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Savills World Research
Japan

Spotlight
Japan logistics

September 2015

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"The industrial sector in Japan continues to enjoy robust demand backed by the growth of e-commerce and third party logistics. Because of the large number of logistics facilities due to complete over the next few years, we may see supply run ahead of demand. However, the sector should stabilise and grow steadily, thanks to the underlying strength of the logistics sector and positive business sentiment at home."

SUMMARY

- Helped by strong demand for logistics facilities, vacancy rates in Tokyo and Osaka have remained below 4%. Asking rents in Tokyo have remained stable while Osaka rents have been increasing although at a slower rate of growth than previously. Cap rates have compressed.

- We are expecting to see a number of logistics facilities completed in 2015 and 2016: especially in Osaka in 2016, which could affect the market negatively. However, we believe that there exists sufficient demand to take up most of the new supply and rents are likely to rise, assuming moderate inflation backed by the Bank of Japan.

- The logistics J-REITs have expanded rapidly and are helping to drive the investment market. As logistics takes its place as an established asset class, we are seeing new entrants such as Nippon Life Insurance which recently announced its intention to develop logistics facilities.

- A few end users of logistics facilities utilize REIT structures to own and operate without using their own balance sheet. These new initiatives will reduce available investment grade stock and may decrease the supply of logistics facilities with credible tenants to the market.

- The substantial new development pipeline can be accounted for by the many new players who have aggressively invested in logistics space over recent years. We will see a supply bulge in 2015 and 2016 but it should be noted that this comes after a period of modest growth as new supply since 2000 represented only a 20% increase in total stock in Japan's major cities. As land acquisition for new development has become more difficult, we expect to see new development more widely distributed among suburban/regional areas.

Introduction

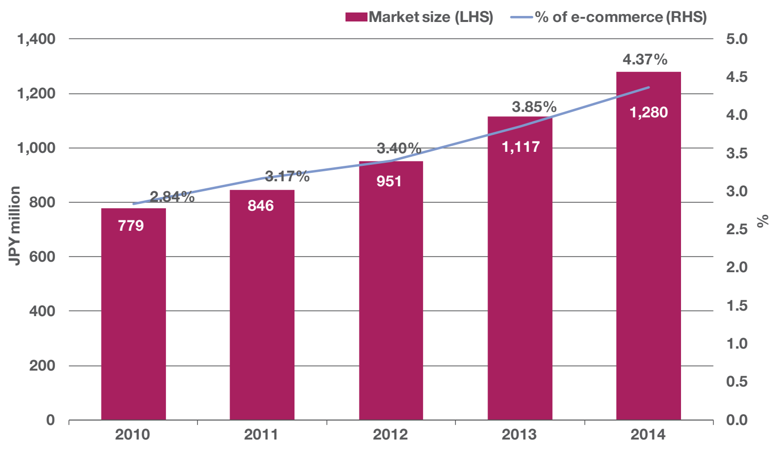
The industrial sector in Japan has a number of unique characteristics: 1) This is a sector re-established and re-developed by foreign players such as Prologis and Global Logistics Properties. 2) The sector embraces rapidly growing underlying logistics businesses driven by e-commerce and third party logistics (3PL). 3) Japanese players have recently caught up with foreign players and local real estate companies and trading houses are aggressively investing in new developments to tap this rapidly expanding market.

The e-commerce market in Japan has recorded remarkable growth over the past few years. At the end of 2014, the market was JPY12.8 trillion in size, a 14.6% increase from the previous year, according to the Ministry of Economy, Trade and Industry (METI). As a result of rapid growth, the market expanded by 64.3% between 2010 and 2014, a compound annual growth rate (CAGR) of 13.2%, and this trend is likely to continue into the foreseeable future.

According to Nippon Prologis REIT (NPR, pictured on cover page), the largest logistics J-REIT, Class A logistics facilities accounted for only 2.4% of total stock in Japan at the end of 2014. This number is expected to increase to account for approximately 3.4% by the end of 2016. There should be significant room for further growth if this figure is compared with more developed markets elsewhere in the world - Class A facilities account for approximately 30% of stock in the U.S.A. and approximately 15% in Europe.

GRAPH 1

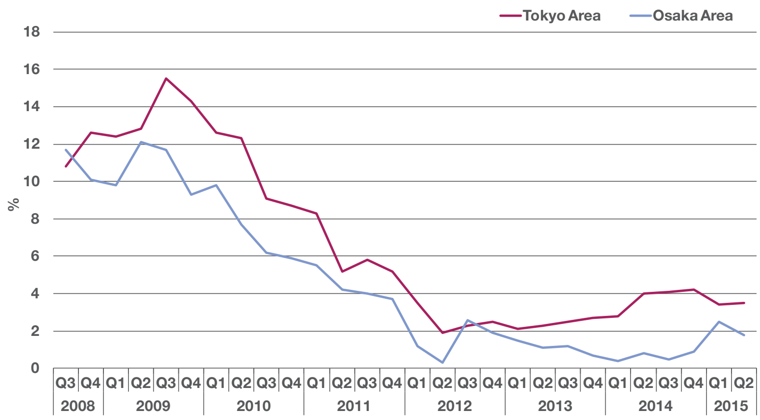
E-commerce market size and share in Japan, 2010–2014



Source: Ministry of Economy, Trade and Industry, Savills Research and Consultancy

GRAPH 2

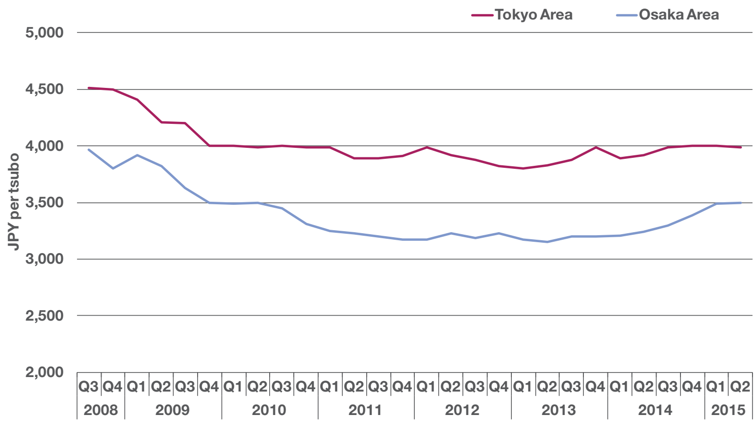
Vacancy rates in greater Tokyo and Osaka, Q3/2008 – Q2/2015



Source: Ichigo Real Estate Services, Savills Research and Consultancy

GRAPH 3

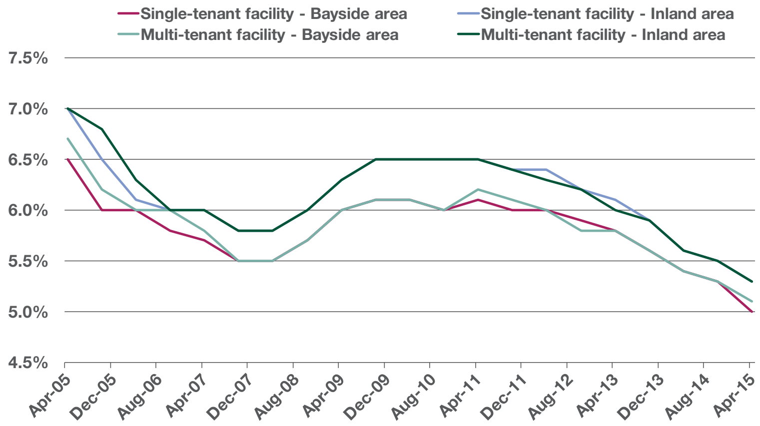
Asking rents in greater Tokyo and Osaka, Q3/2008 – Q2/2015



Source: Ichigo Real Estate Services, Savills Research and Consultancy

GRAPH 4

Cap rates for logistics facilities in greater Tokyo, Apr 2005 – Apr 2015



Source: Source: Investor Survey by Japan Real Estate Institute, Savills Research and Consultancy

Market trends

Thanks to the robust demand for logistics facilities, vacancy rates in both greater Tokyo and Osaka have remained low, at below 4% over the last few years, according to Ichigo Real Estate Services. The low level of vacancy is a reflection of strong occupier demand from a growing base of end users. The vacancy rate in greater Tokyo in Q2/2015 stood at 3.5%, a 0.5 percentage point decrease from the same period last year. The rate in greater Osaka in Q2/2015 stood at 1.8%, a 1.0 percentage point increase from the same period last year, but a 0.7 percentage point improvement from the previous quarter.

The average asking rent in the greater Tokyo area stood at JPY3,990 per tsubo per month in Q2/2015, a JPY10 decrease from the previous quarter. For the last 12 months, the average rent in greater Tokyo has been seesawing around JPY4,000 per tsubo per month. Average asking rents in greater Osaka stood at JPY3,500 per tsubo per month in Q2/2015, a JPY10 increase from the previous quarter. Rents in greater Osaka bottomed out at JPY3,150 per tsubo per month in Q2/2013. However, the rate of increase has slowed more recently.

Given the strength of underlying demand, cap rates have been compressing since the Global Financial Crisis (GFC). Post-GFC, the cap rate has fallen by 100bps or more in Tokyo, according to the Japanese Real Estate Investor Survey by Japan Real Estate Institute. In particular, cap rates have fallen by 70 to 80 bps over the last two years because of the logistics boom. Cap rates for prime logistics facilities are now close to 4.0%. That figure could seem quite aggressive, but is still over 100bps above prime office buildings in Marunouchi.

In today's robust markets, investors tend to prefer multi-tenanted facilities because they tend to have an upside potential for rent upon renewal, while build to suit (BTS) facilities tend to operate with a fixed long-term contract with a single tenant. If Japan escapes deflation and returns to moderate inflation, owners of long-term fixed contracts in BTS facilities are likely to be badly affected.

Short-term/long-term forecasts

While demand from end users remains strong, ample supply of logistics facilities since 2013 has kept rents broadly in check. This trend is expected to continue and supply in 2015 in greater Tokyo will total approximately 1.6 million sq m, a record high. We see a similar trend in greater Osaka where supply in 2015 stood at approximately 300,000 sq m but in 2016 that figure is expected to reach 1,000,000 sq m, much higher than 2006/2007, the previous peak, according to the Japan Logistics Field Institute, Inc. Accordingly vacancy rates are expected to rise temporarily in both greater Tokyo and Osaka. This trend may negatively affect rents and exert some downward pressure on occupancy rates. However, assuming moderate inflation as the Bank of Japan predicts, rents are more likely to see a modest uptick.

In the mid- to long-term, e-commerce will expand further. The share of e-commerce in the United Kingdom is more than 10% of the commercial market, while the e-commerce market in Japan is expected to expand further from its current level of 4% to 5%. In this context, the need for logistics facilities will keep pace with supply and the sector should continue to enjoy strong take-up if underlying fundamentals remain robust.

The growth of logistics J-REITs

In terms of Class A logistics facilities, foreign players have paved the way but local parties are now much more active. From late 2012 to early 2013, three J-REITs[1] were listed on the Tokyo Stock Exchange (TSE) and the logistics J-REIT sector has expanded significantly since then. The total asset size of the three logistics J-REITs was JPY483.3 billion at IPO. That number has skyrocketed to JPY899.5 billion at most recent financial period ends[2], an almost 100% increase. NPR expanded its asset size from JPY173.0 billion at IPO to JPY405.0 billion at its most recent fiscal year end, an eye watering 134% increase in only two years. This is remarkable growth and testament to the potential of the industry.

2015 has also been a busy year for acquisitions by the logistics J-REITs. DHR announced the acquisition of seven logistics facilities last March with a total value of JPY48.4 billion at a 5.3% cap rate based on appraised NOI. In August 2015, GLP announced the acquisition of five logistics facilities for a total value of JPY38.1 billion. The lowest cap rate of the five properties was recorded at 4.3%.

Investment trend

According to Real Capital Analytics (RCA), investments in logistics facilities have risen since 2011, when the logistics J-REIT sector was established and started to grow. Investment volumes of logistics facilities accounted for between 4% and 7% of all real estate transactions before the end of 2010, from 2011 to 2013 more than 10%, and since 2014 around 8%. Transactions of logistics facilities have become more common, in line with the growth of the logistics J-REITs.

According to transaction data provided by RCA, there have been over 140 logistics transactions in Japan since January 2014 (to August 2015). J-REITs, or their sponsors, have been the buyers in the case of more than 80 of those transactions. Logistics is one of the best performing J-REIT sectors because equity investors, particularly international ones, like the favourable macro growth story and logistics J-REITs are therefore frequent equity issuers with plenty of fire power to acquire more properties. As a result, cap rates of logistics facilities have compressed and some transactions of large scale facilities in prime locations have witnessed rates as low as 4.0%. There are still many property acquisitions with reported cap rates of 5.0% plus however.

Over the last 12 months, all major logistics J-REITs have acquired a portfolio of logistics properties and expanded their asset size. Industrial and Infrastructure Fund, a J-REIT investing in logistics, industrial and infrastructure assets, has bought several logistics facilities as well as other industrial assets such as a research and development centre. Currently, 'industrial assets' mostly refers to logistics facilities, but other assets such as manufacturing related facilities may be more frequently traded in the near future.

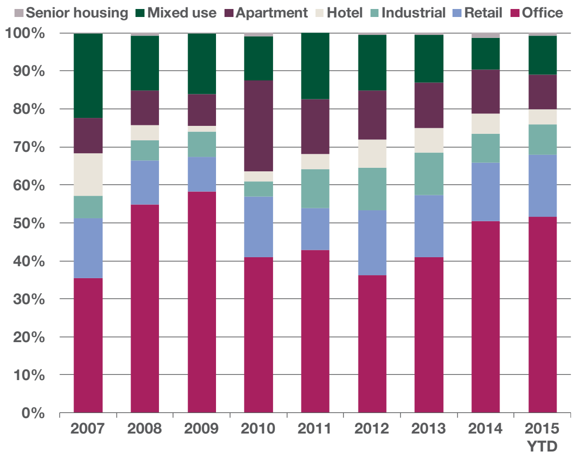
We see more and more investors entering into the logistics space. Nippon Life Insurance Company announced its new mid-term management plan and investment policy in March 2015. In the same month, it also announced its plan to invest and develop a logistics facility in Osaka. This is the first time for the company to engage in the construction of logistics space. The

1 Daiwa House REIT (DHR), GLP Investment Corporation (GLP) and NPR. DHR owns logistics (80%) and retail (20%). Only logistics facilities are counted in this report.

2 Including the additional acquisitions in relation to the equity offering by GLP in August 2015

GRAPH 5

Investment volumes by asset class, 2007 – 2015 YTD



Source: RCA, Savills Research and Consultancy

TABLE 1

Selected investments, Jan 2014 - Aug 2015

Property name	Transaction value (JPY million)	Cap rate (%)	Buyer
Takaragumi Higashiogishima	55,000		LaSalle Investment
Logiport Sagamihara	43,000		Mitsubishi Jisho Investment Advisors
GLP Tokyo II	36,100	4.4	GLP Investment Corporation
Former Fukagawa Government Warehouse	30,124		Daiwa House Industry
GLP Urayasu III	18,866	5.0	GLP Investment Corporation
Tokorozawa and Funabashi Distribution Center	14,000		EPF
Prologis Park Kawanishi	13,600	5.2	Nippon Prologis REIT

Source: RCA, Savills Research and Consultancy company currently owns two logistics facilities and this development is the third addition. This implies that logistics facilities have become a more common asset class for investment. Under the current ultra low interest rate environment, life insurance companies are broadening their investment targets to secure yield.

New movement by logistics players

Recently some end users have started to use REIT structures to keep their key operational assets under their control. They build, indirectly hold (without using their own balance sheet) and manage the logistics facilities themselves. If this trend continues, the supply of logistics facilities to the investment/trading market is likely to be somewhat limited.

SG Holdings (SGH), the parent of Sagawa Express, a major logistics company, launched a private REIT with 10 logistics facilities worth JPY30 billion in March 2015. This is a remarkable move by a logistics company who used to sell its operating assets to third parties. By using the REIT structure, SGH secures its own vehicle to hold its operating assets without using its own balance sheet.

Daiwa House Industry announced in October 2014 that they were setting up a private REIT to fund and manage around 10 logistics hubs in major cities starting in 2016. Fast Retailing, an operator of the Uniqlo chain of casual clothing stores, will exclusively use these logistics hubs to deliver goods faster to customers and enhance its online shopping business.

New development

Both domestic and international players are planning to expand and transactions of land for new development have been popular. For example, Daiwa House Industry acquired the former Fukagawa Government Warehouse in Koto Ward, Tokyo for JPY30 billion and Mitsui Fudosan bought a land bank in Ohta Ward, Tokyo for JPY30 billion during 1H/2015. Both parties are expected to (re-) develop logistics facilities in both locations.

While the market witnessed substantial supply in 2013, a larger volume of supply is expected in 2015, and even more in 2016. In 2013, there was enough demand to absorb the supply and vacancy rates remained low. While currently there is still strong demand for facilities and we are confident that this year's new supply will also be largely absorbed, it should be noted that demand is not as robust as in 2013. In 2016, Osaka is likely to see record new supply and this is expected to result in rising vacancy rates as demand is not expected to keep pace. The greater Osaka market is approximately a quarter the size of the greater Tokyo market.

According to the Japan Logistics Field Institute, Inc., the supply of major new development across Japan will total 2 million sq m in 2015 and over 2.6 million sq m in 2016. The previous peak in 2008 did not reach 2 million sq m. On the other hand, the new supply of logistics facilities on an accumulated basis since 2000 accounts for only 20% stock in major cities implying that there still exists significant growth potential. Given the current strong momentum in the logistics industry, any negative adjustment may only be temporary.

OUTLOOK

The prospects for the market

The burgeoning logistics sector in Japan is being driven by fundamental changes to retail patterns, as is happening elsewhere in the world. Japan currently lags behind in the development of e-commerce and third party logistics but is catching up rapidly. While international players have been first-movers in the development of modern logistics facilities, logistics is now emerging as an established asset class within Japan, and is increasingly attracting the interest of J-REITs and insurers. Operators are also taking more control of their own facilities via new structures which keep assets off their balance sheets. A supply boom in 2015 and 2016 may negatively impact rents and occupancy rates but only temporarily. On a mid- to long-term basis, the sector should continue to grow to satisfy the growing need for logistics services. Since land acquisition is becoming more and more difficult in prime areas in Tokyo, logistics facilities are also expected to expand to more suburban/regional locations.

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