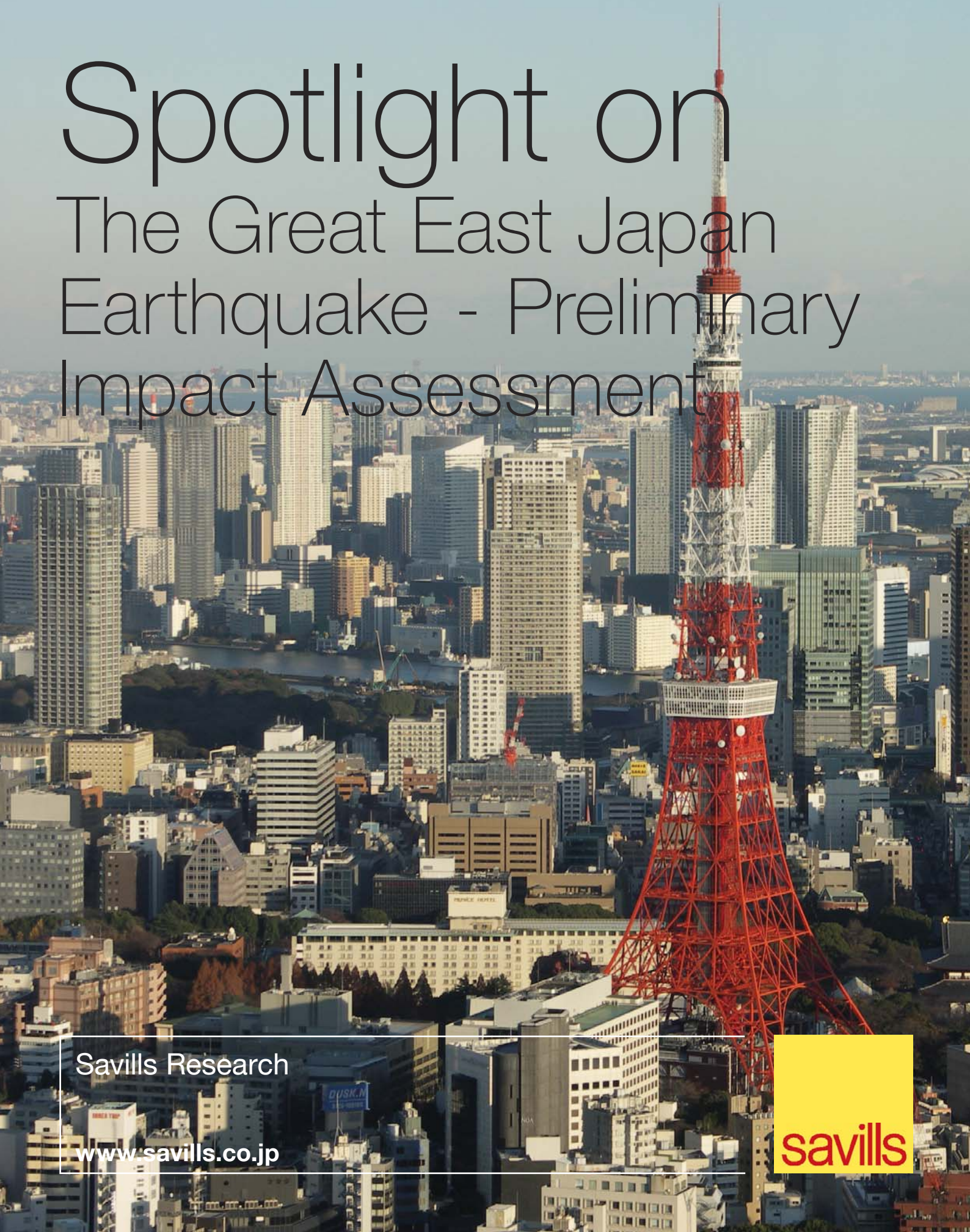
Spotlight on
The Great East Japan Earthquake - Preliminary Impact Assessment



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Spotlight on

THE GREAT EAST JAPAN EARTHQUAKE - PRELIMINARY IMPACT ASSESSMENT

The biggest Japanese earthquake on record

On 11 March 2011, a magnitude 9.0 earthquake hit eastern Japan. The impact of this, the ensuing aftershocks and devastating tsunami wreaked enormous damage, particularly in the Tohoku region – an area primarily focused on the fishery and agricultural industries, although also home to a large number of manufacturing facilities servicing a range of industries. As of 18 April, over 28,000 people have been reported killed or missing and approximately 150,000 people remain displaced in temporary evacuation shelters. Along with these immeasurably tragic natural disasters, the ongoing situation at the crippled Fukushima Daiichi nuclear power plant, where electric support systems were knocked out by the tsunami, remains a serious source of concern and cause of uncertainty for both residents in the outlying areas and investors in the region.

Widespread physical damage, yet minimal impact on institutionally-owned property

"The economic cost of the devastation could total JPY25 trillion."

According to preliminary estimates made by the Cabinet Office, the economic cost of the devastation in the seven affected prefectures could total JPY16 to JPY25 trillion. Much of this relates to the reconstruction of social infrastructure, private housing and corporate facilities destroyed in coastal areas by the tsunami. The damage to real estate further inland appears to have been minimal, including in Tohoku's largest city, Sendai, where the majority of institutionally-owned properties in the region are located.

"While no J-REITs have sustained serious damage to assets, some logistics facilities located close to the coast have required considerable non-structural repair work."

Nine J-REITs own a total of 20 properties in the Tohoku region which were affected by the earthquake; however, none have reported serious damage and currently all of the properties are fully operational. Several logistics providers also reported incidences of non-structural damage to assets in the Tohoku region, largely due to the effects of the tsunami. An asset owned by US-based logistics provider ProLogis near Sendai Airport is reported to have suffered flood damage on the ground floor, while San Francisco-based AMB Properties announced minor damage to an asset situated next to Sendai-Kamaishi Port. Media reports and press releases suggest that total repair costs for the two companies will

HIGHLIGHTS

- The impact of the M9.0 earthquake and the ensuing tsunami has had enormous costs both in terms of human life and physical devastation, particularly in the coastal regions of Tohoku.
- No J-REITs have reported serious damage to their operating assets either in the worst affected areas or in the Greater Tokyo region; some investment-grade logistics facilities located close to the coast did, however, sustain non-structural damage as a result of the tsunami and underlying soil liquefaction.
- The Bank of Japan has accelerated its measures to support the property market, including an additional JPY50 billion capital allocation for J-REIT purchases, which has helped to sure-up the TSE J-REIT Index after sharp post-quake declines.
- Preliminary economic forecasts from leading research institutions suggest that Japan's GDP will fall sharply in Q2 and thereafter pick up in the second half of the year on the back of reconstruction efforts. Despite this, full-year GDP growth in 2011 is expected to be nominal.
- Assuming that the situation at the Fukushima nuclear plant remains localised and can be stabilised over the coming weeks and months, the recent rise in demand for office relocation space in western Japan can be expected to be largely temporary in nature. Some international and domestic firms may, however, look to secure a more permanent back-office presence to facilitate business contiguity strategies.
- Newly built or recently renovated office properties conforming to full seismic codes and located away from bayside areas are expected to achieve a demand premium in the short to mid term.
- While the longer term fundamentals of the residential, retail and logistics sectors have not been significantly affected by the recent natural disasters, disruptions to power, distribution networks and subdued consumer sentiment will likely have an impact in the short term.

be in the region of JPY800 million. GL Properties, a subsidiary of Singapore's GIC Real Estate, has reportedly incurred approximately JPY3.17 billion of damage to seven properties in the region.

In Tokyo, the destination of most institutional capital in Japan, no significant structural damage was reported as a result of the earthquake. Several properties did however experience minor facade damage, while soil liquefaction has caused subsidence in some coastal properties, particularly in the Tokyo Bay area. The fact that Tokyo's real estate emerged largely unscathed from the strongest earthquake to hit the city since the Great Kanto Earthquake of 1923 is testament to the stringent seismic countermeasures required under Japan's Building Standard Law.

Government initiatives

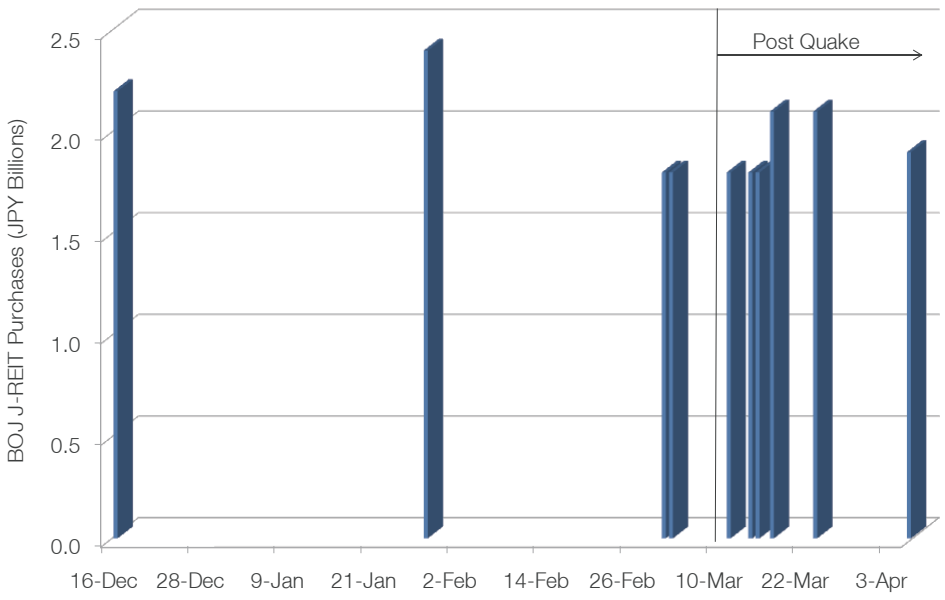
"The Bank of Japan is fast-tracking measures to support the property market, including an additional JPY50 billion capital allocation for J-REIT purchases."

With a view to preventing negative business sentiment and increased risk aversion in the financial markets from adversely affecting economic activity, the Bank of Japan (BOJ) has announced its decision to inject a further JPY5 trillion into its asset purchase programme. Approximately JPY50 billion of this is allocated to J-REIT purchases, matching the bank's previous allocation to the domestic REIT market in October. Acting as a sign of the BOJ's commitment to revitalising the Japanese property market, approximately JPY11.5 billion has already been invested by the BOJ in six bulk J-REIT purchases since 11 March 2011. The market has responded positively to date, with the Tokyo Stock Exchange's J-REIT Index recovering to 96.5% of its 10 March pricing after an initial post-quake fall of around 15.1% between 11 March and 13 March.

"The market has responded positively to the BOJ's assistance, with the Tokyo Stock Exchange's J-REIT Index showing signs of a turnaround."

CHART 1

BOJ capital injections into the J-REIT market, Dec 2010 - April 2011



Source: Bank of Japan

The Japanese government, along with other major G7 economies, has intervened in the FX market to limit the appreciation of the yen, helping to mitigate excessive and destabilising short-term movement. Meanwhile, the BOJ has injected a significant amount of capital to sustain market liquidity and stock prices. These efforts have been widely accepted by the market and have led to a moderate pull-back in the Nikkei 225 stock price index.

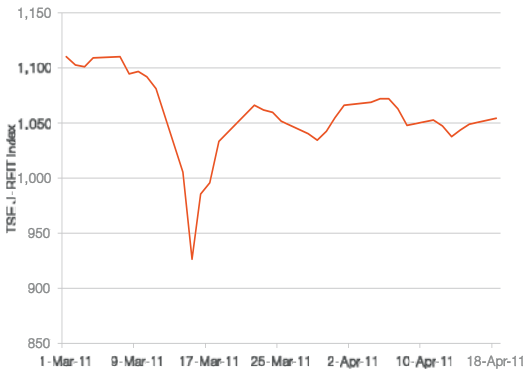
Economic outlook

"Preliminary economic forecasts suggest that Japan's GDP will fall sharply in Q2 and pick up in the second half of the year on the back of reconstruction efforts. Despite this, full-year GDP growth in 2011 is expected to be nominal."

According to FocusEconomics, preliminary post-quake forecasts from 24 private-sector research institutions suggest that Japan's economic output will contract by a seasonally adjusted annualised rate of -1.0% in the second quarter. This compares with a consensus growth forecast of 1.6% in

CHART 2

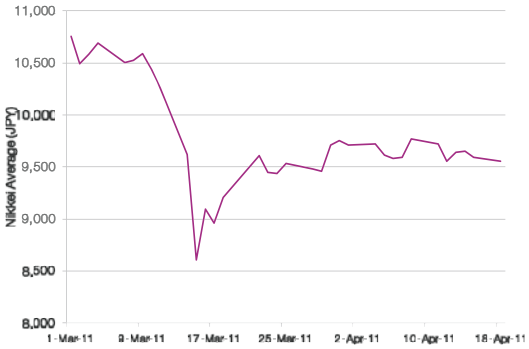
TSE J-REIT index, 1 Mar - 18 Apr 2011



Source: Tokyo Stock Exchange

CHART 3

Nikkei 225 stock price index, 1 Mar - 18 Apr 2011



Source: Nikkei

early March, prior to the earthquake. Projections for full-year GDP in 2011, however, anticipate that recessionary pressures will be largely offset by an uplift spurred by reconstruction efforts in the latter half of the year. Individual estimates for 2011 ranged between -0.2% and 1.9%, while the consensus figure fell 40 basis points from the previous month's estimate to 0.9%. The outlook for full-year GDP growth in 2012 was raised from 1.8% to 2.2%.

With uncertainty remaining over several key issues, preliminary growth estimates are expected to see additional adjustments over the coming months as a clearer picture of the situation unfolds. The impact of electricity shortages and supply chain disruption on manufacturing output and exports is one major source of concern. Although Tokyo Electric Power Co. (TEPCO) has announced that it will no longer conduct rolling blackouts, which have intermittently halted electricity supply in parts of its service area since 11 March, a mandatory cut in power consumption of up to 25% by plants and other large-lot energy users is due to be implemented in the third quarter. While promoting heightened energy efficiency should help balance the current supply limitations against the extra demand expected in the peak summer period and mitigate against disruptive power outages, it will restrict industrial capacity in the Tokoku-Honshu region in the near term.

The condition of the nuclear power plant in Fukushima is another ongoing source of uncertainty. According to official guidance, the designated evacuation zone set up around the stricken facility conforms to international safety standards. The Scientific Advisory Group in Emergencies (SAGE) asserts that even in the worst case scenarios, the risks to human health beyond the exclusion zone could be managed by precautionary measures, in particular staying indoors to avoid exposure. The Japanese government is monitoring radiation levels across the region and has imposed export bans on potentially contaminated foodstuffs. Nonetheless, although the associated risks are reported to be gradually declining as the reactors cool and as facilities to stabilise them are established, the situation in Fukushima will continue to have a negative impact on consumer confidence and exports (especially consumables) until assurances can be given that the situation has been successfully stabilised.

The Cabinet Office's Economy Watchers' diffusion index, a measure of the confidence of business-cycle sensitive workers such as retail and restaurant staff, hotel managers and taxi drivers, fell from 48.4 in February to 27.7 in March – its fastest ever monthly rate of decline. As well as being an indicator of consumer confidence, the index serves as a leading indicator for the rest of the economy; the unprecedented post-quake drop can therefore be seen as indicative of the sharp contraction in economic activity that is anticipated in the short term. Uncertainty surrounding aftershocks and the Fukushima situation will likely continue to dampen consumer sentiment over the coming months. However, outside of the worst affected Tohoku region, recent depressed consumer activity can be largely attributed to self-restraint practiced by Japanese citizens, who have tempered purchases of non-essential items to demonstrate solidarity with the earthquake and tsunami victims. As day-to-day life in most parts of the country normalises and reconstruction efforts gather pace over the coming months, consumer spending and business sentiment should pick up in the second half of the year.

Investment market

"While some deals have inevitably been cancelled or postponed, major investors remain committed to their Japanese portfolios with the long-term prospects continuing to be sound."

Market intelligence suggests that major investors remain committed to their Japanese portfolios and no plans to exit the market have been reported to date. Some deals have, perhaps inevitably, been cancelled and closings postponed due to uncertainties arising in the aftermath of the disaster. The postponement of an additional public offering and multiple asset acquisition by United Urban REIT (UUR) is one notable example.

While some core/core-plus investors are hesitating in closing deals given the short-term uncertainty surrounding the stricken Fukushima nuclear power plant, some opportunistic investors and hedge funds are reported to be eyeing the market for potential buying opportunities. The prospects for Japanese real estate investment in the longer term remain sound and investor appetite for well positioned assets is expected to hold up after a short-term lag. In particular, it is believed that domestic investors, who took the lead in the nascent recovery prior to the quake, will remain active.

Immediate challenges will come in the form of valuation and competition for bank financing from affected businesses and the demands of the reconstruction effort. Potential volatility in the capital markets will also have a substantial impact on J-REITs both in terms of unit pricing and the secondary offering environment, which could hamper their ability to raise additional capital.

Impact on the real estate market

OFFICE

"The recent pickup in demand for office relocation space in western Japan is believed to have been largely temporary in nature. Some international and domestic firms may, however, look to secure a more permanent back-office presence to facilitate business continuity strategies."

Some non-Japanese companies such as H&M and IKEA temporarily relocated their head office functions from Tokyo to the Greater Osaka region shortly after the earthquake to minimise potential risks from the Fukushima nuclear facility. Most of these companies are reported to have now reoccupied their Tokyo offices and a related rise in Tokyo vacancy rates is not expected in the near term. Some smaller international companies may, however, decide to relocate their headquarters to Osaka on a more permanent basis, which could result in a boost in demand for Grade B quality office buildings in the central

IMAGE 1

Marunouchi District

IMAGE 2

Roppongi Hills Residences

Osaka market. Western Japan may also witness heightened demand for back office space over the longer term as occupiers seek to manage seismic risk and implement business contiguity strategies. The largest short-term risks for the Tokyo real estate market remain the ongoing situation in Fukushima and the associated power supply problems. If conditions in Fukushima were to deteriorate significantly or power supply uncertainties to continue for an indefinite period, instances of relocation to the economic centres of western Japan are likely to increase.

"Newly built or recently renovated office properties conforming to full seismic codes and located away from bayside areas are expected to achieve a demand premium."

While it is still too early to assess the longer-term impact of recent events on the office leasing market, leasing agents in various markets have reported an increase in demand for properties which offer advanced seismic technology and technical infrastructure. A move away from pencil building structures (floor plates of around 50 tsubo / 165 sq m or below) to larger, more robust floor plates (200 tsubo / 660 sq m and above) is anticipated in the short to medium term. Newly built or recently renovated properties conforming to full seismic codes and located away from bayside areas are expected to achieve a demand premium. In Tokyo, companies located in the outer 23 wards and surrounding areas are reported to be consolidating moves into the central five wards and/or Osaka area, which are considered safer and have been less disrupted by power outages.

For the most part, Grade A and Grade B buildings which fit the above criteria have not benefited from any direct rental uplift to date, even with the elevated demand. This is in part due to a cultural consideration of the tragedy but also reluctance by tenants to increase their operating budgets if avoidable. However, initial indications suggest that incentives such as rent-free periods are being negotiated downwards. In the short to mid term, the impact of recent events on tenant sentiment will likely see a shift away from submarket-led demand to asset-specific demand. Therefore, assuming that the Fukushima nuclear situation can be brought under control without too much disruption to trade and distribution routes, average rents for Grade A and good-quality Grade B properties in Tokyo's central five wards are expected to continue to bottom out over the next several quarters, albeit with a rental recovery possibly subject to some delay. In contrast, lower quality Grade B and C properties built prior to 1981, when the seismic design codes in the Building Standard Law of Japan were comprehensively revised, are likely to suffer as a result of recent events.

RESIDENTIAL

"While the longer term fundamentals of the residential, retail and logistics sectors are not considered to have been significantly affected by the recent natural disasters, disruptions to power, distribution networks and subdued consumer sentiment will likely have an impact in the short term."

The worst of the structural damage to residential stock was largely restricted to the coastal areas devastated by the tsunami and older, mostly privately-owned detached properties in the Tohoku region. Institutionally-owned residential assets are not reported to have been badly affected and no serious damage has been confirmed by J-REITs with residential assets in Sendai and Greater Tokyo. Since the building quality of most J-REIT assets is relatively high compared to typical mass-market properties, the seismic risks are believed to have been somewhat minimised.

"In Greater Tokyo, stable demand is expected to maintain the currently high average occupancy rates for modern mid-market residential assets, although the luxury market is likely to witness some short-term softening."

With regard to the worst affected areas in Tohoku, as clean-up operations continue, heightened demand is expected to be seen further inland in locations such as central Sendai. In Greater Tokyo, although minor damage was suffered by several J-REIT-owned assets as a result of the earthquakes and soil liquefaction, especially in the coastal areas of Chiba Prefecture, no residential buildings or condominiums are reported to have collapsed. This is testament to the strong earthquake-resistant specifications in place. Stable demand has been witnessed for modern mid-market residential assets in recent quarters; with the exception of areas affected by soil liquefaction, high average occupancy levels as well as the recent trend towards rental recovery are expected to be maintained in the short to mid term.

For the luxury residential market, however, the primary risk is that the expatriate community will exit the market for an extended period. According to one luxury residential operator, no termination notices have been received since the earthquake, in part due to the fact that families have been reluctant to relocate their children at the beginning of the April school year. However, whether this trend will continue will likely depend on how quickly and efficiently the situation in Fukushima can be resolved. Indeed, increased occurrences of foreign executives opting to repatriate their families are expected to be seen over the coming months, placing downward pressure on occupancy levels – especially in larger units – as a consequence. A softening in luxury residential rents is therefore anticipated in the short term.

RETAIL

Some operations have been suspended by large retailers located in quake-affected areas; however, no serious damage has been reported by institutional owners. Rather than structural damage to retail properties, incidences of suspended trade are attributed to the temporary disruption of supply routes and a resulting lack of produce. While the authorities continue to make efforts to re-establish distribution networks, demand for food and general household goods is expected to temporarily increase as a result of the relief effort and as households stock up on daily essentials. As a consequence, retailers such as supermarkets and GMS operators which have access to supply networks, especially those in large shopping centres, can expect to see above average sales over the coming weeks and months.

In contrast, sales of non-essential items, particularly luxury goods, as well as catering services are reported to be experiencing a short term dip, not only in the worst affected regions but across Japan as a whole. In Tokyo, electric power shortages and subdued consumer sentiment are having a significant negative impact on high-street and luxury sales. Landlords of retail and hospitality assets are therefore expected to receive an increase in rent reduction or rent holiday requests for the months immediately following the earthquake. Moreover, some chain retailers affected by the earthquake, either directly through damage or supply network disruption or due to reduced sales as a result of weakened consumer demand, have decided to close non-profitable outlets in various parts of the country to minimise company losses. Landlords of retail assets in secondary and tertiary submarkets could consequently experience a slackening of occupancy rates in the short term.

LOGISTICS

With regard to institutionally-owned real estate, the logistics sector is believed to have been the hardest hit by the Great East Japan Earthquake when measured in terms of repair costs. However, while some assets have sustained minor damage as a result of the earthquake and tsunami, no serious damage has yet been reported by the operators of the

IMAGE 3

Shibuya

majority of high-quality modern logistics facilities. Although some assets in the Tohoku region are unable to resume full operations, heightened demand for distribution facilities to support the relief effort has already been seen, especially for functional assets in the quake-affected areas. Media reports suggest that assets operated by GL Properties in two locations in the Tohoku region are now front-line bases for distributing emergency goods to shelters. The Singaporean investor is also said to be providing short-term flexible agreements to tenants with much smaller requirements than usually accepted, particularly in the Greater Tokyo region. J-REP is also reported to be considering allocating some of the available space in its facility in Kawagoe City, Saitama, for emergency needs.

In the Greater Tokyo area, problems with soil liquefaction, especially in Tokyo Bay, have disrupted operations at several logistics facilities. Nonetheless, all assets have continued to operate with full functionality. Given that the demand for logistics facilities is expected to increase considerably as relief efforts make way for reconstruction over the short to mid term, occupancy levels at logistics facilities are expected to increase, particularly within the Greater Tokyo area. Demand for modern distribution space is also likely to improve as occupiers of older or independently owned properties – which bore the brunt of the disruption in this sector – look to reduce risks and secure modern premises. ■

IMAGE 4

Waterfront Warehouses in Shibaura Pier

For further information, please contact:

japan

Christian Mancini
Managing Director, CEO

+81 3 5562 1717
cmancini@savills.co.jp

japan

Koji Naito
Associate Director, Research

+81 3 5562 1733
knaito@savills.co.jp

research & consultancy, asia pacific

Simon Smith
Senior Director

+852 2842 4573
ssmith@savills.com.hk

address

Savills Japan Co., Ltd.
CR Kamiyacho Building 10F
1-11-9 Azabudai, Minato-ku
Tokyo 106-0041
Japan
T: +81 3 5562 1700
F: +81 3 5562 1705

corporate website

www.savills.co.jp