Savills World Research
Japan

# Spotlight
# **Japan logistics**

September 2018


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"Greater Tokyo is in the midst of a wave of new supply lasting until 2019, and vacancy has ticked up slightly. Encouragingly, Greater Osaka is showing steady absorption of last year's supply and vacancy is coming down. Equity capital markets are showing signs of caution, but sentiment for hard assets is positive and the outlook has improved somewhat."

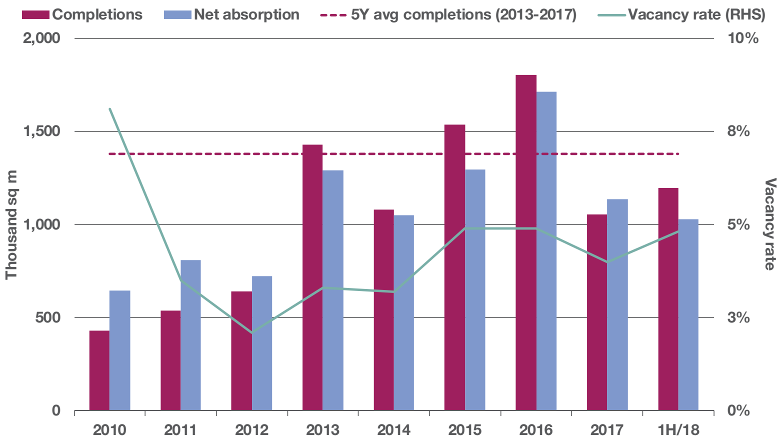
## Introduction

The logistics market is experiencing a wave of supply that will last at least until 2019, though e-commerce and third-party logistics (3PL) companies continue to demand new facilities, which should support the market balance. In Greater Tokyo, bayside property vacancy is exceptionally low, while inland facilities have higher vacancy. In Greater Osaka, while vacancy is high, it appears to have peaked as the supply pipeline falls. If demand remains strong, average vacancy is likely to continue its downward trend.

Improvements to transport infrastructure and changing consumer demand are making less traditional locations more attractive for prospective tenants. Parts of Chiba and Saitama that are close to the Gai-Kan and Ken-O Expressways have easy access to potential customers and employees. The high level of supply in these areas may over time be met with strong demand from delivery companies, and in the meantime, ageing facilities, which may undergo redevelopment, could help balance the market by taking some existing stock offline.

GRAPH 1

**Supply, take-up, and vacancy in Greater Tokyo, 2010 – 1H/2018**




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


# SUMMARY

- High supply levels of approximately 5 million sq m between 2018 and 2019 in Greater Tokyo warrants a cautionary outlook, though vacancy, standing at 4.8%, has only risen slightly so far in 2018.

- Greater Osaka vacancy has fallen to 11.6% as the market continues to digest last year's supply. Limited upcoming supply to the area should enable the market to tighten further.

- Asking rents are trending higher in both Greater Tokyo and Greater Osaka, standing at JPY4,260 and JPY3,400, respectively, at the end of 1H/2018, bolstered by the large number of new, modern facilities entering the market.

- Pre-leasing activity is strong, driven by steady demand for new facilities from e-commerce and 3PL companies.

- Investment volumes are robust and cap rates are gradually sharpening.

- Logistics J-REIT performance in 2018 has so far lagged the all-sector index, possibly indicating the onset of a bear market.

- Ageing stock in Greater Tokyo could present redevelopment opportunities in good locations as owners may start disposing of tax-inefficient warehouses.


The logistics market continues to see strong investment demand: transaction volumes in 2018 have already exceeded 2017 levels. Cap rates are compressing and market outlook for rent increases has turned somewhat positive. A high volume of equity offerings by J-REITs, however, could be a warning sign of future softness. Nevertheless, the outlook for hard assets is good.

## Market trends

In Greater Tokyo, vacancy rose by 0.8 percentage points (ppts) over 1H/2018 to 4.8%, as net absorption of 1 million sq m did not keep up with new supply of 1.2 million sq m. Bayside property vacancy remains low as properties in the area enjoy excellent access to various modes of transport infrastructure and supply is limited. There is some vacancy among inland facilities, though improving road infrastructure is increasing the area's appeal. Despite a rise in vacancy, rents managed to rise from JPY4,200 to JPY4,260, as new supply with modern specifications was able to command a premium.

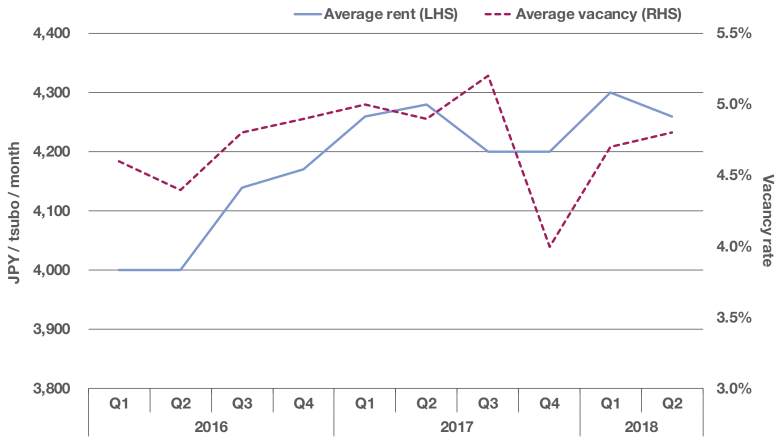
The south-eastern section of the Tokyo Gaikan Expressway, which many market players consider influential for the development of logistics facilities, was opened in June 2018. The completed section connected four radial roads, the Higashi Kanto, Joban, Tohoku and the Kan-Etsu Expressways, greatly improving access to North and East Japan without the need to traverse central Tokyo. The south-western section, once completed in 2020, will join up with the Chuo and Tomei Expressways for better access to Osaka and Nagoya. Continued infrastructure development should help bring down vacancy and ultimately push up rents in areas with convenient access to expressways as supply is absorbed.

In Greater Osaka, net absorption over 1H/2018 of 392,000 sq m was slightly higher than completions of 376,000 sq m, and average vacancy fell by 1.2ppts to 11.6%. Encouragingly, vacancy has declined for two consecutive quarters and the supply pipeline for 2018 looks calmer than for 2017. Rents have responded in kind, rising 2.7% YoY as the market tightens, standing at JPY3,400 at the end of 1H/2018. As long as demand remains strong, vacancy is likely to dip further.

As new road infrastructure connecting Osaka to other metropolises is brought online, demand for facilities with convenient expressway access should perform well. For example, Osaka's inland facilities are currently congregated around existing roads on the eastern side of the city. Extensions along the Shin-Meishin Expressway should open up development spots on the western side. An extension between Takatsuki JCT/IC and Kobe JCT on the Shin-Meishin Expressway was completed in March 2018, and there are four facilities in development near this section of the expressway.

GRAPH 2

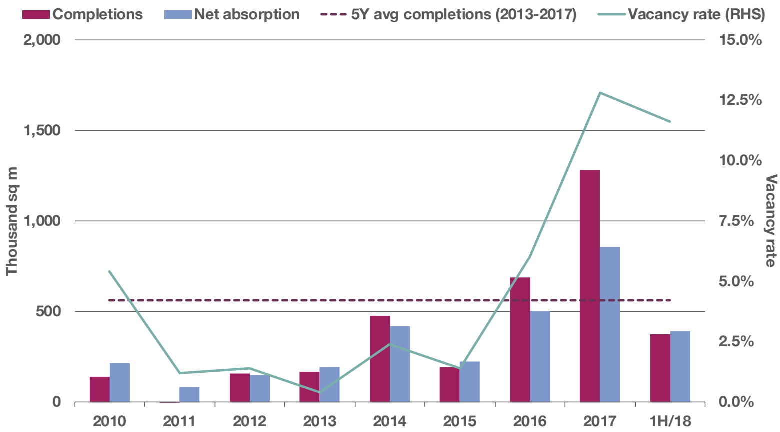
## Greater Tokyo rent vs. vacancy, Q1/2016 – Q2/2018




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

GRAPH 3

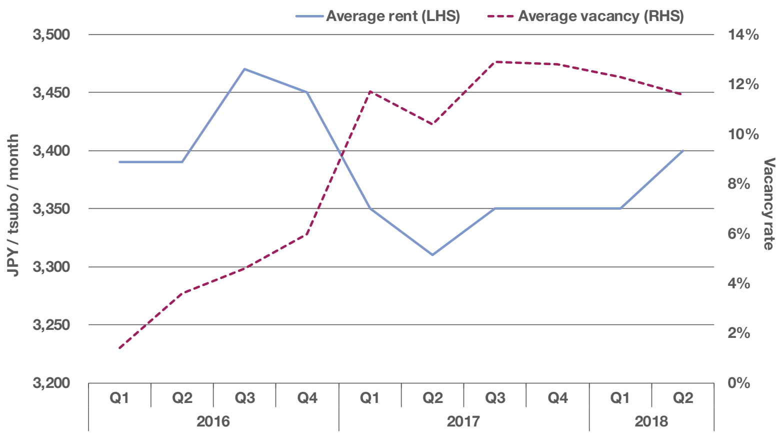
## Supply, take-up, and vacancy in Greater Osaka, 2010 – 1H/2018




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 – Q2/2018




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

## Incoming supply

In Greater Tokyo, the supply pipeline is strong and continues to break through historical highs, with forecast supply for FY2018 at 2.1 million sq m while FY2019 is expected to see 2.8 million sq m enter the market. The majority of new supply is focused inland: Tokyo Bay has just one facility planned for 2018 and only a handful in 2019, which should keep vacancy in that area low and help drive up rents. Inland vacancy rates may rise as a result of strong supply levels, but pre-leasing activity is encouraging, and certain areas are in particularly high demand. This year, the Nagareyama City government opened up vast swathes of land well located between Narita Airport and central Tokyo, and neighbouring Ichikawa is a favourable location for logistics facilities. In Greater Osaka, forecast supply over FY2018-2019 is 1.3 million sq m, half of which will arrive in 2H/2018 through just five facilities, helping existing facilities fill their availabilities.

The largest facility planned for Greater Tokyo over the next two years is a 300,000 sq m development in Kawasaki Bay by LaSalle. Other large developments include MFLP Funabashi II in Chiba by Mitsui Fudosan at 225,000 sq m, and ESR is developing what will be the largest distribution centre in Japan, with a GFA of almost 400,000 sq m, slated for completion in Amagasaki, Osaka in 2020. The six-story, double-ramp warehouse will have enough space for 3,000 workers.

Pre-leasing is going well, as 3PL and e-commerce firms are actively sweeping up space. Sumitomo's SoSiLa brand, for example, has already pre-let half of two facilities slated to complete in 2019 and 2020 to major logistics companies, and Goodman has announced the signing of a lease with Senko, a 3PL company, at its Business Park Stage 3 facility due in early 2019. Global Logistic Properties' (GLP) Rokko III facility, due in September 2019, has been fully pre-leased by Mizuiwa Transportation, a logistics company, and their Yachiyo II facility, due in March 2020, has been pre-leased by e-commerce firm Locondo. Rakuten has also entered pre-lease agreements at multiple GLP sites and leased space at Nagareyama II, completed in May. Strong pre-leasing activity looks promising, given the large supply pipeline ahead.

## Investment trends

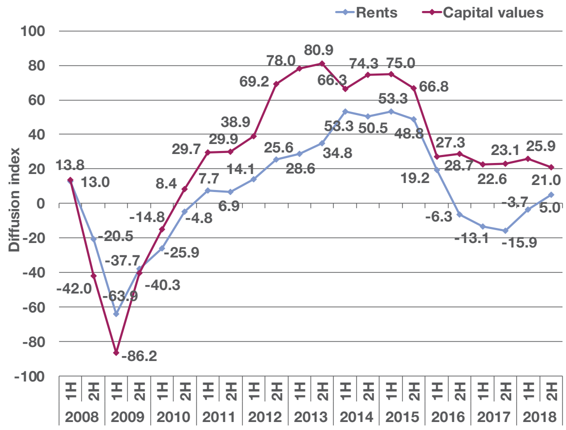
Ichigo Real Estate Service's July survey of market players showed the outlook for short-term rental growth continues to improve, as the diffusion index of responses rose from -3.7 in April to +5.0 after having bottomed at -15.9 in July 2017. The most commonly cited reason for expectations of rental growth was strong profits in the e-commerce industry. Respondents also noted that high specification facilities were seeing strong demand, which would naturally push up rents. The majority of respondents who expected rents to tread water cited a strong supply pipeline as the primary cause, though fewer cited this concern than in the February survey. The reading of players' expectations for capital appreciation has held steady at a positive level, although it dipped slightly to +21 in July.

Investment demand is also robust. Logistics sector investment volumes in 1H/2018 totalled JPY276 billion, according to data from Real Capital Analytics – well in excess of the JPY157 billion recorded in 1H/2017. Based on the most recent bi-annual investor survey conducted by the Japan Real Estate Institute (JREI), cap rates for property in bayside Tokyo and inland Osaka continue to tighten, down 20 basis points (bps) YoY, while rates for inland property in Tokyo are 10bps lower YoY. From their post-crisis peak, cap rates in Tokyo and Osaka have tightened over 150bps and now register at 4.8% (inland) and 4.5% (bayside) in Tokyo and 5.2% in Osaka (inland). While Tokyo bayside has enjoyed a lower cap rate relative to Tokyo inland since at least 2005, cap rates for inland facilities in Tokyo may provide attractive value for long-term investors. As road infrastructure improves connectivity and last-mile deliveries continue to take a larger share of total deliveries, inland facilities should see increased demand due to proximity to residential areas.

On the other hand, while investor demand is increasing capital values now, the strong supply pipeline could be a sign that developers are keen to dispose of their logistics properties. J-REIT unit prices may be reflecting market concerns over the sector outlook and have lagged the wider market so far this year (Graph 6). In August, GLP's J-REIT announced a secondary offering and completed a JPY85 billion portfolio acquisition, through which its unit price experienced a major correction. Mitsubishi Estate also announced a secondary offering with a total issuance of around JPY7.5 billion, resulting in the lowest unit price since listing. In September, the IPO of Itochu Advance Logistics REIT had a bumpy start, with unit price dropping more than 10% from the initial offering price during the first days of trading. The REIT launched with seven "I Missions" assets worth JPY54 billion transferred from sponsor Itochu.

GRAPH 5

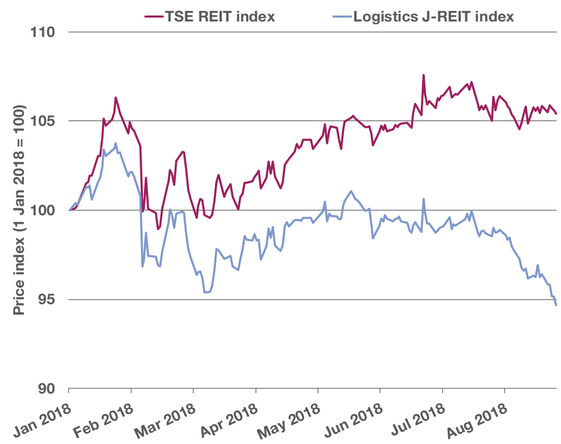
### Six-month-ahead expectations for rent and capital appreciation, 2008 – 2H/2018




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 Service, Savills Research and Consultancy

GRAPH 6

### TSE REIT index vs Logistics J-REIT index*, Jan – Aug 2018



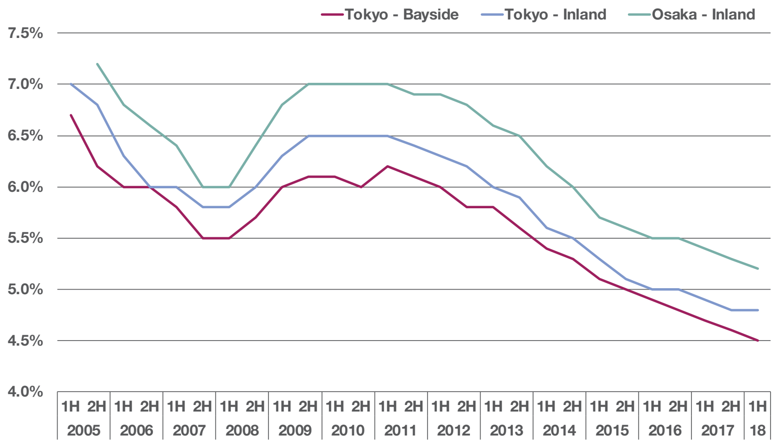

Source: Tokyo Stock Exchange, Savills Research and Consultancy
*Logistics J-REIT index is calculated as the simple average of the change in price of seven pure logistics REITs and two mixed-sector REITs with logistics exposure.

TABLE 1
## Selected investments, announced Apr – Sep 2018

| Property name | Transaction value (JPY million) | Appraisal direct cap rate | Buyer | Seller |
|---|---|---|---|---|
| GLP Osaka | 36,000 | 4.0% | GLP J-REIT | Osaka Logistics SPC |
| GLP Shinsuna | 18,300 | 4.0% | GLP J-REIT | Shinsuna Logistics SPC |
| Logicross Atsugi | 8,440 | 4.3% | Mitsubishi Estate Logistics J-REIT | Atsugi Development TMK |
| Logicross Kobe Sanda | 3,900 | 4.7% | Mitsubishi Estate Logistics J-REIT | Mitsubishi Estate Co., Ltd. |
| Toda Logistics Centre | 2,052 | 4.3% | Japan Logistics J-REIT | Nakano Shokai |

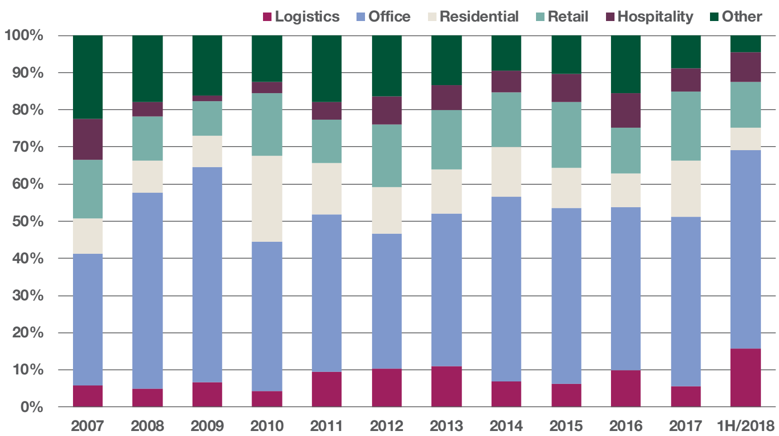
Source: Company disclosures, Savills Research and Consultancy

GRAPH 7
## Cap rates for large modern logistics facilities, 1H/2005 – 1H/2018




Source: Japan Real Estate Institute, Savills Research and Consultancy

GRAPH 8
## Share of investment volumes by asset class, 2007 – 1H/2018




Source: RCA, Savills Research and Consultancy

## Developers looking to alternatives

The lumpiness of supply over the next few years demonstrates that land may be scarce. Developers are looking to redevelopments, expansion projects, and brownfield land recovery as they search for opportunities. For example, CRE has partnered with EnBio Holdings to decontaminate land for development, having completed two such projects at Urawa Misono and Niiza, claiming a greatly improved profit margin as brownfield land is much less in demand yet can be found in great locations. Japan Logistics Fund, a logistics J-REIT, made use of an alternative source of development opportunities this June when it partnered with a tenant to redevelop the site of the Toda Logistics Centre. It plans to continue to use this technique to supplement standard open market purchases of development land. Since 2017, Mitsubishi Corporation Urban Development has acquired two old facilities and renovated them, one with the tenant in place. It is also undertaking expansion projects at existing facilities.

In 2013, the Tokyo Metropolitan Area Traffic Planning Council conducted a survey of logistics facilities. Throughout Greater Tokyo, over a quarter of all surveyed facilities were found to have been built before 1980. In South Saitama, the area with the largest number of surveyed facilities, there were 650 separate buildings that fell into this category. As the useful life of logistics facilities for tax purposes is approximately 38 years, they present opportunities for redevelopment into modern, high-demand logistics centres. Shrewd investors who can leverage local expertise and target such development opportunities could reap the rewards of improved returns. South Saitama should benefit from improvements in infrastructure and its convenient location, so redevelopment projects in this area may be attractive targets. In the meantime, as facilities are taken offline for refurbishment, reduced stock may help suppress vacancy levels throughout Greater Tokyo, albeit marginally.

# OUTLOOK

## The prospects for the market

E-commerce has room to catch up to international levels as a share of retail spending, and the 3PL sector is still growing as companies streamline their operations by outsourcing logistics functions. Improvements in road infrastructure and greater demand for home deliveries should help this sector grow, increasing demand for facilities, particularly inland near population centres.

Greater Tokyo will dominate the supply pipeline through to 2019. Vacancy may rise inland, where supply is concentrated, and an acute labour shortage may depress delivery companies' demand for space. Greater Osaka is steadily digesting 2017's large volume of supply, and vacancy should steadily lower if the current favourable environment continues. Delivery companies increasingly require easy access to residential areas to recruit and retain workforce, and to facilitate last-mile deliveries, so facilities in such locations may be somewhat insulated by sturdy demand.

Investment volumes have been robust in 2018 and cap rates are expected to stay sharp as investors continue to find the sector attractive. A large number of J-REIT acquisitions in early 2018 may imply that some developers are offloading portions of their portfolios over supply concerns, and unit prices in the sector have weakened this year. This may be a harbinger of a bearish market in the logistics sector.

That said, investor expectations for rental growth have turned somewhat positive for the first time since early 2016, showing further optimism for the expanding market of modern facilities. Redevelopment opportunities could also present themselves over the next few years as outdated stock is taken offline and alternative sources of land become available. Overall, despite negative indicators from capital markets, hard assets should remain popular and determined investors with a long-term horizon may be able to capitalise on possible intermittent weakness.

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