Japan - March 2019

SPOTLIGHT
Savills Research

Japan Logistics

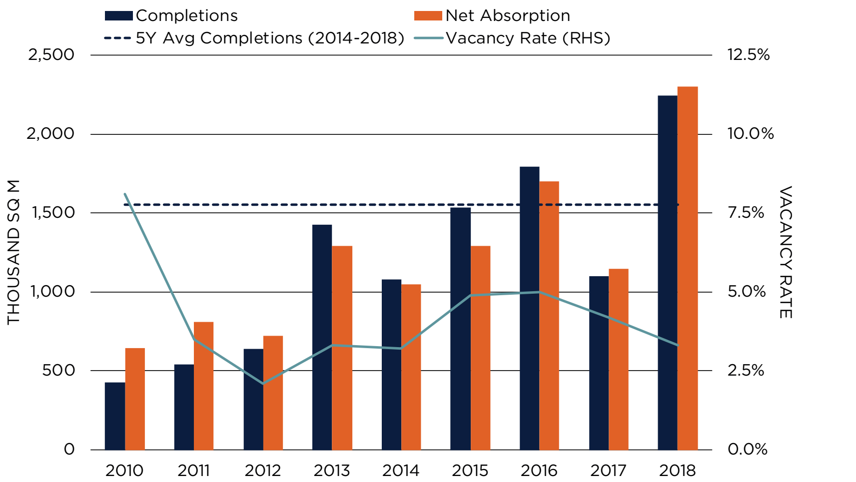
©ESR LTD

Logistics demand stronger than expected

Summary

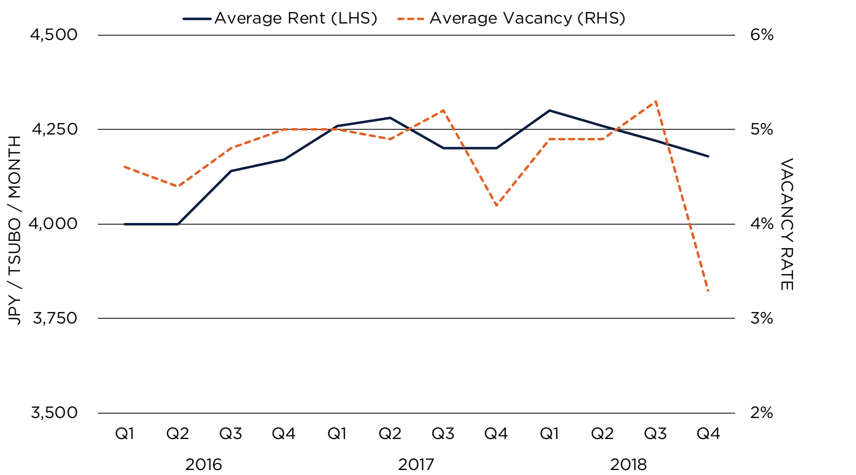
- Despite an influx of supply, demand was stronger than expected in Greater Tokyo, resulting in a vacancy rate of 3.3%.
- Greater Osaka vacancy fell to 7.1% as the market continues to digest supply added in 2017.
- Asking rents have been stable in Greater Tokyo, while rising top rents are pulling the average up in Greater Osaka.
- Demand for new facilities from e-commerce and 3PL companies supports sound pre-leasing activity.
- Investor interest in this sector remains strong, highlighted by the recent announcements of new funds targeting logistics facilities.
- Major logistics companies have improved financial performance, which appears to have resulted in strong demand for logistics facilities.
- Given the sector's strong investment demand and moderate yield spread, cap rates might have room for further compression.

Graph 1: Supply, Take-up And Vacancy In Greater Tokyo, 2010 to 2018



Note: Annual periods from February to January.
Source Ichigo Real Estate Service, Savills Research and Consultancy

Graph 2: Greater Tokyo Rent Vs Vacancy, Q1/2016 to Q4/2018



Note: Annual periods from February to January.
Source Ichigo Real Estate Service, Savills Research and Consultancy

Introduction

Prompted by demand from e-commerce and third-party logistics (3PL) companies, the logistics market continues to witness a wave of supply that will extend through 2019. Despite surging supply in Greater Tokyo in 2018, demand growth was stronger than expected early in the year and resulted in tighter vacancy in 2H/2018. In particular, properties that are advantageously located close to demand centres are experiencing strong leasing activity. In Greater Osaka, existing vacant space has been gradually let up, resulting in a substantial tightening in vacancy. Although some properties in the bay area might require more time to fill up space, overall market conditions are likely to tighten further.

Market Trends

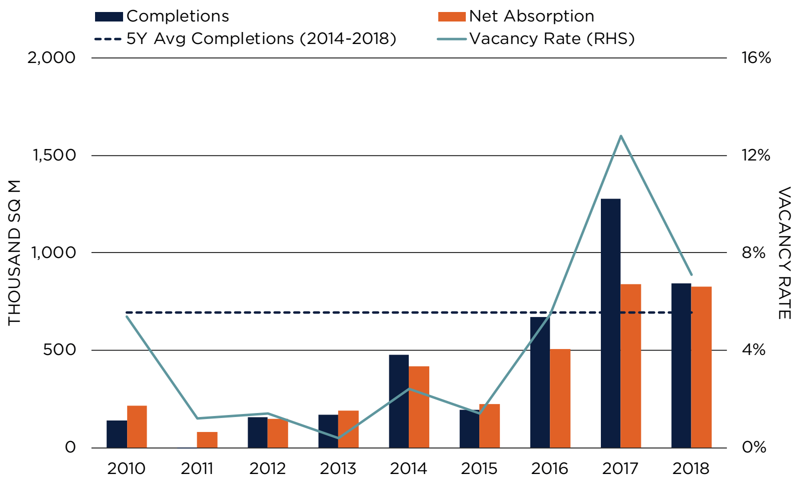
In Greater Tokyo, vacancy declined by 0.9 percentage points (ppts) year-on-year (YoY) to 3.3% as a result of improving demand. Many new facilities saw sound pre-leasing before starting operation, while existing properties also let up vacant space. Although asking rents in this market posted a slight decline in 2H/2018, they are generally stable around 4,200 yen per tsubo. The peripheral area also appears to have held up rental levels, despite concerns over supply along the Ken-O

Expressway. While large properties require more time to lease, new locations proximate to demand centres with good access to major thoroughfares appear to be seeing sound demand.

Large projects in 2H/2018 included facilities such as ESR Kuki Distribution Centre, MFLP Prologis Park Kawagoe, and GLP Goka. These facilities reportedly had some vacancy upon completion, though demand from e-commerce and 3PL companies steadily filled the new space. Additionally, LaSalle Investment Management's Kanto Transport Sayama Logistics Centre came online as the largest logistics centre of Kanto Transport, with advanced features allowing for the storage of wholesale foods at five different temperatures. Demand for advanced cold and chilled storage features should continue to grow as volumes of pharmaceutical goods, as well as frozen foods, are expected to increase. The completion of the phase-out of hydrochlorofluorocarbon (HCFC) refrigerants - commonly used in older facilities - in 2020 is expected to create some supply shortage as well.

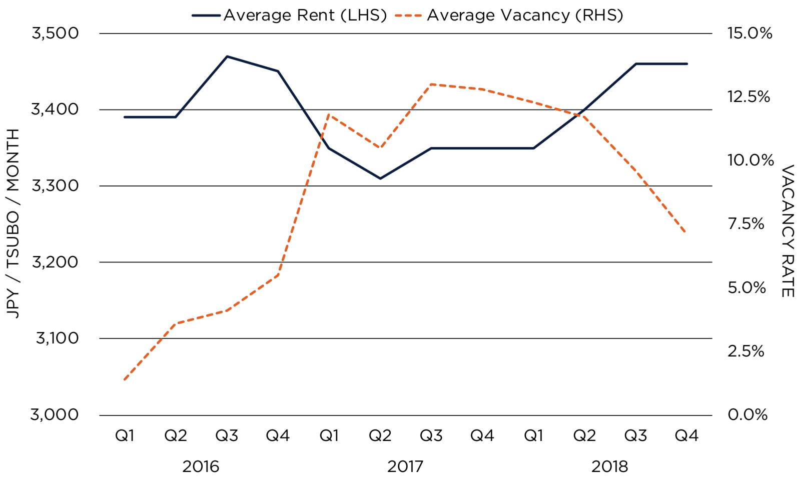
Notwithstanding a wave of new supply, the logistics market has seen stronger-than-expected demand in 2018 marked by sound leasing activity. Supported by positive prospects, interest in this sector remains strong among investors.

Graph 3: Supply, Take-up And Vacancy In Greater Osaka, 2010 to 2018



Note: Annual periods from February to January.
Source Ichigo Real Estate Service, Savills Research and Consultancy

Graph 4: Greater Osaka Rent Vs Vacancy, Q1/2016 to Q4/2018



Note: Annual periods from February to January.
Source Ichigo Real Estate Service, Savills Research and Consultancy

In Greater Osaka, vacancy tightened 5.7ppts YoY to land at 7.1%, a significant decline from the recent peak of 13% in Q3/2017. Although the bay area was showing signs of struggle as a result of abrupt supply increases, vacancy in this area appears to be tightening as well. For instance, Logiport Amagasaki gradually let up remaining vacant space and reportedly exceeded 50% occupancy after a little over a year from its completion. Asking rents continued to show improvement across the market, with top rents gradually increasing through 2018 and recently exceeding 6,000 yen per tsubo. New high-specification facilities should continue to pull up average market rents. As the industry has been adopting modal shifts from trucks, logistics locations with flexible transportation routes may also enjoy sound demand over a longer term[1].

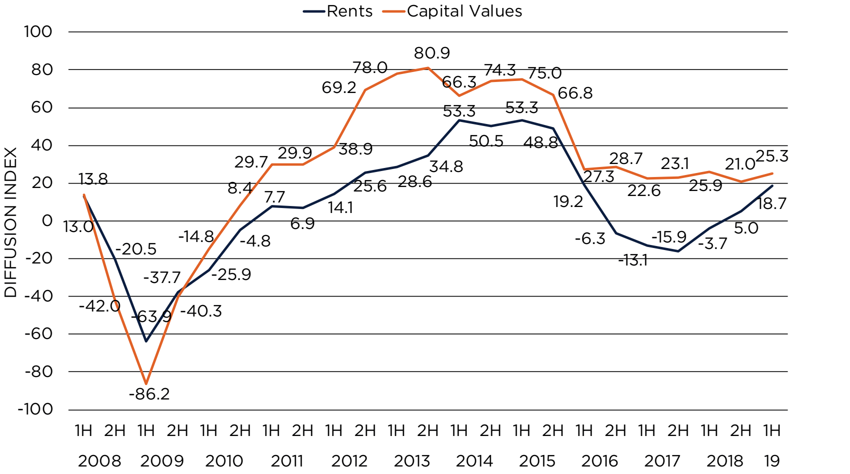
Incoming Supply

Greater Tokyo continues to experience a glut of supply as about 2.8 million sq m of new space is expected to enter the market in 2019. Chiba Prefecture is expected to account for almost a half of total supply with a high concentration in the bay area, including Ichikawa, Narashino, and Funabashi, while inland locations such as Nagareyama and Inzai continue to increase total space as large, multi-phase projects add new buildings.

In Kanagawa, the enormous Logiport Kawasaki Bay offering 300,000 sq m is slated for completion in May 2019. Although its location in Higashi Ogijima, a logistics hub, is advantageous, according to LaSalle

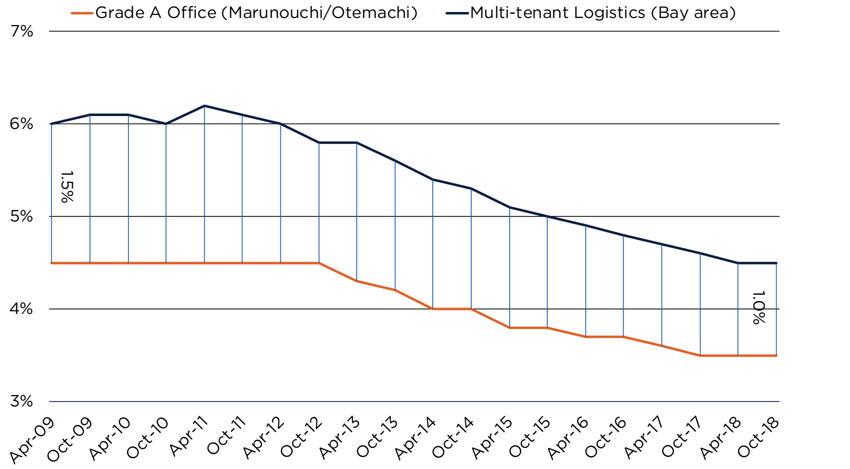
1 For instance, in 2018, four major beverage companies announced their collaboration plan to utilise railways for weekly product deliveries between Kansai and Kyushu, a transport capacity equivalent to 2,400 trucks. Sagawa Express also significantly reduced drivers' working hours by including marine transport in its delivery route between Tokyo and Fukuoka. However, the partial shutdown of the Sanyo Line after torrential rain in West Japan caused a temporary surge in demand for truck deliveries and reminded industry players of the importance of business continuity planning.

Graph 5: Six-month-ahead Expectation For Rent And Capital Appreciation, 2008 to 1H/2019



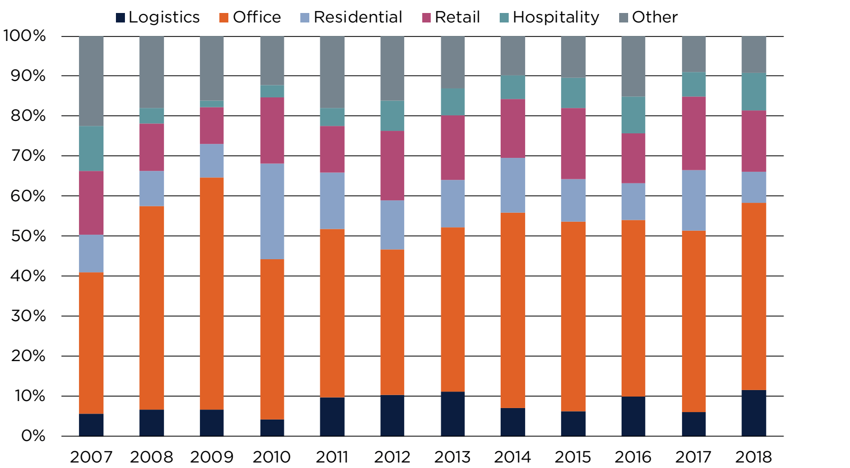
Source Ichigo Real Estate Service, Savills Research and Consultancy

Graph 6: Comparison Of Tokyo Grade A Office And Logistics Expected Cap Rates, April 2009 to October 2018



Source JREI, Savills Research and Consultancy

Graph 7: Share Of Investment Volumes By Asset Class, 2007 to 2018



Source RCA, Savills Research and Consultancy

Investment Management, over 250,000 sq m of Logiport Higashi Ogijima A, B, and C will see the lease terms of multiple tenants come to an end in 2019 and 2020. Considering that ESR is also building three large facilities totalling about 680,000 sq m between 2020 and 2025 on the artificial island, the area might experience some loosening in vacancy in the medium term.

In Greater Osaka, around 350,000 sq m is estimated to enter the market in 2019. This is a relatively moderate amount compared to 2017 when large properties were rapidly completed over a short period of time. Each new property in Osaka Prefecture is expected to be less than 40,000 sq m and will be located inland, which should avoid aggravating vacancy in the bay area. In Hyogo, large projects such as the Mapletree Kobe Logistics Centre are set to enter the market. Although the total amount of new space is not very substantial, the impact might be felt temporarily as the size of the Kobe inland market is relatively small compared to the expected supply.

Investment Trends

According to Ichigo Real Estate Service's investor survey, fewer market participants hold pessimistic views on current market conditions and more see room for rental growth compared to previous periods. The improvement is rooted in strong demand trends exhibited both in Greater Tokyo and Greater Osaka. While many investors sense that the Japanese logistics market is approaching its peak, improving performance metrics indicate that the late upward cycle may continue longer than previously expected, albeit at a slower pace. Indeed, recent announcements of new funds targeting this sector illustrate sound investor interest.

The Canada Pension Plan Investment Board (CPPIB) has committed US$700 million to GLP Japan Development Partners III. The new fund will be used to finance GLP Sagamihara. In January, it also became public that ESR, AXA Investment Managers, and an undisclosed sovereign wealth fund formed a joint venture and acquired six properties from ESR's portfolio for about US$1 billion. Additionally, LaSalle Investment Management plans to launch a new fund, Japan Core Fund, including Logiport Sakai in Osaka as one of the fund's seed assets. The firm aims to expand its AUM to JPY300 billion after five years from the launch of the fund and about 25%, or JPY75 billion, is expected to be allocated to the logistics sector.

According to the Japan Real Estate Institute's (JREI) semi-annual investor survey in October 2018, expected cap rates for multi-tenant logistics facilities remained unchanged from the previous period for the first time since April 2013. However, logistics properties still maintain a yield gap of 1.0%

over Grade A offices. In countries such as the U.S. and the U.K. where e-commerce has taken a stronger hold, yield gaps between Grade A offices and logistics properties are almost non-existent. This could indicate that further compression may be feasible in the logistics sector in Japan as well, particularly if more capital flows to logistics assets, thereby supporting the maturation of the market.

Improving Operator Performance

As we reported in the April 2018 Japan logistics spotlight, Yamato Transport undertook drastic measures to improve its working environment by increasing wages and converting temporary truck drivers into permanent staff. The change was probably necessary as, unlike in other industries, the physically demanding nature of delivery work appears to be making it difficult for female and elderly workers to fill the labour gap in the logistics industry. Despite subsequent increases in labour costs, operating profits of its home delivery business increased to JPY1 trillion, up by 9.2% YoY as of Q3/FY2019. This is largely due to the company's efforts to transfer additional costs to its clients: revenue per package for large corporate clients increased over 16% YoY for the same period. The wide publicity of the logistics industry's labour shortage might have eased the implementation of price increases, as clients are well aware of the industry's cost burden. This might eventually lead to much-awaited wage growth across the logistics sector and other labour-strapped industries. Over the long term, technological advancements should also help alleviate labour constraints as the government is preparing infrastructural and legal frameworks for the implementation of new technologies across the country[2].

2 In December 2018, the world's first platooning experiment with a lane keeping assist (LKA) system was carried out. The government is aiming to establish the vehicle platooning technology with auto-driving trucks by 2020 and commercialise it sometime between 2021 and 2023. Additionally, autonomous vehicles are being tested for last mile deliveries. Companies such as Yamato Transport and Japan Post Services are experimenting with the technology to achieve faster deliveries without labour constraints.

Table 1: Selected Investments, Announced October 2018 to February 2019

PROPERTY NAME	TRANSACTION VALUE (JPY MIL)	APPRAISAL DIRECT CAP RATE	BUYER	SELLER
MFLP Inazawa	16,200	4.60%	MFLP REIT	Mitsui Fudosan
MFLP Atsugi II	13,100	4.30%	MFLP REIT	Mitsui Fudosan
MFIP Inzai (80%)	10,040	4.70%	MFLP REIT	Inzai SPC
MFLP Fukuoka I	5,263	4.90%	MFLP REIT	Mitsui Fudosan
Fujisawa Logistics Center	4,305	4.30%	Japan Logistics Fund	Mitsui & Co. Real Estate

Source Company Disclosures, Savills Research and Consultancy

Outlook

Supported by stronger-than-expected demand in 2018, the logistics sector is signalling further growth. Demand for locations near consumption centres is especially strong and vacancy rates remain tight. Furthermore, average rents remain stable in Greater Tokyo and continue to rise in Greater Osaka, improving investors' prospects for future rental growth. Despite increasing labour costs, logistics companies such as Yamato Transport and Sagawa Express recorded sound financial performance, subsequently contributing to strong leasing demand for logistics facilities. These companies appear to be successfully offsetting the impact of wage growth through service price increases.

Although Greater Tokyo will continue to see an influx of supply in 2019, strong underlying demand is likely to absorb new space without causing an abrupt increase in vacancy. Leasing activity should proceed smoothly, particularly for convenient locations. Greater Osaka is also seeing sound demand across the market, though the bay area may require more time to absorb the large volume of supply. Keeping the current pace, existing vacancy is likely to be digested over the next few years. Market participants are becoming more optimistic about rental growth. Small logistics facilities are expected to perform especially well as they require fewer workers to operate. Amenities such as nursery rooms and cafeterias are becoming more common in new facilities to attract workers.

Furthermore, as illustrated by the recent announcements of new funds targeting this sector, investment interest in the Japanese logistics market remains strong. Cap rates for logistics properties might compress slightly, considering additional increases in capital and the relatively attractive yield spread compared to prime office buildings.

That said, supply concentrations in certain areas remain concerning. Large facilities distant from major thoroughfares and residential areas may continue to struggle as potential tenants are worried that they may not be able to retain sufficient workforce. A shortage of truck drivers is another concern in the logistics industry. With labour costs constantly increasing, expectations for workforce automation as a long-term solution are higher than ever.

savills

For more information about this report, please contact us

Savills Japan
Christian Mancini
CEO, Asia Pacific
(Ex. Greater China)
+81 3 6777 5150
cmancini@savills.co.jp

Savills Research
Tetsuya Kaneko
Director, Head of Research & Consultancy, Japan
+81 3 6777 5192
tkaneko@savills.co.jp

Simon Smith
Senior Director
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk