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Savills World Research
Japan

Spotlight
Japan logistics

September 2017

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Japan logistics

"The Tokyo and Osaka markets have clearly diverged. Rents are slowly growing near Tokyo, while rapid supply in the Osaka region has led to temporary softness."

Introduction

Japan's logistics market is continuing to develop at a swift pace. Rapid modernisation of warehouse facilities and heavy consumer demand for e-commerce have together contributed to a precipitous increase in development projects, occupier demand, and investor interest since the mid-2000s.

Now that the sector is receiving significant attention, the biggest challenge for investors is determining the proper balance of supply and demand. In 1H/2017, the Greater Osaka area has seen a great deal of supply, and vacancy has climbed above 10%. Rents have subsequently softened. The Greater Tokyo area, however, has enjoyed a temporary supply reprieve over the same period and rents are trending gradually upwards.

Both Greater Tokyo and Greater Osaka are expected to see continued large influxes of new supply over the coming years. Though Japan's long-term logistics demand remains strong, it is possible that supply may increase vacancy and soften rents through 2018.

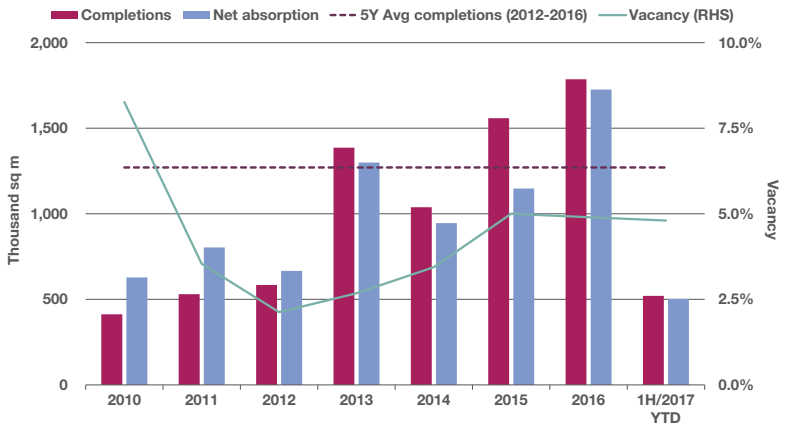
Tokyo area trends

According to Ichigo Real Estate Services, developers added 520,000 sq m GFA of new large-scale space to the Greater Tokyo area in 1H/2017. This is the smallest 1H figure since 1H/2012, which has given the investment market some space to catch its breath.

Significant large-scale completions include Daiwa House's DPL Kawasaki-Yako (119,000 sq m GFA), GLP's GLP Kawashima (49,000 sq m), and CRE's LogiSquare Urawamisono (52,000 sq m).

GRAPH 1

Supply, take-up, and vacancy in Greater Tokyo, 2010 –1H/2017



Source: Ichigo Real Estate Services, Savills Research and Consultancy
Note: Data is compiled with a one-month lag, ie "1H" indicates the period from February to July.

SUMMARY

- Rents in Greater Tokyo have grown for four consecutive quarters, while rents in Greater Osaka have declined for a consecutive three. This divergence is due to differences in supply and demand conditions.

- Greater Tokyo has seen a moderation in supply in 1H/2017, adding only about 500,000 sq m. This is a decline of 57% vs 1H/2016. Take-up has kept pace, and vacancy has consequently held steady at 4.8%.

- Pre-leasing for upcoming facilities near Tokyo is also going well, and the outlook for the rest of 2017 is good. A record-setting 2.7 million sq m of large-scale supply is expected in 2018, however, which will likely result in a temporary increase in vacancy.

- Greater Osaka also saw supply of about 500,000 sq m in 1H/2017, almost double its amount in 1H/2016. Take-up did not increase proportionately, resulting in vacancy almost doubling from 5.9% to 10.4%.

- Heavy supply is currently expected to continue in Osaka, keeping the market under pressure. Some developers are purchasing multipurpose land in an attempt to retain optionality.

- A semiannual survey of logistics market players indicates that many believe there is still room for capital appreciation, driven by increased competition for assets, though rents are not expected to grow over the short term.

- Mitsubishi Estate launched its new logistics REIT on the Tokyo Stock Exchange on 14 September with eight properties and an acquisition price-based AUM of 71 billion yen (US$630 billion). Other logistics-related REITs are also soon entering the market.

As a result of this reprieve, vacancy has held tight at 4.8%. This trend is likely to continue through the end of 2017. Completions scheduled for 2H/2017 include a number of built-to-suit (BTS) facilities, and pre-leasing for multitenant facilities is progressing well. For example, tenants have already been fully decided for Prologis Park Ichikawa 3, due in December.

Vacancy may loosen in 2018, however, when 2.7 million sq m is scheduled to enter the market. This is a full 50% more than the previous record high of 1.8 million sq m set in 2016. Take-up managed to keep pace in 2016 and vacancy peaked at 5.0%, but it is not yet clear whether the market can weather another rapid increase so quickly. Long-term demand remains sound, however, and high-quality space should be absorbed with little delay.

Rents in Greater Tokyo have risen for their fourth consecutive quarter, standing at JPY4,280 per tsubo as of July. This is up 7.0% from July 2016, increasing more than twice as fast as Tokyo Grade A office rent over the same period. Though Greater Tokyo has seen significant logistics supply over the last few years, demand from e-commerce and third-party logistics companies is keeping pace and producing rental increases.

Osaka area trends

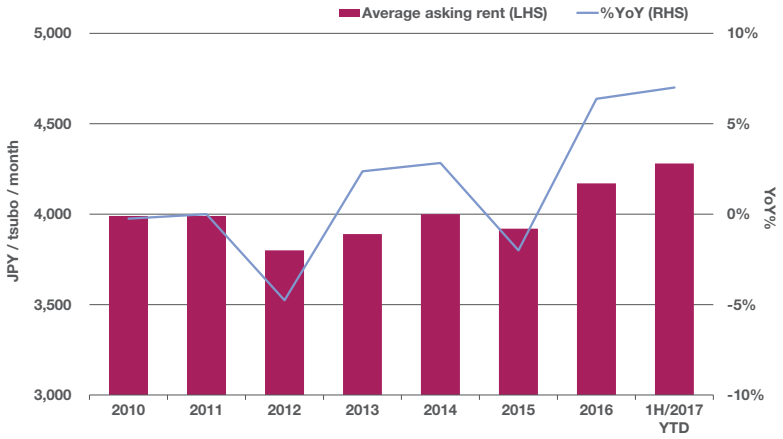
The Greater Osaka area saw record-breaking levels of new supply in 1H/2017, adding 517,000 sq m of large-scale space over the period. This is almost equal to Greater Tokyo's 520,000 sq m, despite being a much smaller market. Greater Osaka saw more supply in 1H/2017 than in most full years on record.

Much of this supply increase came from just a few notable completions, including Redwood's Fujidera Distribution Centre (158,000 sq m GFA) and LaSalle's Logiport Sakai (116,000 sq m).

Vacancy leapt from 5.9% to 11.7% in Q1/2017 before recovering slightly to 10.4% in Q2. Greater Osaka is expected to see continued heavy supply over the coming years, however, and vacancy is likely to remain elevated as new facilities race to lease space.

GRAPH 2

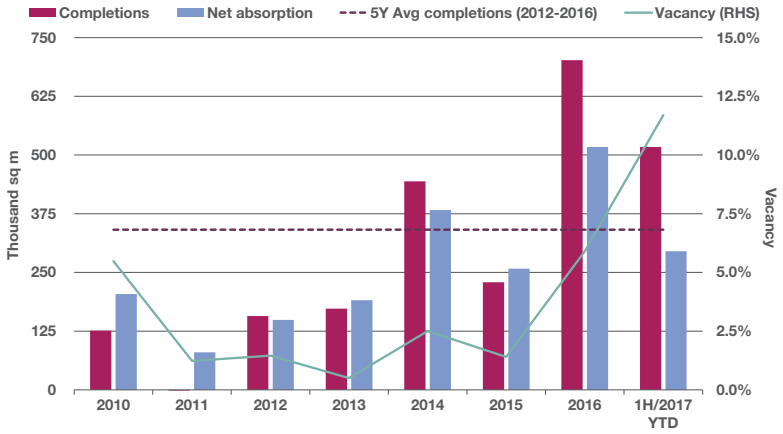
Rent in Greater Tokyo, 2010–1H/2017



Source: Ichigo Real Estate Services, Savills Research and Consultancy

GRAPH 3

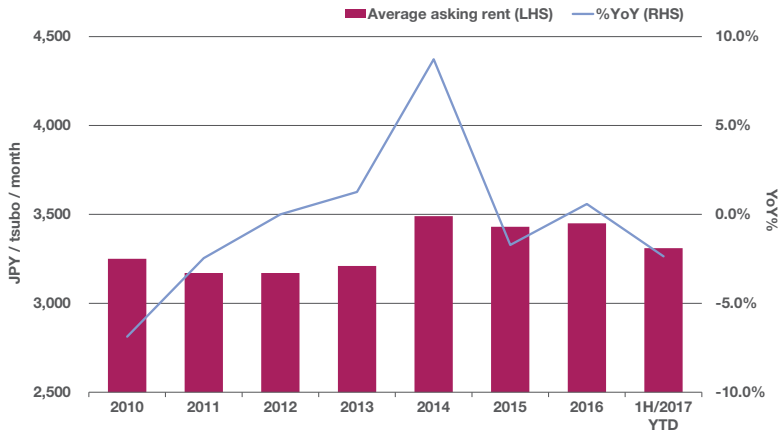
Supply, take-up, and vacancy in Greater Osaka, 2010–1H/2017



Source: Ichigo Real Estate Services, Savills Research and Consultancy

GRAPH 4

Rent in Greater Osaka, 2010–1H/2017



Source: Ichigo Real Estate Services, Savills Research and Consultancy

This ongoing supply pressure is softening area rents. Large-scale facility rents in Greater Osaka averaged JPY3,310 per tsubo in July, down 2.4% from a year ago. Weakness has been especially visible in facilities in the bay area along the coast. An additional million square metres of completions are expected through the end of 2018, and rents will likely stay soft as the region rides out this period of large supply.

Developers have become more cautious, and are now purchasing development sites that could be used for alternative purposes in case it becomes preferable to delay new supply. Both developers and occupiers are also showing preference for land and facilities easily accessible from nearby population centres, as labour shortages remain an issue.

Investment trends

The most recent semi-annual investor survey conducted by the Japan Real Estate Institute (JREI) indicates that cap rates in Tokyo and Osaka have resumed tightening after a brief pause in late 2016. Expected cap rates for Osaka sat at 5.4% in 1H/2017, while expected cap rates in Tokyo areas averaged from 4.7% to 4.9% depending on location. It should be noted that actual market cap rates can range significantly tighter than these surveyed rates – Japan Logistics Fund, a J-REIT, recently estimated an NOI cap rate of 3.8% for its acquisition of the Yokohama Machida IC Logistics Center on 1 September. The reported appraisal NOI cap rate was 4.1%.

Ichigo Real Estate Services' semi-annual survey of market players also indicates slow but steady tightening, despite heavy supply. The survey's diffusion index of responses currently sits at +23.1 points in favour of further capital appreciation over the next six months, in a range of +100 to -100. By contrast, expectations of further rental growth sit at -15.9 points, indicating that many believe rents will soften over the next six months.

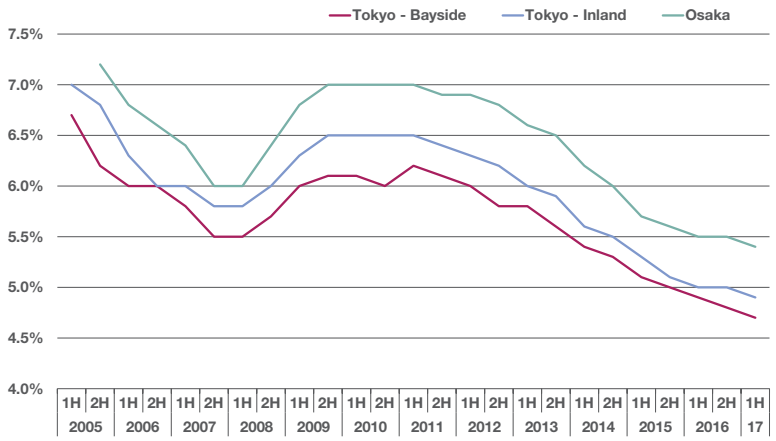
When asked for reasons behind capital appreciation, respondents who answered positively cited increased competition for assets and from new players entering the market. Only a single respondent believed that appreciation would be driven by rental increases. Increased supply was the primary driver for negative sentiment on rents.

Investment volumes

Data from Real Capital Analytics shows that logistics transactions typically comprise about 5-10% of total real estate investment in Japan, and that 1H/2017 investment slightly lagged volumes in 1H/2016. There has also been a shift in regional focus, with over 50% of investment by value occurring outside of Greater Tokyo. Most of this shift has gone to Greater Osaka, though the Chubu (including Nagoya) and Kyushu (including Fukuoka) areas have also seen some increased activity.

GRAPH 5

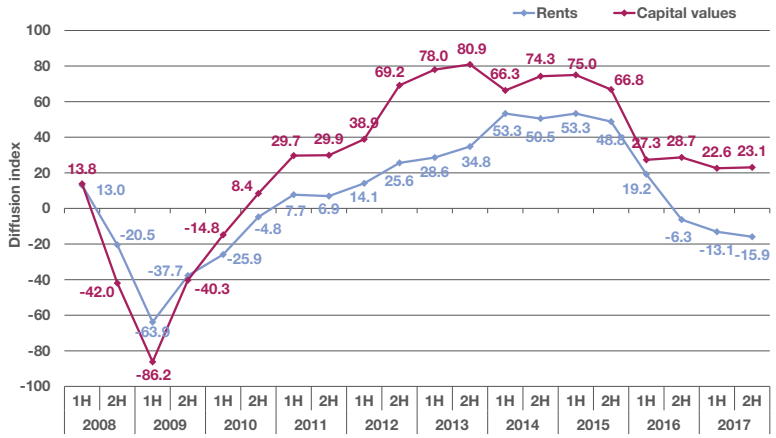
Expected cap rates for large modern facilities, 2005–1H/2017



Source: JREI, Savills Research and Consultancy

GRAPH 6

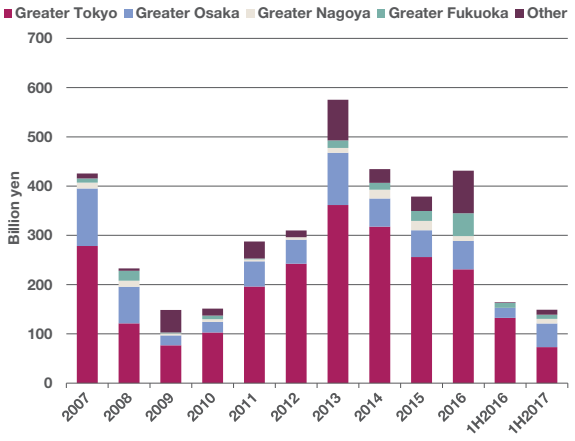
Six-month-ahead expectations for rent and capital appreciation, 2008–2H/2017



Note: Index is calculated as the number of responses saying rents/values will increase minus the number of responses saying rents/values will decrease.
Source: Ichigo Real Estate Services, Savills Research and Consultancy

GRAPH 7

Logistics investment in Japan, 2007–1H/2017



Source: RCA, Savills Research and Consultancy

Year-to-date investment in logistics properties nationwide totalled JPY149 billion through June, down 9.2% from 1H/2016.

A number of logistics-related REITs are also entering the market.

Mitsubishi Estate listed its existing private REIT on 14 September as the Mitsubishi Estate Logistics REIT Investment Corporation (symbol 3481) with an acquisition-based AUM of 71 billion yen. The REIT intends to expand to about 300 billion yen over the medium term and will aim to hold about 50% of its assets in the Greater Tokyo area.

Itochu Corporation also intends to launch a logistics REIT in early 2018 with assets in excess of 100 billion yen. The REIT will primarily target multi-tenant facilities in the Greater Tokyo area.

ESR reportedly hopes to structure a private REIT of about 35 billion yen and three properties in the fall of 2017. LC Holdings will reportedly structure a hybrid logistics and suburban commercial property REIT by the end of this year. ES-CON is also planning on listing a REIT specialising in the land rights of commercial facilities, also with the aim to launch by the end of 2017. CRE is looking to list its own existing private logistics REIT, but will wait until at least next year in order to avoid competition.

New challenges

With its rapid expansion, the logistics sector is quickly confronting new infrastructural issues, including labour shortages, facility management challenges, cost increases, and streamlining "last-mile" delivery. Successfully tackling these challenges could offer unique opportunities and upside to skilled managers.

First, and most significantly, labour shortages are directly affecting some new large-scale facilities. These facilities may not be able to operate at full capacity due to staffing problems. To mitigate this risk, developers are seeking to build facilities close to local population centres, and also include recreational space and other amenities to attract and retain talent.

Second, large-scale facilities are posing new challenges for safety and organisation. A fire at an Askul-managed warehouse in Saitama blazed for six days this past February, partially due to failure of over 50% of its fire shutters. This mishap has sparked conversation about the safety of large multi-tenant warehouses. As a result, some market players have considered refocusing on smaller, easier-to-manage assets.

Third, logistics companies are pushing through cost increases as the strain on their infrastructure – notably labour – intensifies. Yamato Transport, which handles 50% of Japan's home delivery market, increased fees by about 5-20% for home deliveries in April and is negotiating larger increases with high-volume corporate clients such as Amazon. If costs become too heavy (Graph 8), it may become more difficult to raise rents on logistics companies.

Finally, and partially as a solution to labour and cost issues, logistics companies are seeking new ways to streamline last-mile delivery. Some are considering experimenting with smaller centres closer to end users, or even neighbourhood lockers to reduce the need for redelivery. 2016 research conducted by Ryutsu Keizai University and Kanagawa University indicates that approximately 20% of all home parcels delivered in Japan's urban centres require at least one redelivery.

None of these challenges are likely to arrest the breakneck pace of logistics development in Japan, but they do pose new challenges for investors and developers looking to get involved in the market.

TABLE 1

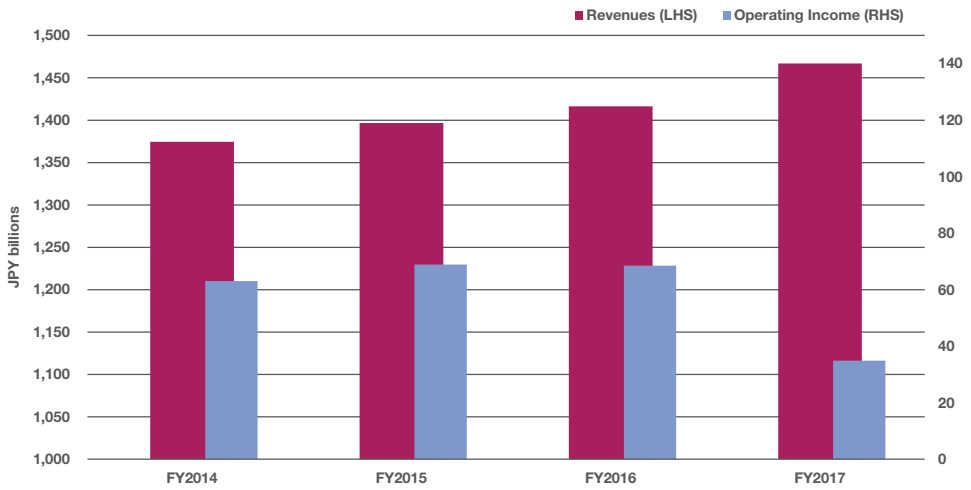
Selected investments, announced Mar 2017–Sep 2017

Property name	Transaction value (JPY million)	Appraisal cap rate	Buyer	Seller
Prologis Park Ibaraki	38,300	4.5%	Nippon Prologis REIT	SPC of Prologis
Yokohama Machida Logistics Center	25,452	4.1%	Japan Logistics Fund	SPCs of Mitsui & Co., Orix, Sumitomo Mitsui Trust
GLP Maishima I	19,400*	4.5%	GLP J-REIT	Sumitomo Mitsui Finance & Leasing
GLP Misato	16,950*	4.4%	GLP J-REIT	Sumitomo Mitsui Finance & Leasing
DPL Misato	16,831	4.5%	Daiwa House REIT	Daiwa House Industry

* GLP Maishima I and GLP Misato prices are conditional upon handover occurring in March 2018. According to the contract, handover may occur as late as 2023, which would result in different pricing.
Source: Company disclosures, Nikkei RE, RCA, Savills Research and Consultancy

GRAPH 8

Yamato transport revenue and profit, FY2014 – FY2017



Source: Yamato Transport, Savills Research and Consultancy

OUTLOOK

The prospects for the market

Both the Greater Tokyo and Greater Osaka markets continue to see rapid increases in supply. Tokyo is still performing well; however, fears of oversupply in Osaka have proven warranted and vacancy has increased. Demand is still strong, and competitive properties should lease up relatively quickly, but developers and investors must now be more conscious of the surrounding competitive landscape before embarking on new projects.

Heavy supply will continue through at least 2018. The Greater Tokyo area is forecast to receive another historical high of 2.7 million sq m next year, and Greater Osaka is also seeing continuous completions. This pressure could dampen the recent rental growth in Tokyo and extend Osaka's softness.

Long-term demand is still positive, however. E-commerce penetration is still catching up to levels in other developed countries, and companies are beginning to explore new ways of fulfilment, such as "last-mile" efficiency. Large-scale, high-spec logistics space is becoming more and more inseparable from modern consumption.

Logistics cap rates are likely to keep marginally compressing even as investors have moderated expectations for rental growth. High consumer and occupier demand has attracted an ever-increasing number of investors to the market, including new REITs, and competition for properties could remain tight even in the face of new supply.

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