Japan - March 2020

SPOTLIGHT
Savills Research

Japan Logistics

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Logistics sector carries the day

Summary

- Despite the large number of completions during the year, vacancy rates continued to decline in Greater Tokyo as pre-leasing remained strong.
- Stability has returned to the Greater Osaka submarket, resulting in a second successive year of positive net absorption. Vacancy rates fell sharply once more as a result.
- Asking rents have seen their downtrend stymied in Greater Tokyo and have subsequently bounced back to reach decade highs. With the availability of prime assets scarce, locations outside the capital, particularly those along major expressways, have benefitted.
- A slight adjustment in Q3/2019 notwithstanding, rents have grown impressively over the year in Greater Osaka.
- Interest in the logistics sector is set to intensify considering the sector's strong fundamentals, higher yield relative to other core assets and the prospect of low inflation for the foreseeable future.
- The ongoing national labour shortage continues to weigh on the sector. That said, steps are being taken to use technology to combat cost-pressures arising from this trend.
- Increased competition, both with entrenched online platforms, as well as in nascent sectors within the e-commerce industry, such as the online food and beverages (F&B) market, implies further growth potential for the logistics sector over the longer term.

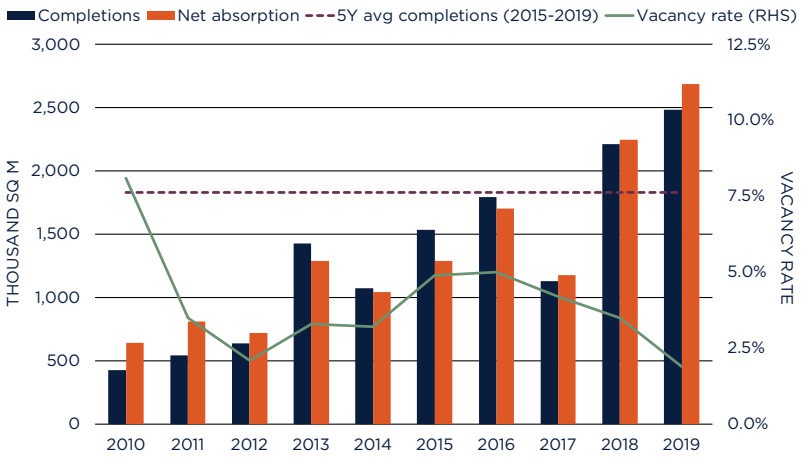
INTRODUCTION

Despite supply increasing significantly in Greater Tokyo, vacancy rates tightened and rents rose, highlighting the solid underlying fundamentals in the submarket. Supply to the Greater Osaka market, on the other hand, has continued to ease. This was expected, however, given the spike in completions experienced in 2017, and has been a necessary condition for the market to stabilise. New supply in both submarkets is expected to be solid this year. As for investors, the sector's long-term prospects remain attractive, and this is set to continue as technology is adopted in order to counter ongoing labour shortages. For the time being, therefore, rental growth should be steady.

MARKET TRENDS

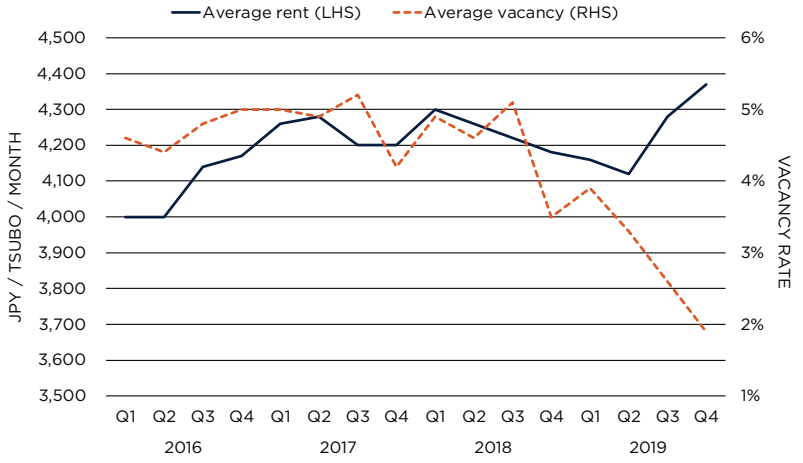
Greater Tokyo saw vacancy rates tighten despite the spate of new developments in 2H/2019. The rate now stands at 1.9% following a year-on-year (YoY) tightening of 1.6 percentage points (ppts), marking the lowest level in a decade (Graph 1). Indeed, pre-leasing levels continue to impress, with over three quarters of facilities completed between August and January being fully leased, pushing net absorption markedly higher than

Graph 1: Supply, Take-up And Vacancy In Greater Tokyo, 2010 to 2019



Note: Annual periods from February to January. Vacancy rates are as of the year end for each annual period, while the rate presented for 2019 is as of January 2020.
Source Ichigo Real Estate Service, Savills Research and Consultancy

Graph 2: Greater Tokyo Rent Vs Vacancy, Q1/2016 to Q4/2019



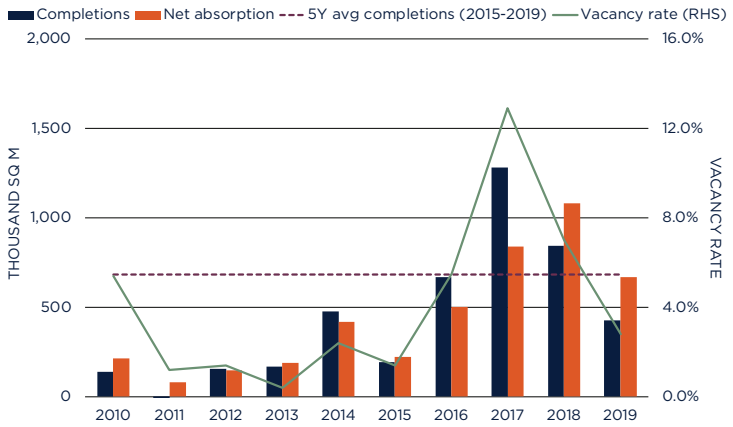
Note: Annual periods from February to January.
Source Ichigo Real Estate Service, Savills Research and Consultancy

the record levels set last year. As for rents, the recent decline was finally reversed in impressive fashion (Graph 2). After a solid 2.1% quarter-on-quarter (QoQ) and 4.5% YoY growth, rents now stand at JPY4,370 per tsubo, around 3% shy of the highs seen in 2008. Given the levels of pre-leasing thus far, market participants appear somewhat calm regarding the significant pipeline of projects anticipated over the longer term, supporting the optimism towards the sector for the time being. That said, the spectre of the novel coronavirus (COVID-19) continues to weigh on both the overall economy and global capital markets, which could, in turn, drag on the logistics sector, albeit with a lesser impact than on other sectors.

Facilities located in the bay area continue to justify their prime reputation. Rents remain significantly higher than for other locations and availability is non-existent. Subsequently, prospective tenants have been keen to occupy other facilities near transportation routes into the capital, leading to improving market conditions in these submarkets. For instance, facilities located along the Tokyo Gaikan Expressway, in areas such as the southern part of Saitama and the western part of Chiba, have witnessed significant upward revisions in rents. Kanagawa prefecture to the west of Tokyo also saw strong rental growth. Rents in this submarket now stand at highs not seen since mid-2008.

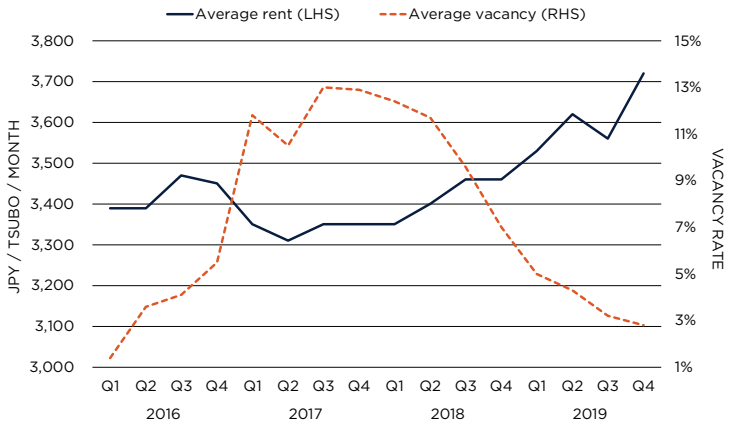
2019 was a year to remember for the logistics sector. With the sector's potential upside, investors were competing fiercely to get some exposure to the asset class. Investment volumes and completions hit record highs, whilst logistics J-REIT unit prices soared. Looking forward, new initiatives by major retailers, such as Aeon and Nike, may have profound implications not only for the logistics sector, but also for retail.

Graph 3: Supply, Take-up And Vacancy In Greater Osaka, 2010 to 2019



Note: Annual periods from February to January. Vacancy rates are as of the year end for each annual period, while the rate presented for 2019 is as of January 2020.
Source Ichigo Real Estate Service, Savills Research and Consultancy

Graph 4: Greater Osaka Rent Vs Vacancy, Q1/2016 to Q4/2019



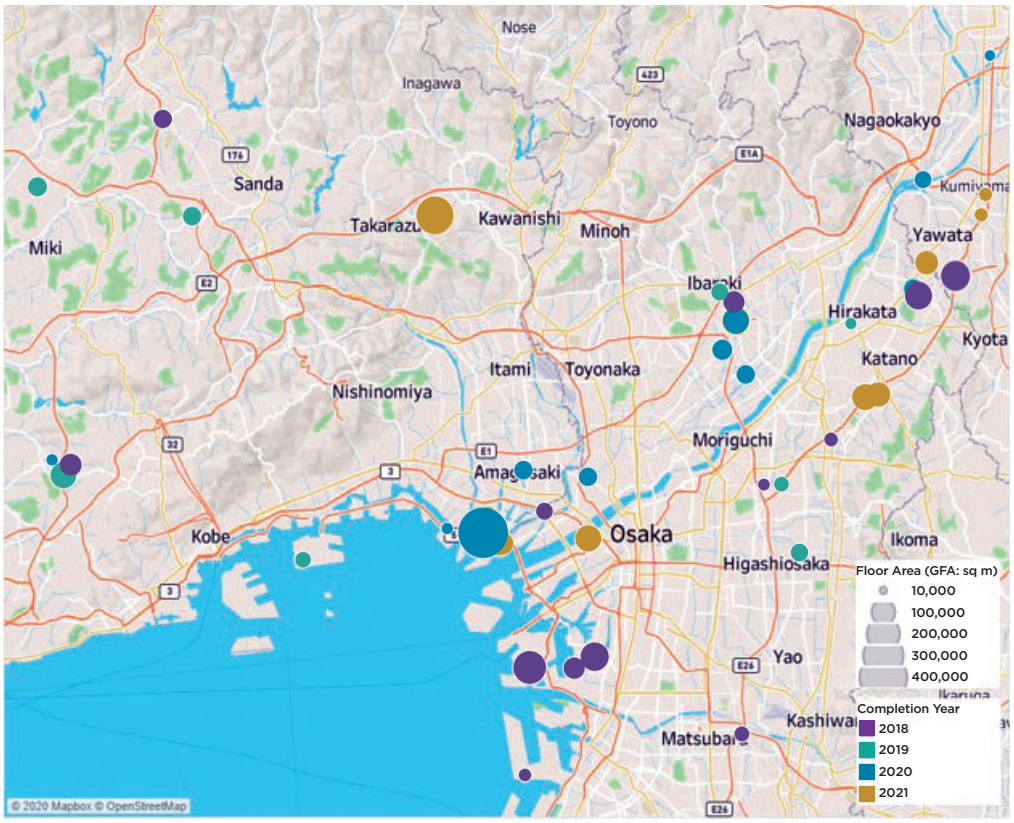
Note: Annual periods from February to January.
Source Ichigo Real Estate Service, Savills Research and Consultancy

The vacancy rate in Greater Osaka continued its descent in 2H/2019, falling 4.2ppts YoY to 2.8% (Graph 3). Following tough market conditions in 2017, it appears the submarket has recovered its poise. Positive net absorption was achieved for the second year in a row – a trend last observed in 2011 – and with this dynamic expected to carry on through 2020, the market is even starting to show some marked tightness. After a slight adjustment in rents during Q3/2019, due to an increased number of listings at the lower end, rents grew 4.5% QoQ and 7.5% YoY to JPY3,720 per tsubo in Q4/2019 (Graph 4). With strong demand expected for facilities in both bay-side and in-land locations, rent growth going forward should be steady. For the same reason, any vacancy from upcoming developments should be temporary.

INCOMING SUPPLY

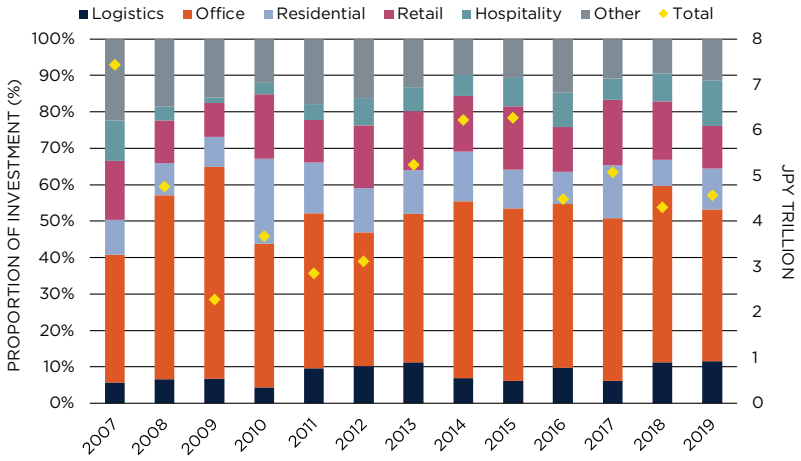
In Greater Tokyo, 2019 turned out to be a bumper year for completions, as the previous record set in 2018 was surpassed. The largest addition in 2H/2019 was MFLP Funabashi II, which was completed in October. Pre-leasing appears to have been solid at the Chiba prefecture-based facility, with reports soon after completion suggesting 80% of the overall space had been leased. The Mitsui

MAP 1: Greater Osaka Logistics Facilities Completions, 2018 to 2021*



* New supply data as of 28 February.
Source Ichigo Real Estate Service, Savills Research and Consultancy

Graph 5: Share Of Investment Volumes By Asset Class, 2007 to 2019



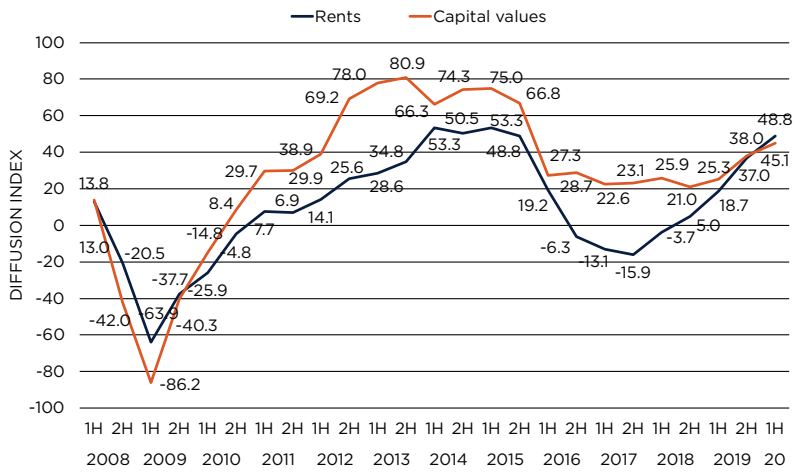
Source RCA, Savills Research and Consultancy

Fudosan owned facility boasts a GFA of over 220,000 sq m and is the second of three facilities to be completed on the site. Once the third iteration is completed in mid-2021 the total GFA of all the facilities is expected to be around 700,000 sq m. Whilst there are few projects of similar size expected in 2020, 2021 is primed to be a record-breaking year in the submarket, with around 3 million sq m due to be added. Even so, there appears little concern for market forces to become unbalanced, with demand likely to match supply once more over the period.

Completions in Greater Osaka during 2019 amounted to around 425,000 sq m – a 50% reduction compared to the previous year – adding to the sense of market normalisation. That said, upcoming developments abound (Map 1). In fact, Hyogo prefecture, located towards the northern side of Greater Osaka, is home to the three largest developments. The largest of which, the Amagasaki Distribution Centre, developed by ESR, will add close to 400,000 sq m of GFA to the market in June 2020. Vacancy rates are anticipated to loosen on completion as result, albeit temporarily.

The reaction to the completion of various developments over the next couple of years is set to be a litmus test for the submarket's

Graph 6: Six-month-ahead Expectations For Rent And Capital Appreciation, 2008 to 1H/2020



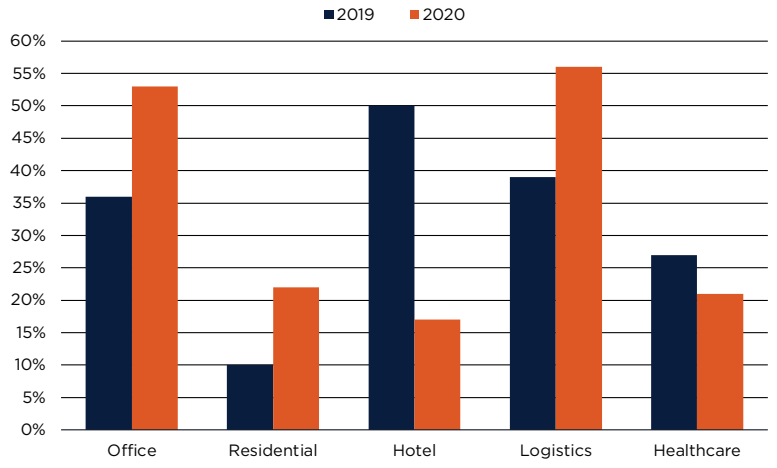
Source Ichigo Real Estate Service, Savills Research and Consultancy

Table 1: Selected Investments, Announced August 2019 to January 2020

PROPERTY NAME	TRANSACTION VALUE (JPY MIL)	APPRAISAL DIRECT CAP RATE	BUYER	SELLER
Odawara Center 1, 2	40,000+	n/a	SPC of Kenedix	Blackstone Group
Logiport Osaka Bay	37,500	n/a	LaSalle Investment Management	SPC (Affiliated with ESR and PAG)
MJ Logipark Kasugai 1	13,670	4.5%	Mitsubishi Estate Logistics REIT	SPC (Affiliated with Mitsubishi Estate)
IIF Hiroshima Seifushinto Logistics Center	6,870	4.9%	Industrial & Infrastructure Fund	Domestic SPC
LOGIPORT Osaka Taisho (20%)	5,755	4.2%	Mitsubishi Estate Logistics REIT	SPC (Affiliated with Mitsubishi Estate)

Source J-REIT Disclosures, Company Disclosures, Nikkei RE, Savills Research and Consultancy

Graph 7: Respondents' Best Performing Sectors In 2020



Source NLI Research Institute, Savills Research and Consultancy

longer-term prospects. With over 2 million sq m of GFA to be added by 2021, market participants will be hoping that it will not be a repeat of 2017, and that the stability experienced hitherto will persist.

INVESTMENT TRENDS

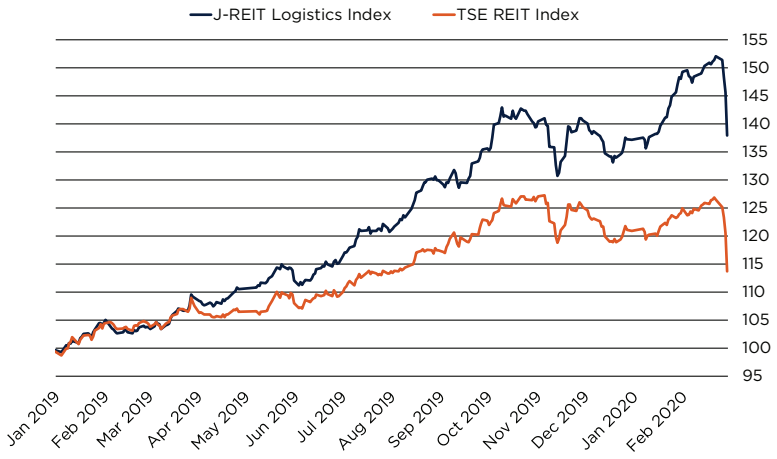
Investment into the logistics sector during 2019 was a tale of two halves. After a slow start to the year, investment volumes soared in 2H/2019 to levels not seen for over a decade. To wit, according to Real Capital Analytics (RCA), around JPY363 billion[1] was pumped into the sector over the period, representing a 43% YoY increase. Over the calendar year, investment volumes stood at an estimated JPY527 billion – the highest level since 2013. Tokyo and Osaka, in that order, were unsurprisingly the main recipients of this flow, with the latter witnessing a near-fivefold increase in investment volumes during the year.

Blackstone had a busy second half of the year, quickly selling off parts of the logistics portfolio acquired from Mapletree in July. The firm sold a logistics facility located in Odawara City, Kanagawa Prefecture for over JPY40 billion to investors including Nuveen Real Estate. Eager to deploy funds into the sector, LaSalle Investment Management finished off the year with a deal worth around JPY38 billion for a logistics facility located in Osaka. This appears to be a somewhat opportunistic investment given only a quarter of the facility was occupied at the time of purchase. Separately, Daiwa Securities and GLP are expected to be active in the sector this year, with reports that the former is set to manage an institutional-focused fund in March. The latter is reportedly following suit later this year.

Although there have been plenty of developments in the logistics sector, investment opportunities have been rather limited. With ample dry powder ready to be deployed, however, demand from investors is rising. As a consequence, it is rumoured that multiple investors have undergone their own development projects, including facilities for last-mile deliveries. As such, with demand high for a range of assets, the momentum for investment activity should continue this year. Indeed, the 25th bi-annual survey of industrial market players, conducted by Ichigo Real Estate Service, echoes this positive market sentiment (Graph 6). Short-term prospects for both rents and capital appreciation increased to four-year highs, with the former's rise being particularly strong. To wit, with no respondents estimating a fall in rents over the next six months, expectations for rental growth experienced a near 12-point increase. Given that the study was conducted during the start of the global COVID-19 outbreak (24–31 January), the sector's positive outlook looks

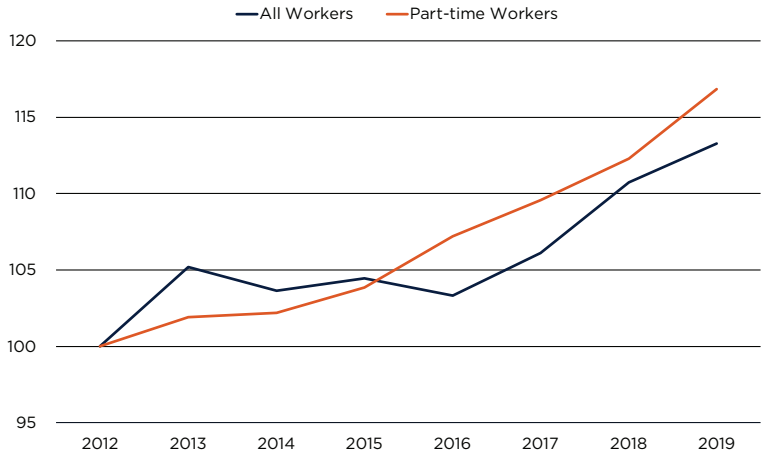
1 In principle, RCA investment volumes exclude related-party transactions, such as those between a J-REIT and its sponsor.

GRAPH 8: J-REIT Performance, January 2019 to February 2020



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy

GRAPH 9: Wage Growth Index Of Workers In The Logistics Sector, 2012 to 2019



*The data for all workers is based on firms with five or more employees.

Source The Ministry of Health, Labour and Welfare, Jobs Research Center, Savills Research and Consultancy

relatively clear.

THE RUN CONTINUES

The wind is still very much in the sector's sails in 2020. Based on the 16th annual survey by the NLI Research Institute (consisting of 126 respondents), whereby market participants were asked to pick their top performing real estate sectors this year, the logistics sector featured most prominently in responses. In fact, over 55% of participants had chosen the sector as one of their top picks, with the office sector not far behind (Graph 7). Indeed, with the momentum set to continue, investor appetite looks unlikely to wane.

After a tepid 2018, the logistics sector took centre stage last year, taking the crown as the best performer in 2019. This was particularly evident among J-REITs. Investors, after observing demand more than match high supply levels, helped push J-REIT returns north of 35% on average, comfortably outpacing the broader market index (Graph 8). In fact, the greatest divergence in returns was seen in 2H/2019, as the spread reached over 16% in December. This theme intensified this year with the spread rising to as much as 26% in February. That said, logistics-focused J-REITs were not exempt from the market correction witnessed at the end of February as the wider potential impact of COVID-19 started to be digested, giving back most of the gains for the year. When compared to the broader market index, however, the impact seems less severe, with the TSE REIT index losing over 7% in value year-to-date.

Of course, the sound fundamentals borne from the growing e-commerce sector was a major contributor to these impressive returns, but there are also other factors to consider. Previously, in a world with some expectation for inflation, investors faced potential uncertainties from committing to long-term fixed rent leasing contracts that are typical in the sector. Yet, in the low-yield, low-inflation environment we currently find ourselves in globally, a wider spread relative to other asset classes gives investors more comfort. Another factor to consider is scale. With logistics assets being big-ticket items by nature, scaling up should be less of an obstacle. This is especially appealing for investors new to Japan with plenty of dry powder available. Given these tailwinds, especially with the relatively wide yield spread, we should, therefore, see further cap rate compression going forward.

The logistics sector continues to suffer from the labour-shortage impacting the nation, and this is likely to be a significant, long-lasting issue. To wit, average wages for workers in the sector have increased by over 13% since 2012, with part-time workers seeing even greater growth of around 16% during the period (Graph 9). Consequently, in some cases, this has meant that consumers have had to bear the brunt in the form of higher delivery fees.

Yet, there is plenty of scope for change, and the logistics sector, more than most, is well-placed to benefit from the advancements in technology. For instance, according to the Financial Times, Aeon – Japan's largest supermarket operator – is set to build robot-powered warehouses in collaboration with Ocado, the UK food delivery service-cum provider of automated warehouses. With the warehouses slated for completion in 2023, the joint venture is reportedly aiming for a sales capacity of over JPY200 billion. Given the low penetration of e-commerce for the food and beverages (F&B) sector, this collaboration could have a profound impact on the logistics sector overall. Specifically, the heightened competition with established online platforms such as Rakuten and Amazon from a retail giant, such as Aeon, could be a catalyst for further growth in the e-commerce market and related logistics activities.

In another example, it has been reported that Nike has joined forces with Geek+, a provider of robotics technology for the logistics sector, to provide same-day delivery. This was made possible thanks to the installation of over 200 robots, tasked with collection and transportation within the facility, which increased efficiency whilst alleviating the workload for human workers. As such, the future looks brighter for the in-vogue sector. The heightened competition by retail players against online platformers, the sole victors so far, may change the prospects for the e-commerce industry and the shape of retail facilities, with a rise in showroom functions, for instance.

OUTLOOK

After a fantastic year for the logistics sector, the momentum is expected to continue throughout 2020. The sector's prospects are expected to move in concert with the growth of e-commerce in Japan, and therefore plenty of potential upside remains. This is especially true for relatively untapped sectors such as F&B. This in turn could spread further to other sub-sectors, pushing broader demand higher and potentially increasing rents. This dynamic is expected to have profound implications not only for the logistics sector, but also for the retail industry. Although the labour shortage continues to be a long-lasting headache for the logistics sector, the use of technology to counter this problem is encouraging.

Despite the high levels of supply expected in Tokyo over the next few years, demand should be more than able to match, ensuring market stability for the time being. Hence, rent growth should be stable. With availability in prime locations limited, facilities in the next grade, such as those located along major expressways, stand to benefit. In Greater Osaka, the story should be somewhat similar. The reaction of both rents and vacancy to the levels of supply coming online by 2021, however, is worth keeping an eye on. That said, the submarket has sounder fundamentals this time around and looks more resilient compared to 2017. Therefore, any spikes in vacancy should be temporary.

As for COVID-19, the outbreak continues to cast a shadow over the global economy. Indeed, strong volatility has manifested in capital markets worldwide, and there appears be to no reprieve in sight. Even so, the impact should be relatively limited compared to other asset classes given the structural changes facing the logistics sector. The rise in e-commerce is expected to be a long-term transition, and therefore the sector is somewhat shielded from short-term adjustments. In addition, modern facilities, which have features that mitigate labour shortages and are more resilient to natural disasters, should have sound long-term demand.

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