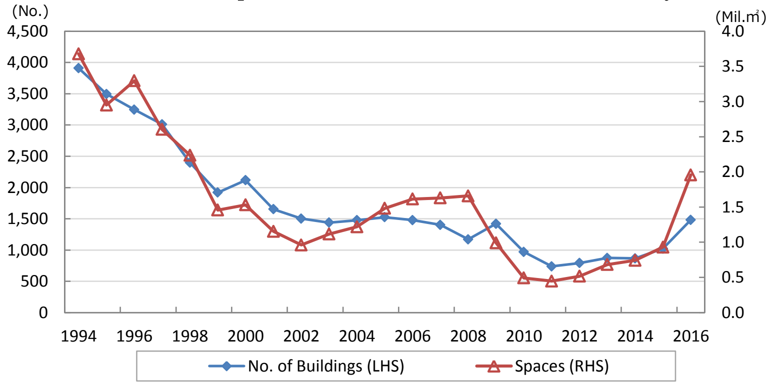
Source: Japan Tourism Agency

Chart-18 Hotel Occupancy Rates



Source: Ohta Publications "Weekly HOTERES"

Chart-19 Number and Space of Construction Starts of Hotels and Ryokans



Source: MLIT

5) Logistics Facility

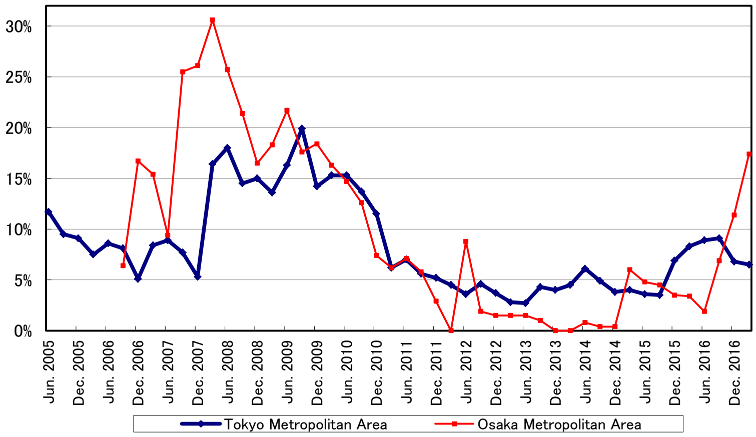
According to CBRE, large, multi-tenant logistics facilities in the Tokyo and Osaka metropolitan areas posted respective vacancy rates of 6.5% and 17.4% in the first quarter (Chart-20). Several large logistics facilities have been supplied in both Tokyo's and Osaka's metropolitan areas on the back of high expectations for e-commerce growth.

While a largest-ever 1.9 million square meters of space was newly supplied in the Tokyo metropolitan area, strong demand absorbed 1.76 million square meters and vacancy rates did not deteriorate much in 2016. While new supply volume will shrink somewhat in 2017, there is concern that more than 2.5 million square meters, a glut of new space, will be supplied in 2018.

On the other hand, in the Osaka metropolitan area 0.71 million square meters of space, which is too much for the area, was supplied and vacancy rates surged in 2016. Even worse, another 1.3 and 0.94 million square meters of space will be supplied in 2017 and 2018, respectively. Though high vacancy rates should be inevitable for years, inland areas close to consumers can expect relatively strong demand and high rents.

In addition, the recent fire accident at a large logistics facility will lead to additional costs charged to investors in preparation for fire prevention and recovery processes.

Chart-20 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 declined by 4.3% in the first quarter (Chart-21) as foreign investors sold aggressively with 28.5 billion JPY of net selling volume. The office sector declined by 5.1%, the residential sector by 2.1% and other sectors – including retail and logistics – by 4.1%.

At the end of March, the value of the J-REIT market was 11.9 trillion JPY, while the price-to-NAV ratio was 1.2 times and the dividend yield was 3.7%, with a 3.7% yield spread on 0% of 10-year JGBs.

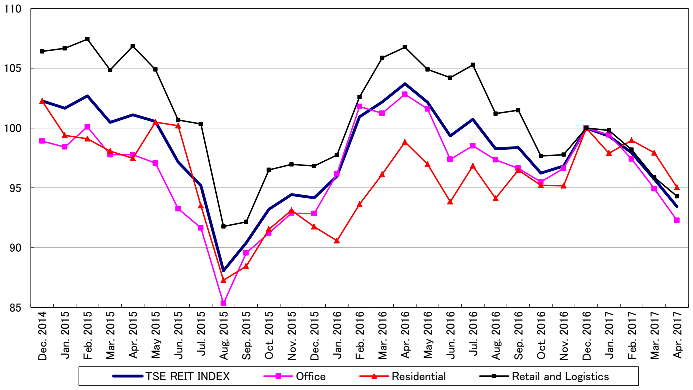
J-REITs acquired properties amounting to 561 billion JPY in the first quarter, increasing by 2% y-o-y (Chart-22). Mori Trust Hotel REIT was listed with 4 assets valued at 102 billion JPY, and the number of J-REITs increased to 58.

Though the recent interest rate hike in the U.S. has worried investors, 10-year JGB yields have remained around 0% due to the “yield curb control by Bank of Japan” while debt funding conditions have been extremely favorable.

J-REITs issued 32 billion JPY of bonds at an average yield of 0.32% in the first quarter, 0.51% lower than in the fourth quarter of 2016 (Chart-23). The current bond issuance conditions for J-REITs are 0% for 3-year, 0.2% for 5-year and 0.5% for 10-year bonds.

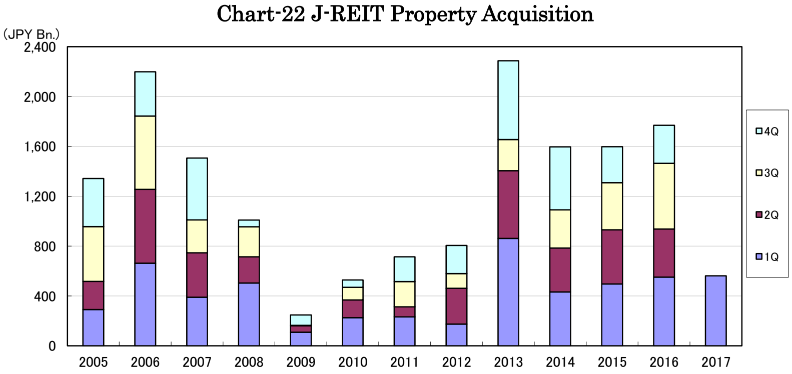
The average bond duration held by J-REITs was greater than 10 years under the negative interest rate environment last year. However, J-REITs have flexibly managed bond issuance conditions and the average duration has shortened to 7-8 years following introduction of “yield curb control by Bank of Japan.” The current average debt costs of J-REITs are 0.8%. In the case that debt costs are brought to 0.5%, earnings of J-REITs will increase by 5%.

Chart-21 TSE REIT Index (Dec. 2015=100)



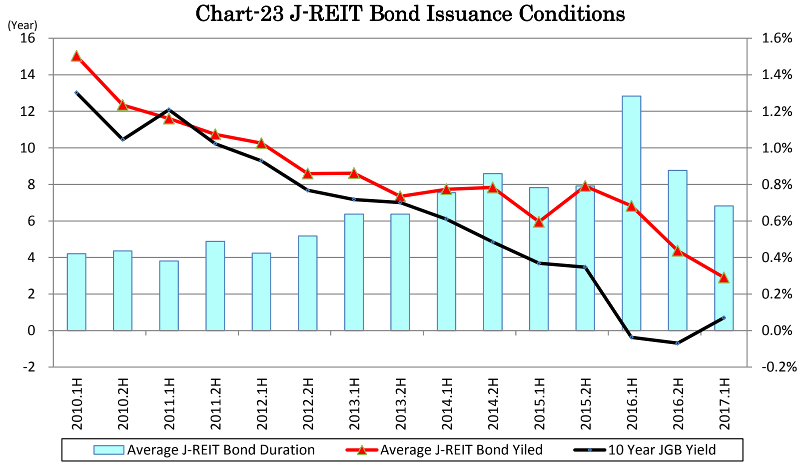
Source: Tokyo Stock Exchange

Chart-22 J-REIT Property Acquisition



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

Chart-23 J-REIT Bond Issuance Conditions



Source: Tokyo Stock Exchange

Expected yields have been lowered in the Japanese property investment market since the negative interest rate policy was introduced by the Bank of Japan in February 2016. According to CBRE, the average expected NOI yield of Tokyo CBD offices in Otemachi was 3.6% in January 2017, shrinking by 0.05% q-o-q and 0.3% lower than its peak of 3.9% in 2008.

Both general corporations and J-REITs disposed their assets at the current high prices with

NOI yields of less than 4% of the Tokyo CBD. Even logistics facilities were disposed by not only developers but also a J-REIT.

Investors have looked for relatively high yields and have acquired large and relatively new office buildings located in fringe areas such as Tennozu Isle, Shinagawa Seaside and Yokohama Minato Mirai 21.

