NLI Research Institute August 30, 2017

Real Estate Analysis Report

Japanese Property Market Quarterly Review, Second Quarter 2017

~Tokyo Grade-A Office Rents Rise Again, Investors Increasingly Consider Selling~

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Summary

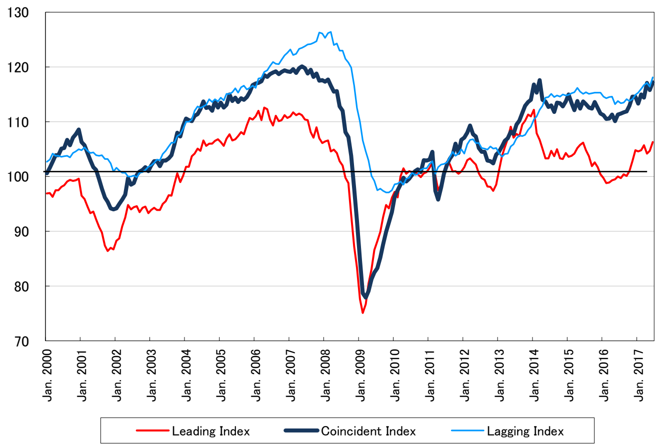
- Economic conditions have been improving. The cabinet office raised its assessment of the current state of the Japanese economy to "a moderate recovery." The favorable economic conditions have brought labor shortages to many industries. While the population of Japan declines, the increase of foreign residents has gradually become obvious.
- Housing starts have remained active led by apartments for lease. While new condominium sales in the Tokyo metropolitan area have been stagnant, luxury units have sold well stimulated by the healthy economic conditions and equity markets.
- Office vacancy rates have improved and Grade-A rents rose again in Tokyo. As upcoming buildings have smoothly secured tenants, anxiety concerning vacancy rate hikes due to large supply has mostly disappeared for 2017. Office vacancy rates in Sapporo and Fukuoka have been even better than those in Tokyo.
- The number of foreign visitors has continuously increased led by tourists from South Korea. Department store sales increased in the second quarter stimulated by the healthy equity market and increase in foreign tourists. Hotel occupancy rates have remained at the highest level as not only foreign but also Japanese tourists increased overnight stays.
- The TSE REIT index declined by 8.7% in the first half of 2017 affected by successive cash outflows from J-REIT mutual funds. Due to the weakening unit prices, J-REITs acquired limited amounts of properties. The weighted average P/NAV of J-REITs has shrunk to 1.1 times.
- Two-thirds of property investors believe the market has peaked. Avoiding very low yields in the center of Tokyo, investors increasingly transacted properties in the suburbs of Tokyo and local cities. On the other hand, foreign investors have relatively become active.

1. Economic Conditions

Economic conditions have been improving. The cabinet office raised its assessment of the current state of the Japanese economy for the first time in 6 months to "a moderate recovery" in the Monthly Economic Report in June. The current fifty-fifth consecutive month of economic recovery (Chart-1) is longer than those in the early 1990s and the third longest since 1945.

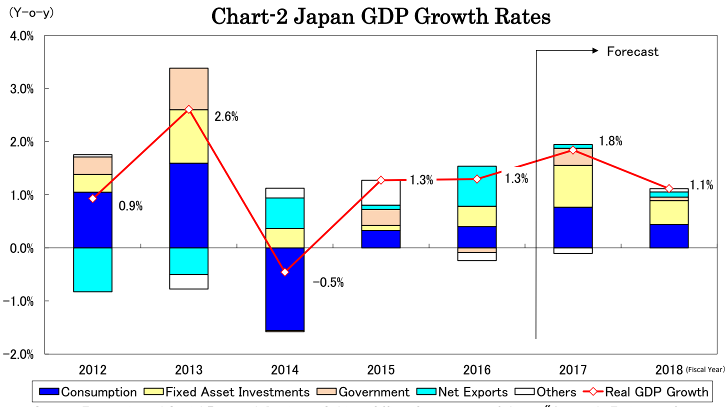
Corporate earnings marked a record high for the second consecutive quarter and private consumption is also recovering on the back of favorable employment conditions and healthy equity markets. NLI Research Institute forecasts a real GDP growth rate of 1.8% for 2017 (Chart-2), led by the corporate sector.

Chart-1 Indexes of Business Conditions



Source: Cabinet Office

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 August, 2017.

2. Labor Shortage and Population Decline

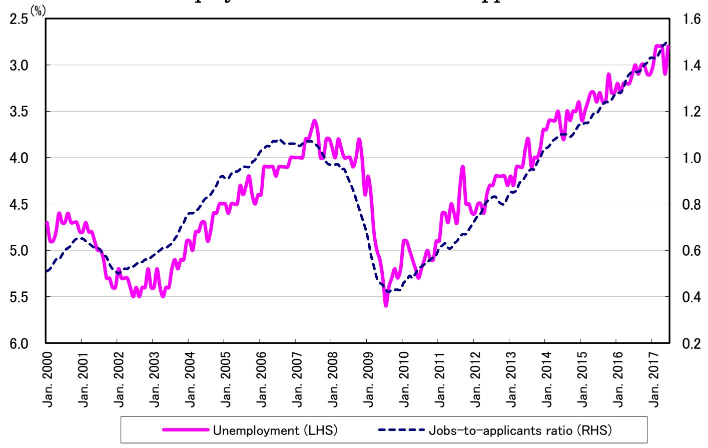
Labor force and employee figures have strongly increased since 2012. Thus, the number of unemployed has decreased for the eighty-fifth consecutive month with an unemployment rate of 2.8% and a jobs-to-applications ratio of 1.51 times in June (Chart-3).

Labor shortages have spread into many industries as 60.6% of respondents answered "labor shortage" in the labor survey by The Japan Chamber of Commerce and Industry in July, particularly in industries such as lodging and restaurants at 83.8%, logistics and transportation at 74.1%, nursing and caring at 70.0% and construction at 67.7%.

While the labor shortage in the construction industry has been gradually moderated by increasing wages since 2014, construction costs have apparently begun to rise again (Chart-4).

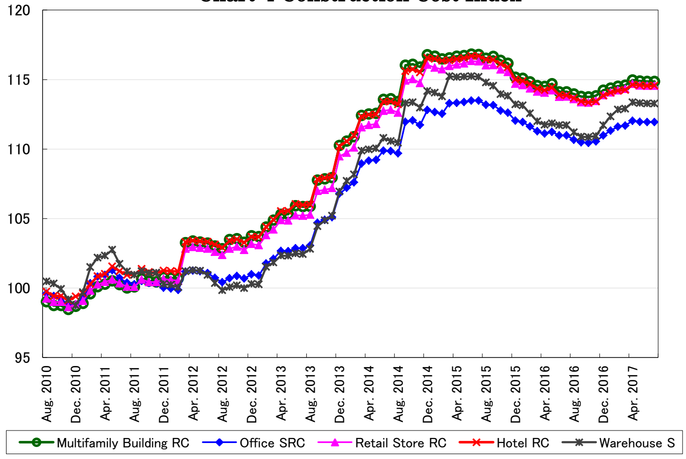
The aging and shrinking of Japan's population which declined by 300,000 in 2016 is clearly a significant factor contributing to the labor shortage. On the other hand, with growth of 140,000 in 2016, the increase in foreign residents has gradually become obvious.

Chart-3 Unemployment Rate and Jobs-to-Applications Ratio



Source; MIC "Employment Report" MHLW "Job Introduction"

Chart-4 Construction Cost Index



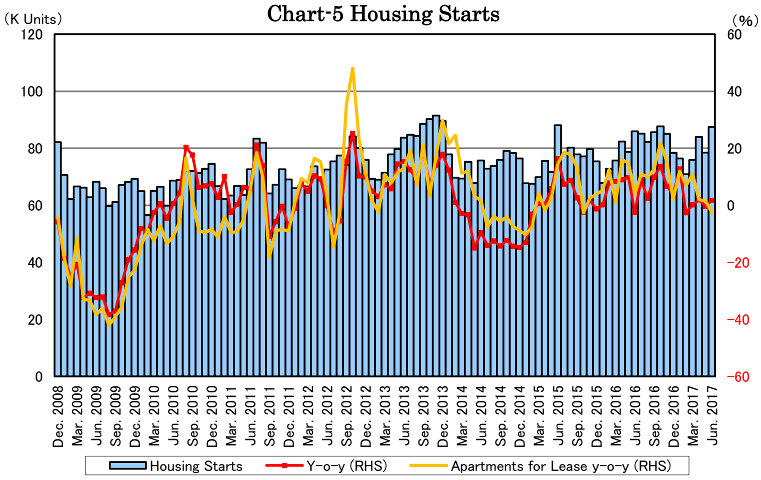
Source: Construction Research Institute

3. Housing Market

Housing starts have remained active at the pace of about 1 million units for 12 months (Chart-5).

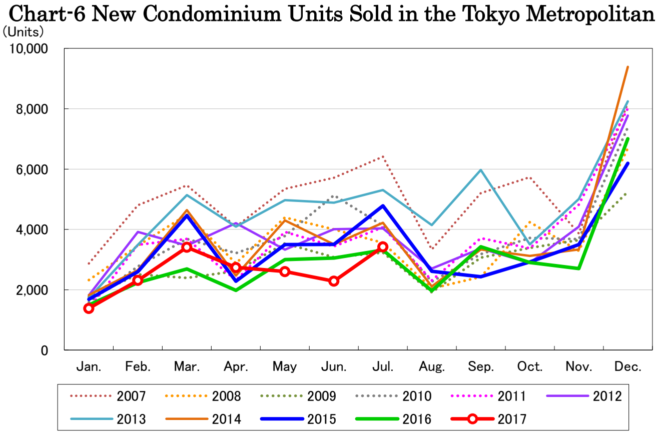
The number of new condominium units sold in the Tokyo metropolitan area was the smallest in 10 years in May and June (Chart-6). Because of expensive prices, closing rates for new condominium units have often fallen below 70%, the so-called boundary between favorable and poor sales conditions (Chart-7). While the number of contracted new units priced at less than 50 million JPY has decreased significantly in recent years, the number of luxury units at over 80 million JPY has been increasing. With rising construction costs, condominium units at less than 50 million JPY have increasingly become difficult to supply in the Tokyo metropolitan area. The closing rates for luxury units have been volatile, susceptible to changes in taxation policies and equity market trends.

Chart-5 Housing Starts



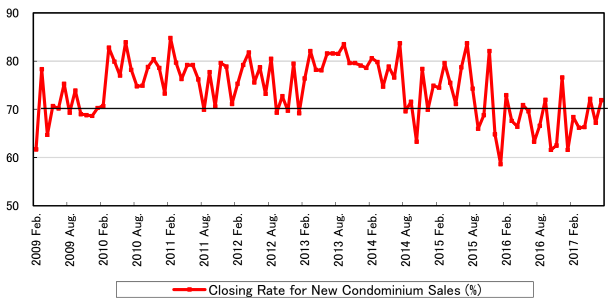
Source: MLIT

Chart-6 New Condominium Units Sold in the Tokyo Metropolitan Area



Source: Real Estate Economic Institute

Chart-7 Closing Rates for New Condominium Sales in the Tokyo Metropolitan Area



Source: Real Estate Economic Institute

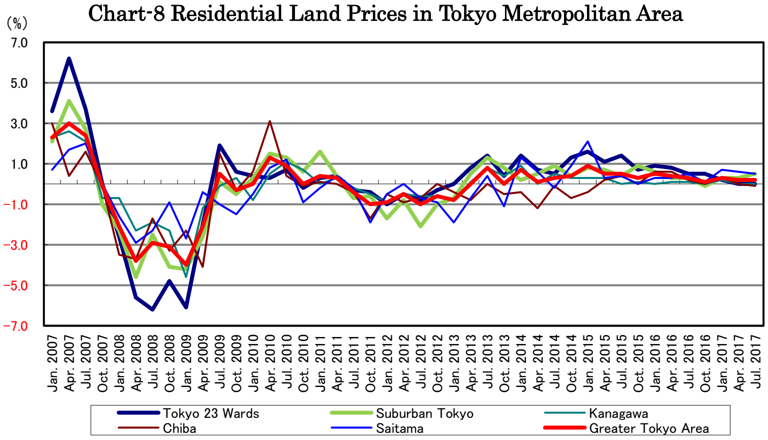
4. Land Prices

Regarding “Rosenka” published by National Tax Authority as of January 1, the average national land price rose for the second consecutive year by 0.4% y-o-y on the back of low interest rates, active urban redevelopment and growing hotel demand in preparation for the increase in foreign tourists. The most expensive monitoring spot in Japan, in front of Kyukyodo in Ginza, posted a record high at 40.3 million JPY per square meter, appreciating by 26% y-o-y and exceeding records from the bubble era of the early 1990s. However, only 13 prefectures posted land price appreciation while the other 32 prefectures continued to post land price decline.

According to Nomura Real Estate Urban Net, residential land prices in the Tokyo metropolitan area rose for the fifteenth consecutive quarter since January 2014 (Chart-8). However, prices have been somewhat cooling down in parts, as Tokyo 23 wards posted 0.0% y-o-y for the second consecutive quarter.

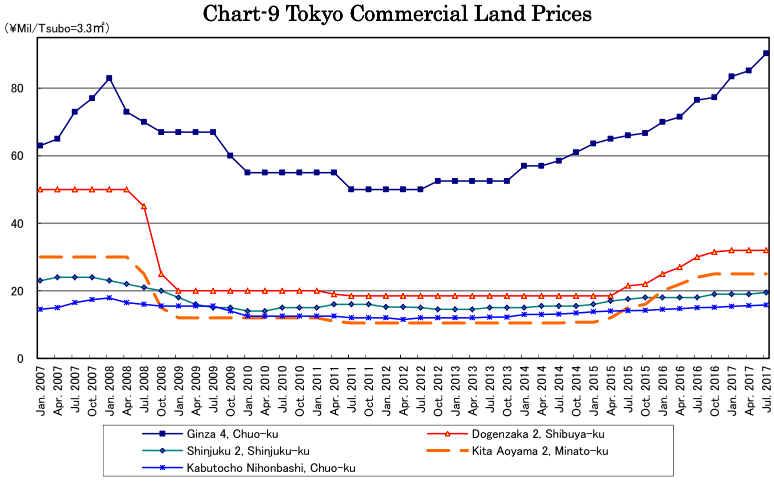
Commercial land prices in the center of Tokyo appreciated significantly in Ginza, however, those in Kita Aoyama and Shibuya have apparently leveled off (Chart-9).

Chart-8 Residential Land Prices in Tokyo Metropolitan Area



Source: Nomura Real Estate Urban Net

Chart-9 Tokyo Commercial Land Prices



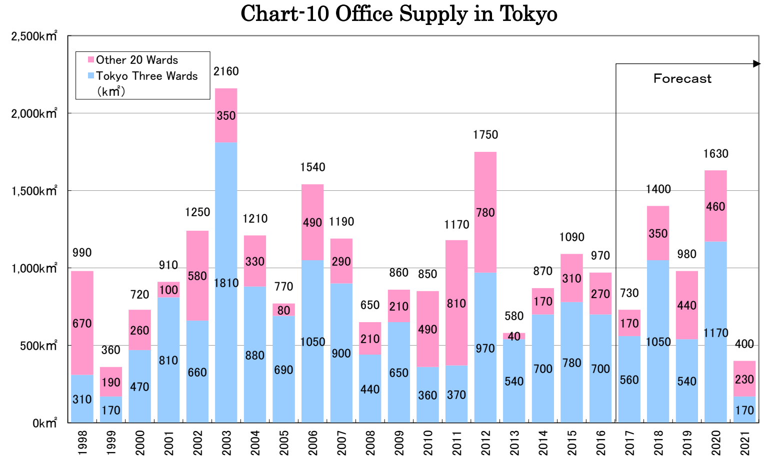
Source: Nomura Real Estate Urban Net

5. Sub-sectors

1) Office

Large buildings such as Otemachi Park Building, Ginza Six and Hibiya Parkfront were completed in the first half of 2017, followed by Akasaka Intercity Air and an office tower in front of Meguro station scheduled for the latter half of 2017. These new and upcoming office buildings have smoothly secured tenants, as seen by Akasaka Intercity Air being fully occupied before completion and Amazon Japan reserving 19,000 square meters in the office tower in front of Meguro station. Thus, anxiety concerning vacancy rate hikes due to large supply has mostly disappeared for 2017. However, many office buildings with total space of 4 million square meters are under construction and scheduled to be completed in 2018, 2019 and 2020 (Chart-10).

Chart-10 Office Supply in Tokyo



Source: Mori Buliding

The vacancy rates of Tokyo Grade-A[1] offices improved to 3.2% and the rent index rose by 4.1% q-o-q and 9.9% y-o-y in the second quarter (Chart-11). Office vacancy rates in Tokyo have remained very low led by Shibuya at 0.98% (Chart-12) and even small- to medium-sized buildings have been enjoying strong office demand.

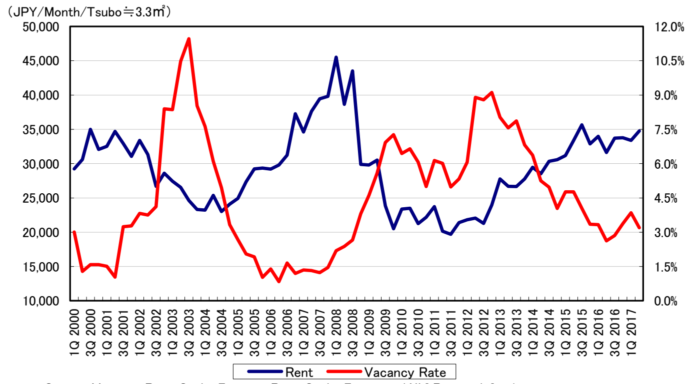
Several business trends have contributed to the current strong office demand such as consolidation of separated offices to one large building; moving from old, self-owned buildings to new, leased buildings; expanding offices by IT companies; and upgrading offices in order to recruit competitive staff amidst the current labor shortage. In addition, demolition of old office buildings being redeveloped into condominiums and hotels have also contributed to the tight office supply and demand.

In local cities, office leasing markets have been even better than in Tokyo, as seen by very low vacancy rates such as 1.4% in Sapporo and 1.56% in Fukuoka (Chart-13). Several new

[1] Sanko Estate selects high grade buildings individually based on its guidelines such as GFA of more than 33,000 m², main floor sizes of more than 990 m², building age of 15 years or less and so on.

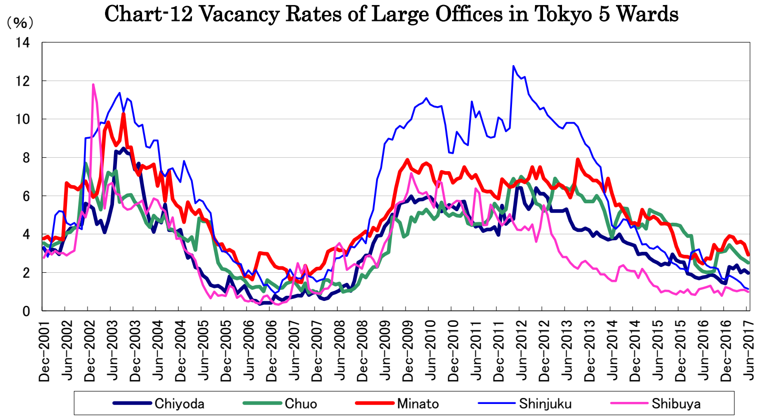
buildings were completed in the first half of 2017 such as Nakanoshima Festival Tower in Osaka, JR Gate Tower and Global Gate West Tower in Nagoya, Fukoku Seimei Koshiyama Building in Sapporo and Nomura Sendai Aobadori Building in Sendai. However, no large buildings are scheduled to be completed in the second half of 2017 and the supply-demand balance will become tighter as a result.

Chart-11 Tokyo Grade-A Office



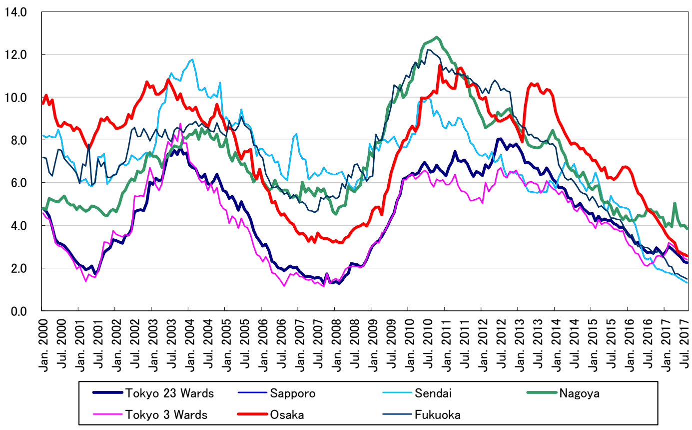
Source: Vacancy Rate･Sanko Estate, Rent･Sanko Estate and NLI Research Institute

Chart-12 Vacancy Rates of Large Offices in Tokyo 5 Wards



Source: Sanko Estate

Chart-13 Vacancy Rates of Large Offices in Major Cities



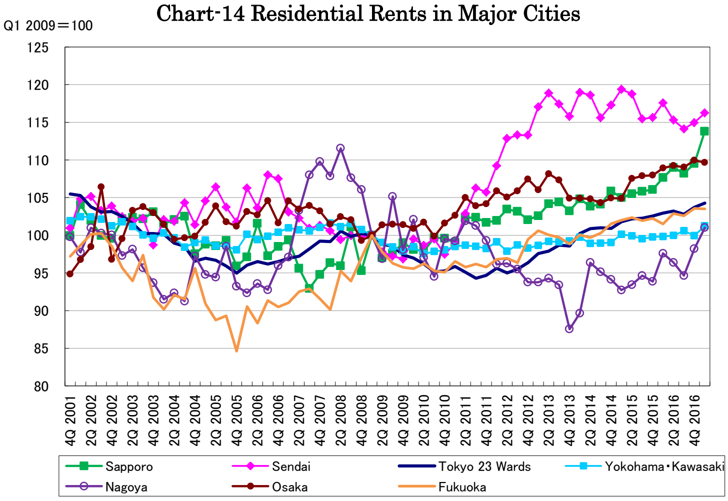
Source: Sanko Estate

2) Residential Rental

Residential rents have been rising led by those in Tokyo, Sapporo and Fukuoka (Chart-14). However, leasing demand does not appear so strong as the number of new leasing contracts has decreased for the sixteenth consecutive month. Particularly, the vacancy rates of apartments for lease have been rising, pushed by increasing housing starts.

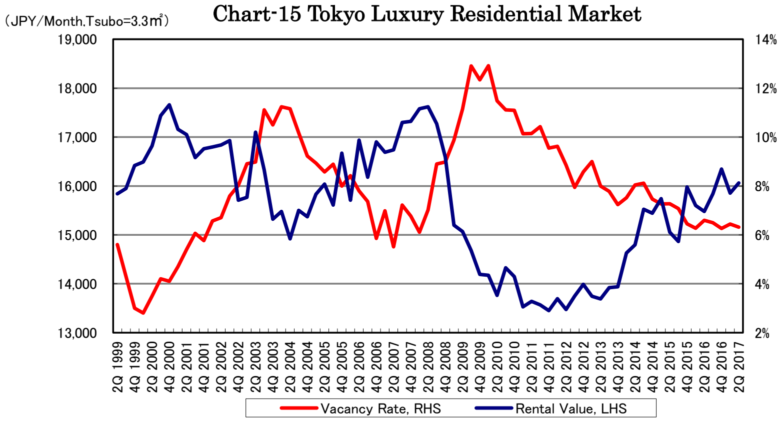
On the other hand, the Tokyo luxury residential market has been robust with improved vacancy rates and rents rising by 3.8% y-o-y in the second quarter (Chart-15).

Chart-14 Residential Rents in Major Cities



Source: Sumitomo Mitsui Trust Research Institute, At Home

Chart-15 Tokyo Luxury Residential Market



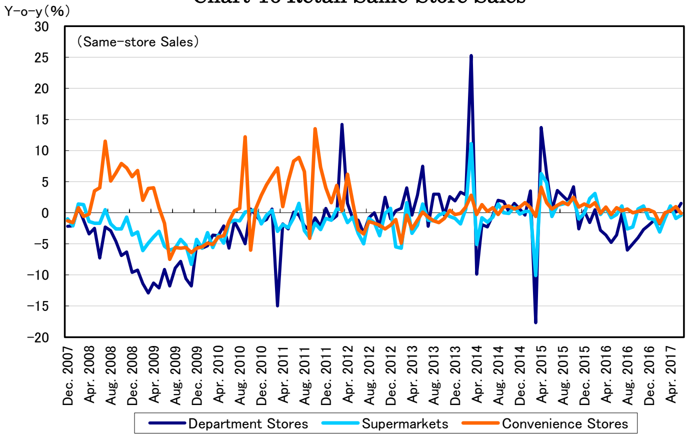
*Sample consists of contracts with more than 300K JPY/Month, tsubo rental value or 30 tsubo space.
Source: Ken Real Estate Advisors Ltd.

3) Retail

Same-store sales of department stores and convenience stores grew by 0.9% and 0.2% y-o-y while those of supermarkets declined by 0.1% y-o-y in the second quarter (Chart-16). Retail sales have been improving as seen by healthy sales of summer clothing and automobiles. In particular, department stores have benefited from strong luxury goods sales stimulated by the healthy equity market and increasing demand from foreign tourists. Regarding foreign tourists, duty-free sales grew by more than 40% y-o-y in May and June. Quarterly consumption by foreign tourists in Japan increased by 13% y-o-y, exceeding one trillion JPY for the first time in the second quarter.

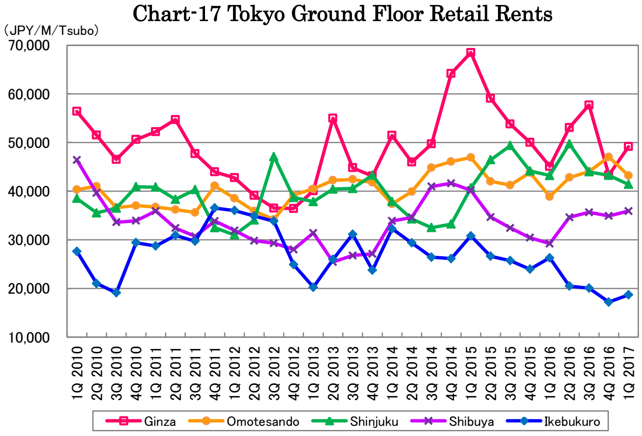
Average retail store rents in Tokyo grew by 10% y-o-y, however, those of ground floors have shown some weakness (Chart-17). For example, GINZA SIX, a large luxury retail mall accommodating 241 tenant stores and aiming 20 million annual customer traffic, opened in April and retail space demand for neighboring sub-streets has faded.

Chart-16 Retail Same-Store Sales



Source: Ministry of Economy, Trade and Industry

Chart-17 Tokyo Ground Floor Retail Rents



Source: Style Act, Nikkei Real Estate Market Report

4) Hotel

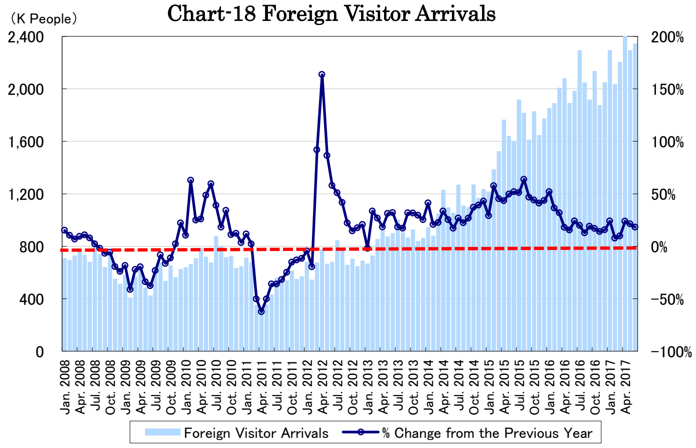
The number of foreign visitors grew by 21.1% y-o-y to 7.2 million in the second quarter (Chart-18). The cumulative number of the past 12 months increased to 26 million. Visitors from South Korea increased particularly by 67% y-o-y in a reversal from last year's decline following the Kumamoto Earthquake. On the other hand, the number of visitors from China has leveled off since February.

The total number of overnight stays in Japan grew by 3.1% y-o-y to 119 million in the second quarter (Chart-19). In addition to overnight stays by foreign tourists increasing by

10.6% y-o-y, those of Japanese tourists also increased for the first time in 6 quarters by 1.6% y-o-y in the second quarter. Hotel occupancy rates have remained as high as those of last year (Chart-20), even with new hotels continuously opening.

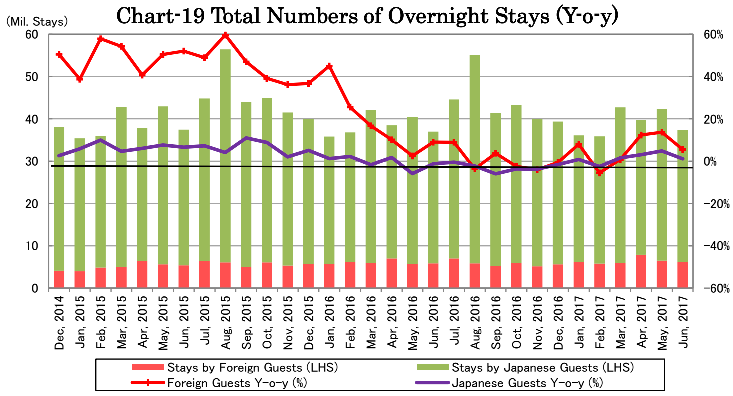
New legislation permitting the operation of *minpaku*, private accommodations serviced to tourists via Airbnb and others, was passed in the National Diet in June. The legislation limits the operating period of *minpaku* to 180 days per year, requiring operators to notify their municipal governor as well as administrators and brokers to register with MLIT and Japan Tourism Agency, respectively.

Chart-18 Foreign Visitor Arrivals



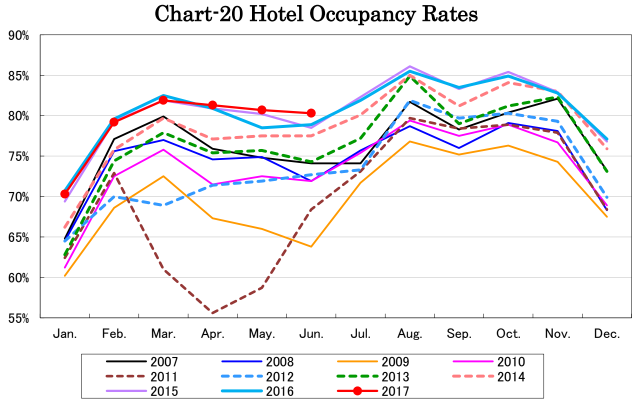
Source: Japan National Tourism Organization (JNTO)

Chart-19 Total Numbers of Overnight Stays (Y-o-y)



Source: Japan Tourism Agency

Chart-20 Hotel Occupancy Rates



Source: Ohta Publications "Weekly HOTERES"

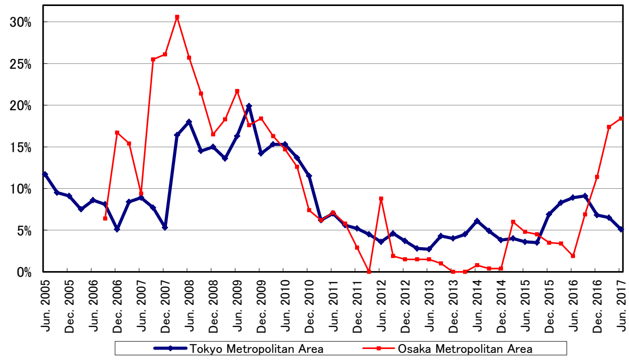
5) Logistics

The Japanese B-to-C e-commerce market grew by 9.9% y-o-y to 15.1 trillion JPY in 2016, according to METI. In addition, the total number of home deliveries also grew by 7.3% y-o-y to 4.02 billion items in 2016, according to MLIT. Based on this trend, strong demand for large logistics facilities has been growing.

The vacancy rates of large, multi-tenant logistics facilities improved by 1.4% q-o-q to 5.1% in the Tokyo metropolitan area while those in the Osaka metropolitan area deteriorated by 1.0% to 18.4% due to excess of new supply (Chart-21).

The largest-ever supply of logistics facilities is scheduled in the Tokyo and Osaka metropolitan areas in 2018 and 2017, respectively. Recently, securing labor force has been the bottleneck for logistics facility operations. Thus, location and accessibility to public transportation have increasingly become important for logistics facilities. During the upcoming largest supply period, the gap between superior and inferior facilities could become clear through leasing activity and rent movements.

Chart-21 Logistics Supply and Demand in the Tokyo Metropolitan Area



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

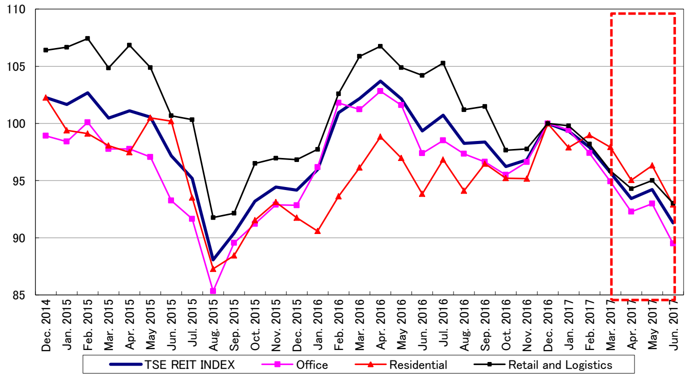
6. J-REIT and Property Investment Markets

1) J-REIT

The TSE REIT index declined by 4.6% in the second quarter, falling below 1,700 points for the first time in 16 months (Chart-22). Office, residential and retail-logistics sectors declined by 5.7%, 5.1% and 3.0%, respectively. Affected by successive cash outflows from J-REIT mutual funds, which have been the largest J-REIT investors, the index dropped by 8.7% from the beginning of the year.

At the end of June, the J-REIT market value was 10.6 trillion JPY with 2.0 trillion JPY of unrealized capital gain. The weighted average price to NAV ratio was 1.1 times and the dividend yield was 4.0% with a 3.9% yield spread on 10-year JGBs.

Chart-22 TSE REIT Index



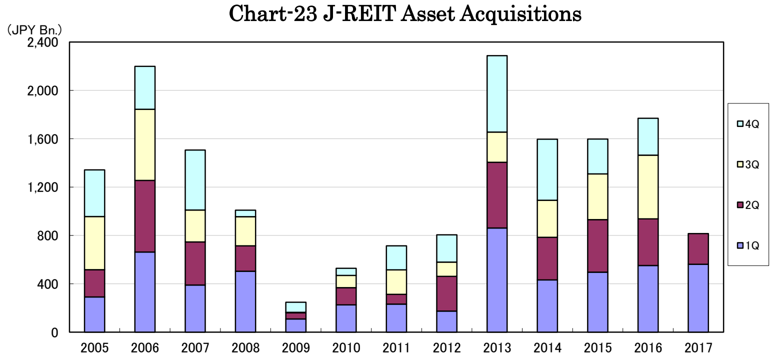
Source: Tokyo Stock Exchange

J-REITs acquired property assets totaling 254 billion JPY in the second quarter, shrinking by 34% y-o-y, and 815 billion JPY in the first half, shrinking by 13% y-o-y (Chart-23). Due to the weakening unit prices, limited IPOs and POs have suppressed the acquisition volume of J-REITs.

J-REIT unit prices rose significantly since the inception of Abenomics at the end of 2012. However, the index has currently fallen to the level of October 2014 when the BOJ tripled the acquisition volume of J-REITs as well as January 2016 when the BOJ announced the negative interest rate policy. It looks as if only J-REITs have lost the benefit from Abenomics, while the equity market has risen considerably as the Nikkei 225 index hovers around 20,000 JPY and 10-year JGB yields have fallen to around 0%.

On the other hand, DPU of J-REITs has grown by 27% since the inception of Abenomics, benefiting from rent recovery and debt cost deduction. In addition, NAV per unit has also grown by 49%. Thus, the valuation of J-REITs has increasingly become attractive, as the weighted average dividend yield increased to 4.0% and price to NAV ratio shrank to 1.1 times.

Chart-23 J-REIT Asset Acquisitions



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

2) Property Investment Market

The property transaction volume increased by 29% to 822.7 billion JPY in the second quarter, according to Nikkei Real Estate Market Report. Avoiding very low yields in the center of

Tokyo, investors have increasingly transacted properties in the suburbs of Tokyo and local cities such as Yokohama Minato Mirai, Tennozu Isle, Shinagawa Seaside and Osaka. And not only large office buildings but also hotels, logistics facilities and bulk of residential portfolios have been transacted.

Two-thirds of respondents replied that the Japanese property investment market had peaked in an April investor survey by the Japan Real Estate Institute. On the other hand, foreign investors have relatively become active in property acquisitions, previously facing difficulty in 2016 with competition from aggressive Japanese investors.

