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Savills World Research
Japan

Spotlight
2015 review and 2016 prospects

February 2016

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Property market review and prospects

Rents increased in 2015, although not as much as originally expected. The house view is that rents will continue to rise in 2016, albeit at a slower pace than 2015. The slower pace of growth is forecast based on a degree of caution returning to the occupier market as tenants become more price conscious, given the uncertain economy.

Tokyo cap rates stand at the pre-global financial crisis levels of 2007, and are expected to compress further due to the large amount of capital seeking investment opportunities. Regional cities still offer a premium over pre-crisis levels and should continue to compress in 2016. Given the relatively sharp pricing in Tokyo there remains significant appetite from domestic and international investors for deals in regional cities.

Interest rate and exchange rate

It is the view of Savills that interest rates will see limited change in 2016 and are likely to be kept at current levels given the recent move by the Bank of Japan. The Yen may undergo some appreciation as a safe haven, when compared to 2015, although a further round of quantitative easing may well result in downward pressure. These factors will most likely not result in any meaningful impact on investor sentiment.

Asset classes & investment rationale

Core (stable income): Grade B offices will continue to provide stable income streams to core investors, whilst rental increases could provide moderate NOI growth. Considering the ultra-low funding costs in Japan, the yield carry (NOI – borrowing costs) continues to be attractive at 3% to 5% with cash-on-cash returns comfortably higher. The same applies to residential properties for which returns historically experience less volatility than office assets.

Value-add: The logistics sector in Japan has been enjoying strong demand. E-commerce currently accounts for only 5% of the commerce market here, compared with 15% in the UK and 10% in the US. Considering the well-reported ageing demographic, the logistics sector should require increased capacity to deliver more packages to people's homes. Because of the substantial supply scheduled to complete next year, there may be a temporary softening in values but the sector should grow strongly on a mid-to -long-term basis.

Opportunistic: The hospitality sector in Japan is well positioned to capture the continued inbound growth in tourists, especially from mainland China. For example, ADRs have grown by 20% over the past three years in Tokyo and by 40% in Osaka. This trend should continue in the run up to the Tokyo 2020 Olympics. Investors in this space must be deft and prepared to risk disruptive events which can dramatically change the outlook of the industry, including natural/man-made disasters. Cap rates in the sector have compressed significantly over recent years, while ADRs are still likely to rise further.

J-REIT price as a proxy for property market sentiment

J-REITs may be considered a good barometer of property market sentiment since J-REIT units are priced daily and are very liquid. During 1H/2015, strong rental growth was expected and the 10-year government bond yield hit as low as 20 basis points (bps). The J-REIT index peaked at 2,000 and fluctuated between 1,800 and 1,900 until the market experienced some uncertainty towards the end of 1H/2015, especially in relation to China. The index then plummeted to 1,500 in the midst of the global economic chaos followed by a recovery to 1,700-1,750. Despite the recovery, expectations are not as positive as they were in 1H/2015. This movement appears to be reflected in property investor sentiment and rental growth expectations. Rental growth should help to drive up the J-REIT index, as well as the property market, in 2016.

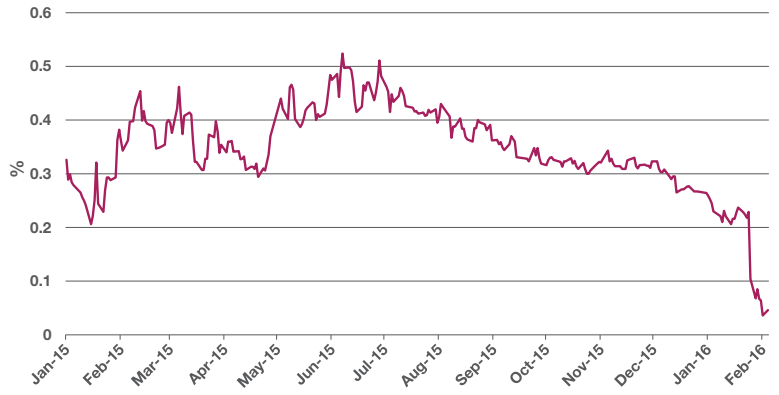
GRAPH 1

TSE REIT Index, Jan–Dec 2015

Source: Tokyo Stock Exchange, Savills Research and Consultancy

GRAPH 2

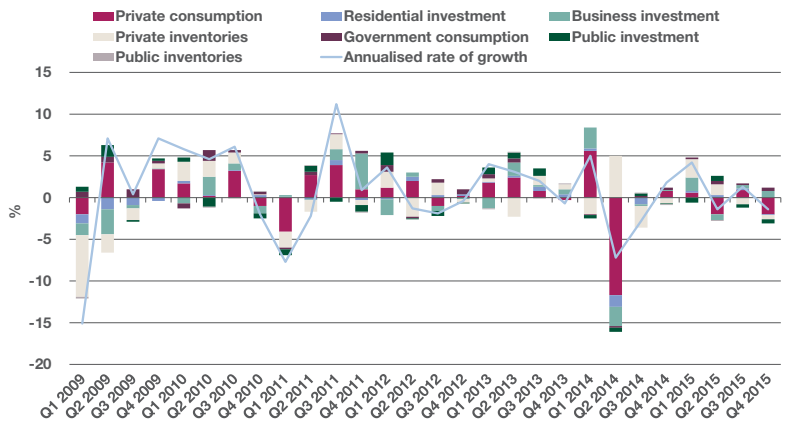
10 Year Japanese Government Bond Yield, Jan 2015–Feb 2016



Source: Ministry of Finance, Savills Research and Consultancy

GRAPH 3

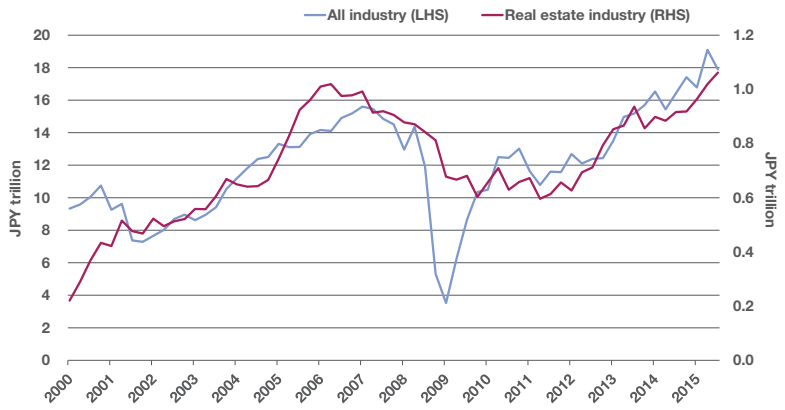
GDP growth of Japan, Q1/2009–Q4/2015



Source: Cabinet Office

GRAPH 4

Corporate profit, Q1/2000–Q3/2015



Source: Ministry of Finance
Seasonally adjusted series.

Japan's Macro Economy

The Japanese economy had a fair year in 2015. Although GDP growth was moderate, Abenomics developed and nurtured market fundamentals. As an extension, the new Abenomics, announced in September 2015, focuses on improving people's lives and targets raising nominal GDP to JPY600 trillion by 2020 (from the current JPY500 trillion).

Summary of 2015

Whilst the original Abenomics has somewhat stalled, there was some recovery in economic activity in 2015. Japan's GDP for 2015 was 0.4% higher than the previous year. A rise in corporate investment contributed to the growth, while private residential investment and private consumption remained weak.

On the back of the capital expenditure expansion, there has been an increase in corporate profits, predominantly due to lower energy prices and a cheaper Yen. After hitting JPY19.1 trillion in the second quarter 2015, corporate profits in the third quarter maintained high levels (JPY17.9 trillion). Moreover, the corporate profits of the real estate industry in Q3/2015 stood at JPY1.1 trillion, the highest figure since 1954.

Lending attitudes

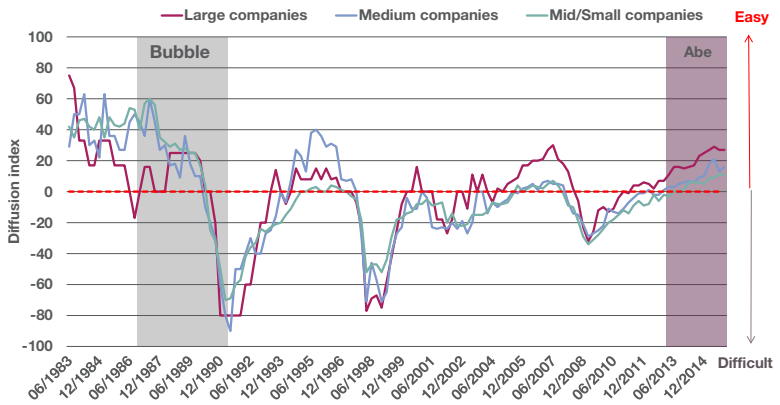
Conditions surrounding the real estate industry have changed for the better and are manifested in the Tankan, a business sentiment survey. The diffusion index for such firms has been above zero and rising since Q4/2013, meaning that there are more and more firms who have found it easy to obtain bank loans.

Particularly noticeable is the improved lending attitude by financial institutions toward medium/small firms, which typically worsens when the economy is struggling.

Although not as significant in magnitude as during the bubble period the fact that medium/small firms are finding it easier to borrow money is one sign of fundamental economic improvement.

GRAPH 5

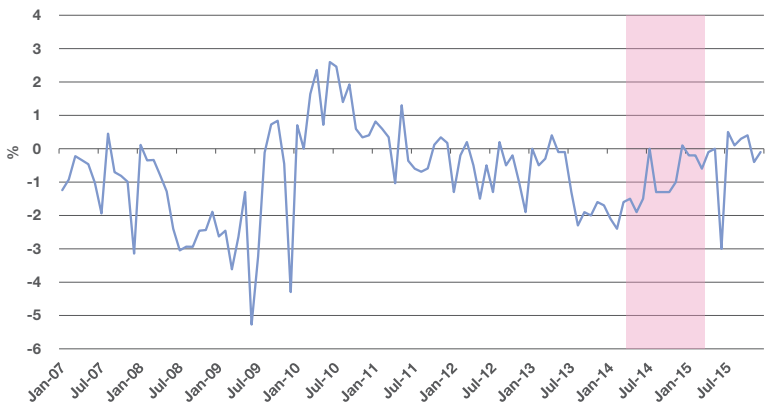
Lending attitude of financial institutions, real estate firms, Q2/1983–Q3/2015



Source: Bank of Japan

GRAPH 6

Real wage growth, Jan 2007 – Dec 2015



Source: Ministry of Health, Labour and Welfare
Note: Shadow is considered to be the period when the consumption tax rate hike had an impact.
Real wage growth rates during this time are adjusted by 2.1%, the adjustment rate for headline inflation, which is released by the Cabinet Office in order to exclude the impact of the consumption tax rate hike.

Wage growth

Low energy prices have improved Japan's business climate, but also created an issue for the inflation target. The bold monetary policy of the Bank of Japan (BOJ), or the First Arrow of Abenomics, was seen as a success when it was launched in April 2014. Share prices climbed and the inflation rate rose. However, the 2% inflation target has not been achieved after nearly three years.

The shortfall could be the result of slow real wage growth. Since the beginning of the Abe administration, real wage growth rates have been in negative territory for a good period of time, partly due to the consumption tax rate hike. Since mid-2015, however, growth rates rose above zero, albeit marginally. In addition, according to Recruit Jobs[1], the average hourly wage of irregular workers such as part-time and temporary workers in large cities has been improving.

The FY2016 Tax Revision is aimed at household spending in order to rescue lower income households in light of another consumption tax rate hike in April 2017. Although initially limited to fresh food, the reduced tax rates will also be applied to processed food and take-aways. The widening of the product range was possible because of an increase in corporate tax revenues, though the Ministry of Finance still has to seek additional revenue to compensate for a revenue shortage.

Prospects for 2016 and beyond

Prospects for the Japanese economy in 2016 look fair but there are still reasons for caution.

In politics, the House of Councillors election is to be held in July 2016, and possibly the House of Representatives, too. No announcements have been made yet, but the double election could result in a re-shuffling of the Cabinet which could boost the Japanese economy, but cause a delay in implementing policies.

The December 2015 Tankan Outlook for Q1/2016 reflected the pessimistic view of Japan's corporates. Indeed, uncertainty in emerging markets, especially China, is of concern for exporters who have benefited from the Yen's depreciation, combined with the expansion of such economies.

In light of the consumption tax rate hike in April 2017, an increase in spending and investment, such as residential investment, can be expected to temporarily boost the economy. In order to improve and sustain the levels of investment, it is desirable that interest rates be kept at current levels for the time being.

1 For example, in November 2015, temporary workers' hourly wage in large cities recorded a 3.6% increase on the year, representing thirty straight months of positive growth rates. Furthermore, part-timers' hourly wage in November increased by 2.0% from a year earlier, the 6th consecutive positive growth month, for Tokyo, Tokai, and Kansai Metropolitan areas.

Investment & sales

Investors have maintained a positive view of the Japanese property market. Due to limited opportunities, competition for property has been fierce, leading to cap rate compression and as a result, more investors have started to look at regional cities.

Summary of 2015

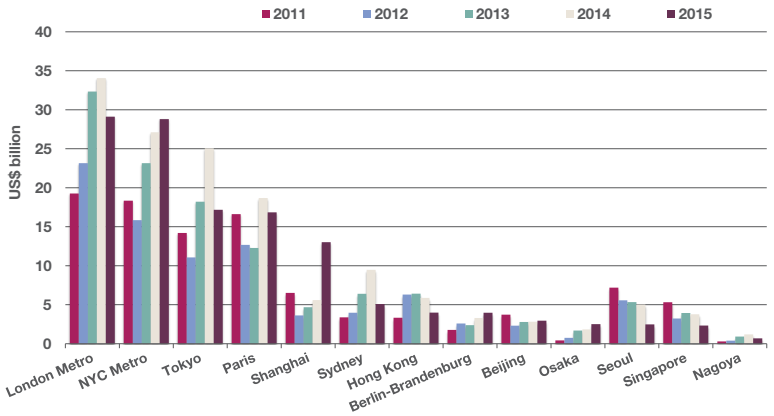
In 2015, property transaction volumes for Japan remained strong, standing at approximately US$44 billion, according to figures released by Real Capital Analytics (RCA). The office sector recorded US$21 billion in transactions; around US$17 billion of which was transacted in Tokyo. Among major gateway cities, London and New York were the largest office markets in terms of transaction volumes in 2015, followed by Tokyo and Paris. The same source also indicates a growing trend in Osaka, which recorded a larger transaction volume than both Seoul and Singapore.

Favourable investment prospects in Japan

In the Urban Land Institute's (ULI) 2015 Investment Prospects survey, Tokyo remains the investor favourite by a wide margin, followed by Osaka, which as recently as 2013 ranked bottom. With the Abe administration introducing a new round of easing, there seems to be plenty of room for further growth, but Tokyo's attraction lies not only in its inflation prospects but also in its gateway city status: low risk, together with levered returns comparing favourably with those on offer in other parts of Asia.

GRAPH 7

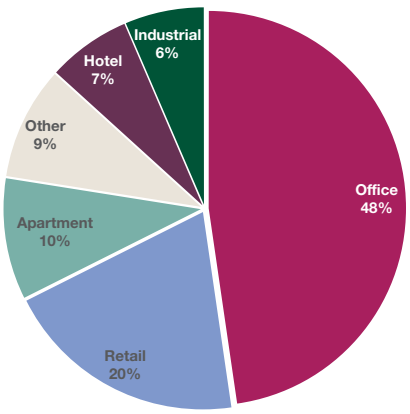
Transaction volume of office assets by selected cities, 2011-2015*



Source: Savills Research & Consultancy, RCA
*preliminary figures

GRAPH 8

Transaction volume in Japan by asset class, 2015*



Source: Savills Research & Consultancy, RCA
*preliminary figures

TABLE 1

ULI City Investment Prospects, 2015

		generally poor	fair	generally good
1	Tokyo		3.50	
2	Jakarta		3.44	
3	Osaka		3.35	
4	Sydney		3.33	
5	Melbourne		3.31	
6	Shanghai		3.30	
7	Seoul		3.30	
8	Manila		3.21	
9	Singapore		3.16	
10	Beijing		3.11	
11	Mumbai		3.11	
12	Kuala Lumpur		3.09	
13	Ho Chi Minh City		3.09	
14	New Delhi		3.06	
15	Auckland		3.05	
16	Bangkok		3.01	
17	Bangalore		3.01	
18	Taipei		3.01	
19	Shenzhen		3.01	
20	Guangzhou		3.01	
21	Hong Kong		2.97	
22	China - secondary cities		2.89	

Source: Emerging Trends in Real Estate Asia Pacific 2015

The positive outlook and high levels of liquidity recorded in the market have attracted attention. Similarly, according to a survey conducted by PricewaterhouseCoopers, Tokyo is ranked above 22 other cities in Asia-Pacific as the region's best bet for 2016, followed by Sydney, Melbourne and Osaka. The limited number of assets for sale in the current market has forced some investors to look for opportunities outside of Tokyo, with an expectation of yield compression and rental increases.

Investor appetite

Transaction volumes of office buildings accounted for close to half of Japan's total, followed by retail (20%) and residential (10%). The current limited inventory in Tokyo's market is seeing investors flock to regional cities. The share of investment volumes in Osaka against Japan's total grew from 10% in 2014 to 13%, to stand at US$5.8 billion in 2015.

Similar to 2014, domestic capital continued to be driven by the J-REIT market. In 2015, six new J-REITs were successfully listed on the Tokyo Stock Exchange (TSE). The aggregated initial portfolio size of these new J-REITs reached JPY960 billion based on acquisition price. The strong momentum was also present in the Private REIT market, with numbers of new Private REITs increasing in 2015; including SC Realty Private REIT and SG Assetmax-REIT.

These new players are a testament to the further diversification of REITs in terms of asset class and geography. There are several new entrants into the private REIT market: Daiwa House, NTT Urban Development, Tokyo Tatemono, Senko and the Keihan Railway. The current market is attracting more players with Nippon Life Insurance recently announcing its plan to raise JPY100 billion in 2016 with a medium-term target of approximately JPY300 billion, aiming for the title of Japan's largest Private REIT.

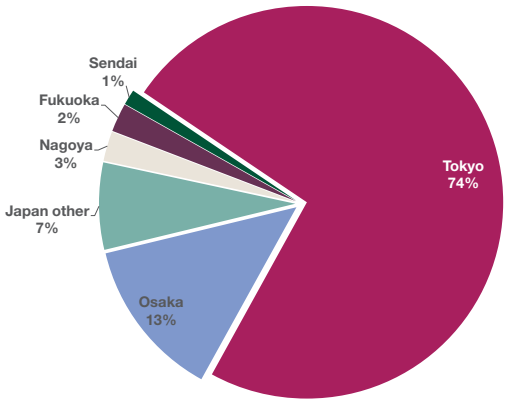
Prospects for 2016 and beyond

Sentiment towards the Japanese real estate market remains steady and groups of international investors have successfully raised funds to pursue more opportunities, proof of robust appetite. 2015 saw market entry by mega funds including the German pension fund BVK, the Malaysian public pension fund EPF and the Azerbaijan State Oil Fund (SOFAZ). Norges Bank Investment Management (NBIM) also opened an office in Tokyo. These new and existing investors look set to remain active in 2016.

Transaction levels in 2015 were healthy, with acquisitions by various types of market player across the region. A resort asset in Hokkaido changed hands from domestic luxury-resort operator Hoshino Resort to a subsidiary of Chinese conglomerate Fosun. One of the largest deals during the year was Hulic's acquisition of Simplex Investment Advisors from Aetos Capital Real Estate. The purchase price was estimated at JPY155 billion.

GRAPH 9

Transaction volume of all asset classes in Japan by geography, 2015*



Source: Savills Research & Consultancy, RCA
*preliminary figures

TABLE 2

List of new J-REITs listed in 2015

Sector	J-REIT	Number of properties	Initial portfolio size* (JPY bil)	Listing date
Hotel	Ichigo Hotel REIT Investment Corporation	9	20	30 Nov
Office/retail etc	Nomura Real Estate Master Fund, Inc.	257	779	2 Oct
Healthcare	Japan Senior Living Investment Corporation	14	28	29 Jul
Residential	Samty Residential Investment Corporation	28	30	30 Jun
Healthcare	Healthcare & Medical Investment Corporation	16	23	19 Mar
Retail	Kenedix Retail REIT Corporation	18	80	10 Feb

Source: Savills Research & Consultancy, Nikkei RE, press releases
* Acquisition price basis

TABLE 3

Notable transactions in 2015

Location	Asset name	Buyer	Price (JPY bil)	Date
Hokkaido	Hoshino Resorts Tamamu	Shanghai Yuyuan Tourist Mart	18	Nov
Sendai	AER	Japan Real Estate REIT	15	Aug
Tokyo	Kirarito Ginza	The State Oil Fund of Azerbaijan	52	Aug
Tokyo	Meguro Gajoen	LaSalle Investment Management	143	Jan
Greater Tokyo	Five logistics properties	Diamond Realty Management, Malaysia's Employment Provident Fund	14	Feb
Nagoya	Nagoya Nikko Shoken Building	Undisclosed domestic buyer	4.8	Aug
Kyoto	Aeon Mall Kyoto	Aeon REIT	21	Jan
Osaka	Epson Osaka Building	CBRE GI, Universal-Investment	14	Mar
Hiroshima	Active-Inter City Hiroshima	Japan Hotel REIT	17	Dec
Fukuoka	Torius	Croesus Retail Trust	8	Sep
Okinawa	Okinawa Marriott Resort & Spa	Japan Hotel REIT	15	Jul
Various	26 builings from GE	PAG Investment Management	100	Jul

Source: Savills Research & Consultancy, Nikkei RE, press releases
* Acquisition price basis

Office

The office market in Tokyo remains popular with investors by virtue of the continued positive sentiment with regard to Japan's economic outlook and the sheer size of its institutional grade market. Amid growing interest from overseas investors and strong domestic demand, acquiring assets at reasonable yields has become more challenging. The weight of capital seeking investment opportunities in Japan has led to further compression in cap rates, bringing them back to historical lows.

Summary of 2015

Tokyo Grade A rents have risen steadily over the past three years. As of Q4, the average Grade A office rent stood at JPY31,125 per tsubo, an increase of 4.8% year-on-year (YoY), but approximately 35-40% below the previous cyclical high in 2007. The current market cycle provides a somewhat positive picture and indicates upside potential for future years with relatively limited downside risk.

A steady flow of large lease agreements has dramatically reduced the amount of office space available in top grade buildings in Tokyo. The vacancy rate for Grade A office space improved by 1.0 percentage point YoY to 2.2% as of Q4/2015.

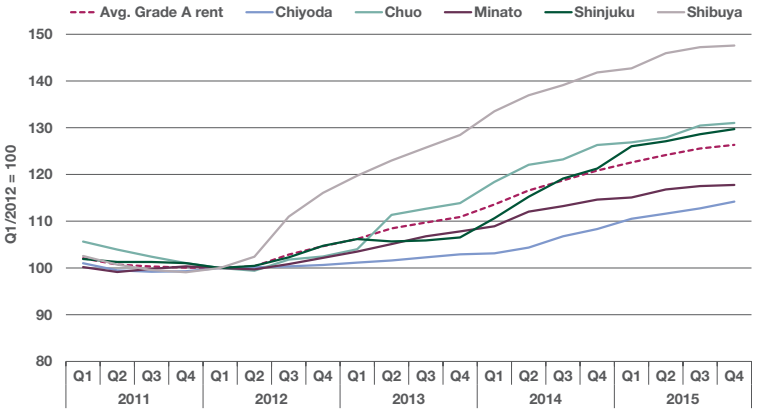
Taking the rental nadir of Q1/2012 as an indexed value of 100, Grade A rents in the central five wards (C5W) have now reached 127. Shibuya has outpaced the market, reaching a value of 148, followed closely by Chuo Ward at 131. Growth has been driven by low-market vacancy rates compared to other submarkets which saw large amounts of new supply.

Investment appetite

As of Q4/2015, the expected capitalisation rate for Grade A office space in Tokyo was 3.5%, having compressed by 15 bps over the past 12 months, back to a cyclical low. This came from a positive rental story which allowed investors to be more bullish on pricing. With strong commitment from the Abe administration and the Bank of Japan, the 10-year JGB yield is likely to remain low for a few more years. As of December 2015, the cap rate spread for Grade A office space was

GRAPH 10

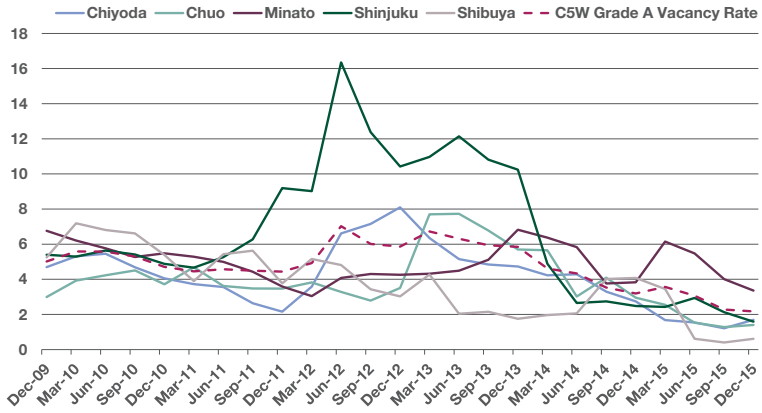
Grade A office rental index by ward, Q1/2011-Q4/2015



Source: Savills Research & Consultancy

GRAPH 11

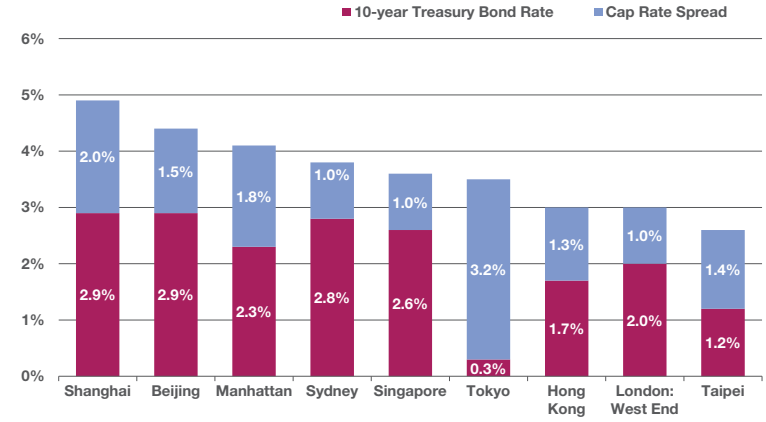
Grade A office vacancy rate by ward, Q1/2011-Q4/2015



Source: Savills Research & Consultancy

GRAPH 12

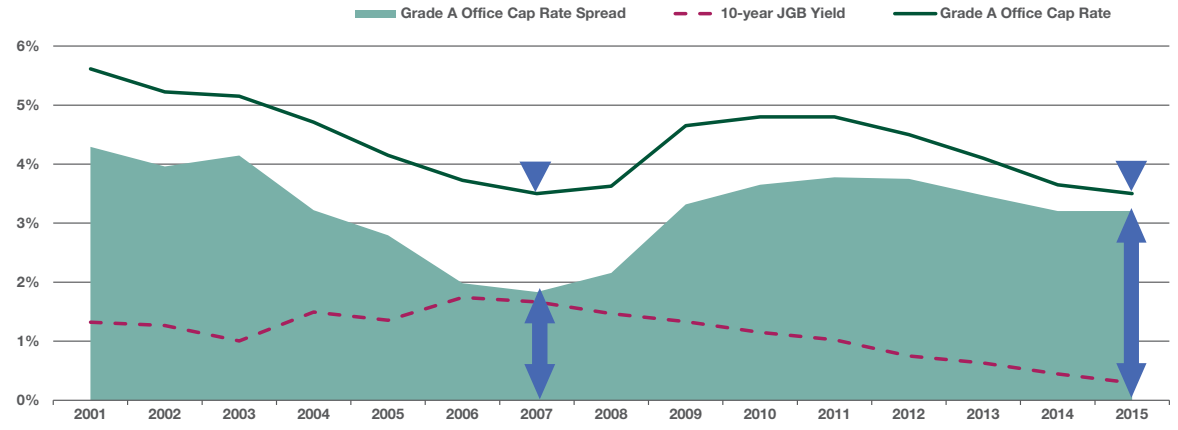
Grade A Office cap rate spread by selected cities, Q4/2015



Source: Savills Research & Consultancy

GRAPH 13

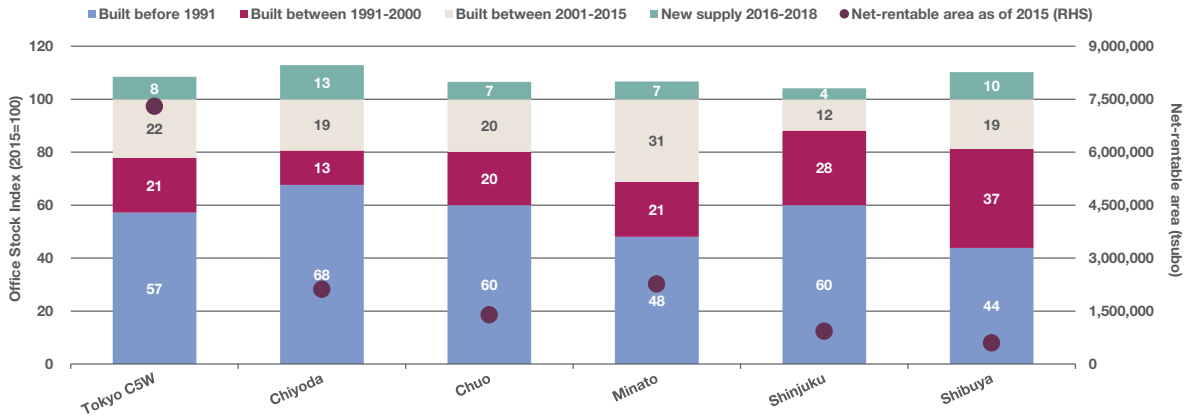
Grade A Office cap rate trend, 2001-2015



Source: Savills Research & Consultancy

GRAPH 14

Office stock and supply by ward



Source: Savills Research & Consultancy, Miki Shoji
*New supply ratio is based on total supply in 2016-2018 divided by total stock in 2015.

3.1%. Despite the recent cap rate compression, the yield spread is still wider than pre-crisis levels thanks to the ultra-low interest rates.

The steady rental recovery story for the office sector captivated investor interest especially during 1H/2015. Some large-scale transactions were recorded during the year. The largest transaction was the purchase of Meguro Gajoen by LaSalle Investment in January, for an estimated price of JPY143 billion. GreenOak Real Estate acquired the Aoyama Building, located in Kita-Aoyama 1 chome, for JPY46 billion from Mitsubishi Jisho Investment Advisors. Goldman Sachs also made an appearance by purchasing a sectional ownership in Gran Tokyo South Tower, an office building located in the prime area close to Tokyo Station. Besides these deals, some portfolio transactions by J-REITs were recorded. PAG Investment Management also successfully acquired a portfolio of 26 buildings for JPY100 billion. The assets were transferred from GE Capital Real Estate, which has exited from the real estate business.

Prospects for 2016 and beyond

Approximately 78% of the office buildings in Tokyo's central five wards are older than 15 years (built before 2001). Moreover, a majority (57%) of the buildings were built before 1991.

Vacancy rates in the office market have recorded a positive trend since early 2011, reflecting a flight to quality among tenants at the expense of older, small-to-mid-scale rental buildings. This has resulted in uncompetitive properties being removed from the market for both refurbishment and redevelopment. As of 2015, Tokyo's C5W is estimated to see around an 8% increase in office stock by the end of 2018, supplied by on-going development projects.

It is still too early to conclude whether this amount of supply will have any negative impact on the current vacancy rate, since some floors of the development projects have already secured tenants. Notably, Chiyoda ward is expected to see a 13% increase in stock, followed by Shibuya (10%), and Shinjuku (only 4%). As long as pre-commitment activity remains strong, vacancy rates may remain stable.

Residential

The residential sector remains favourable to investors as a core asset class. Preliminary figures for transaction volumes in 2015 were US$4.3 billion, accounting for approximately 10% of Japan's total transaction volumes. Over three quarters of the transacted residential properties were located in Tokyo.

Summary of 2015

As of Q4/2015, the occupancy rate in Tokyo's 23 wards was 96.3%, an increase of 7 bps YoY, comfortably above the stable 95% threshold based on a basket of residential properties held by selected J-REITs. Similarly, occupancy in Tokyo's C5W stood at 96.1% in the fourth quarter.

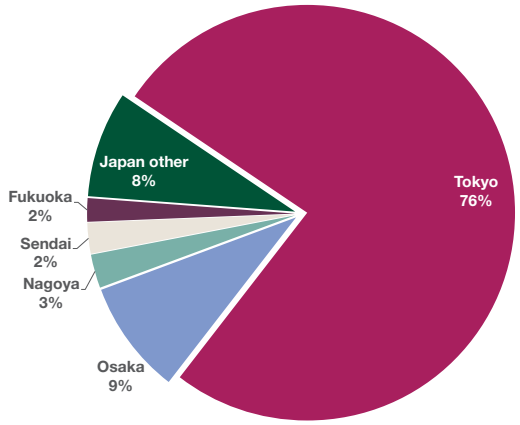
As the urbanization trend looks set to continue, demand for rental apartments is expected to remain stable in large cities with moderate potential for rental increases. The average mid-market rent in Tokyo's 23 wards is JPY3,623 per sq m as of Q4/2015, an increase of 2.4% YoY. While in Tokyo C5W, the average rent is JPY4,195 per sq m, an increase of 1.8% over the past 12 months.

Sales price

According to figures released by the Real Estate Economic Institute (REEI), the average price per sq m for residential properties in Tokyo's 23 wards increased by 13.1% YoY in 2015 to stand at JPY987,000

GRAPH 15

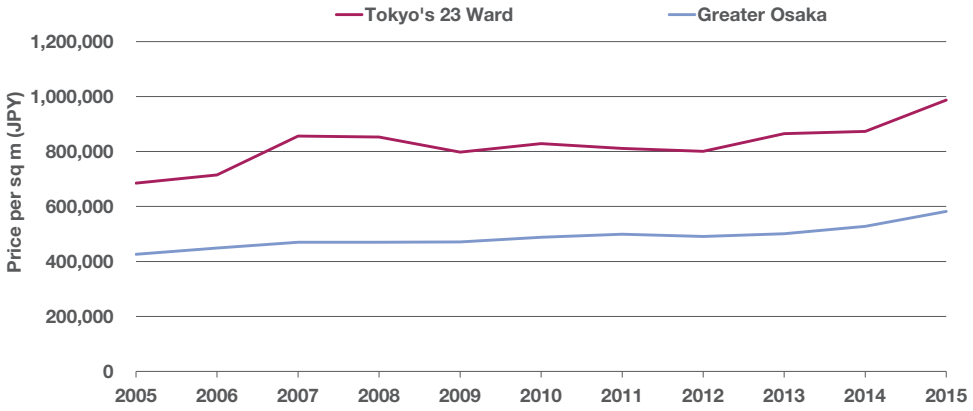
Transaction volume of residential assets by geography, 2015*



Source: Savills Research & Consultancy, RCA
*preliminary

GRAPH 16

Average price per sq m for new condominiums in Tokyo and Osaka, 2005–2015



Source: Savills Research & Consultancy, REEI

TABLE 4

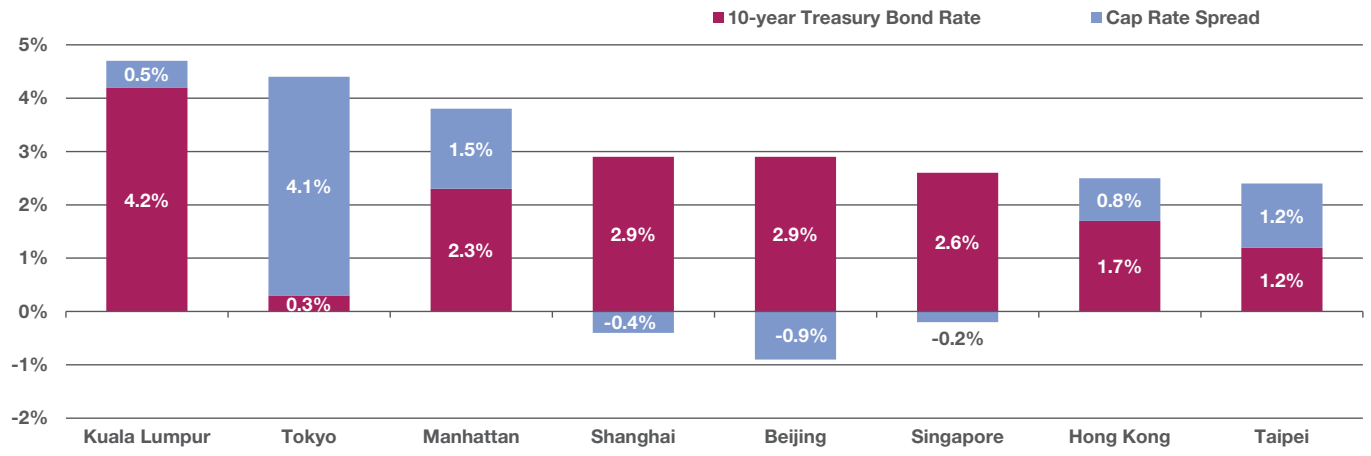
Average rents in Japan's major cities, Q4/2015

Area	Rent per sq m (JPY)	YoY Change (%)
Tokyo's 23 Ward	3,623	2.4
Tokyo Central Five Ward	4,195	1.8
Osaka City	2,446	0.0
Sapporo City	1,620	-0.5
Nagoya City	2,221	1.4
Fukuoka City	2,016	2.1

Source: Savills Research & Consultancy

GRAPH 17

Prime residential cap rate spread, Q4/2015



Source: Savills Research & Consultancy

per sq m. In Greater Osaka, prices increased by 10.2% YoY to stand at JPY582,000.

The private housing market attracted a lot of interest from both domestic and international buyers. Stable and positive macroeconomic fundamentals are viewed as the main factor. Strong demand is coming from domestic high net worth individuals looking to real estate for the tax benefits against increased inheritance taxes. International buyers, mostly from elsewhere in Asia, have also shown confidence in the upside potential of Japan's residential market. The sector is viewed as still offering relatively high yields compared to their home countries, while the current relatively soft Yen is a good opportunity to acquire a quality asset in Japan.

Current positive market conditions have also incentivised developers to push the market to another level. A good example is Mitsui Fudosan who has announced a new development project named Park Court Akasaka-Hinokicho The Tower, a luxury condominium located in one of the most prime areas in Tokyo, with completion targeted for early 2018. The price of this project is rumoured to make it one of the most expensive condominiums on the market.

Prospects for 2016 and beyond

The ultra-low yields from Japanese government bonds have been favourable to real estate investors. The cap rate spread offered in the country is among the widest compared to other global cities, with an outlook of continued low interest rates over the foreseeable future. As of Q4/2015, the cap rate spread for residential assets in Tokyo was 4.0%, which is not achievable in most other markets. The residential sector is expected to remain in demand, as investors tend to buy and hold such assets as a core investment. In addition, there are currently limited opportunities and an abundance of potential buyers.

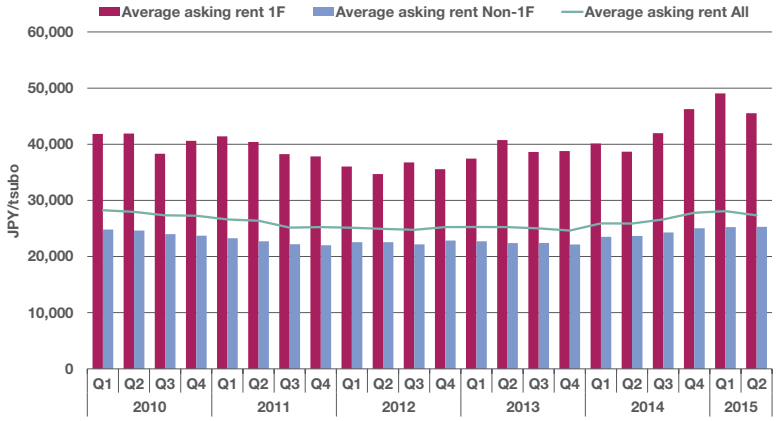
Large portfolio transactions

In 2015, some institutional investors acquired properties through corporate/portfolio acquisitions. Private equity behemoth Blackstone Group recently snapped up Japan Residential Investment Company, a UK investment fund specialising in rental apartments in Japan. The price paid was nearly JPY50 billion for a portfolio of 57 buildings composed of approximately 2,700 residential units, mainly located in Tokyo.

Another notable transaction was the acquisition of Singapore's Saizen REIT by Lone Star in October 2015. The US fund acquired all of its properties, including 136 buildings with 5,421 residential units, primarily located in Japan's regional cities. Lone Star's acquisition price was reported to be approximately JPY45 billion.

GRAPH 18

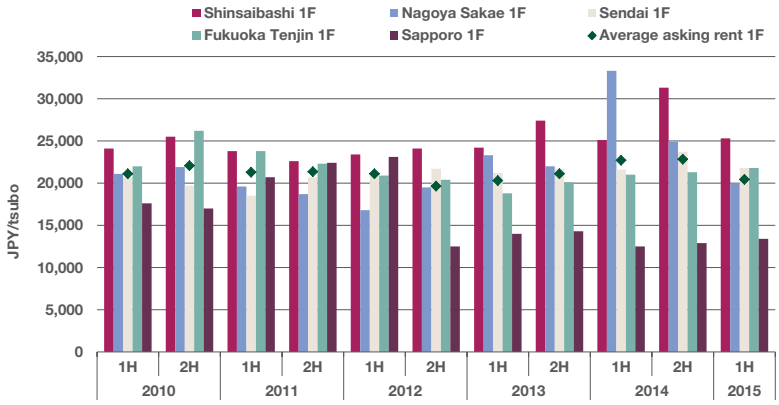
Average asking rents for major retail areas in Tokyo, Q1/2010 – 1H/2015



Source: Japan Real Estate Institute

GRAPH 19

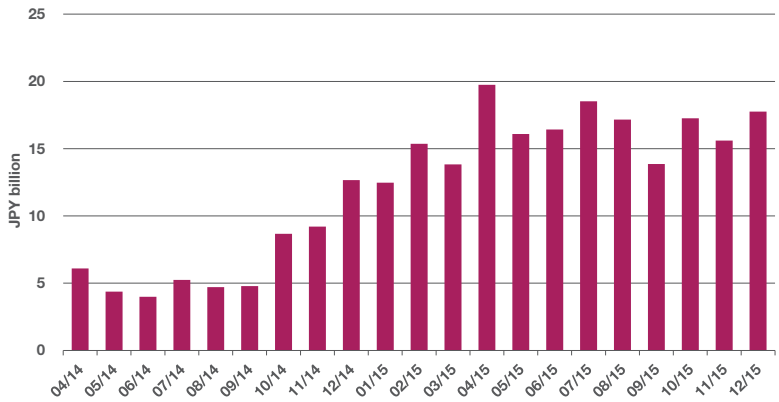
Average asking rents for major regional cities, 2010–1H/2015



Source: Japan Real Estate Institute

GRAPH 20

Duty free sales at department stores, Apr 2014 – Dec 2015



Source: Japan Department Stores Association

Retail

While the retail industry for domestic customers has remained stable, it has benefitted from an increasing number of overseas visitors in 2015. Though small in proportion, the impact of tourist purchasing power on retail sales cannot be overlooked, and is a trend that is expected to continue for the foreseeable future.

Although household spending suffered from the consumption tax rate hike in April 2014, it has shown some degree of improvement since the second quarter of 2015. For example, Japan's household confidence recorded gradual recovery through 2015.

The further expansion of inbound tourist consumption has been a driving force behind ongoing redevelopment projects in central Tokyo and retail assets in regional cities, attracting investment interest.

Summary of 2015

Supported by an increase in inbound tourist demand, retail rents in major commercial areas have remained high. For example, the average asking rent for Tokyo's major retail areas stood at JPY27,300 per tsubo per month for the first half of 2015, up by 7% from the same period the previous year. Asking rents for the first floor rose even more. Average asking rents for 1F for 1H/2015 were JPY47,300 per tsubo, up by 20% from a year earlier. Particularly significant was the growth in Ginza. In 1H/2014, Ginza's 1F asking rent was JPY48,700 per tsubo; in 2015, it increased by over 30% to JPY63,800 per tsubo.

Retail properties account for approximately 20% of total property transaction volumes in Japan. Both urban and regional properties have been actively traded and cap rates continued to compress.

Retail asking rents in some cities are gradually rising, whilst other cities, such as Fukuoka and Sapporo, have room to improve. For example, Shinsaibashi (in Osaka City) 1F asking rents between 2010 and 2012 stood at JPY21,100 per tsubo on average, increasing by over 11%

over the period from 1H/2013 – 1H/2015 to JPY19,600 per tsubo.

Throughout the year, the retail industry benefitted from an expansion in the number of overseas visitors as the Yen depreciated and visa criteria were gradually relaxed. This has led to significant growth in duty free sales at department stores, which marked 100% to 400% growth rates (on the year) on a monthly basis.

Total duty free sales at department stores in 2012 stood at JPY20 billion, increasing to JPY73 billion in 2014. Throughout 2015, total sales reached over JPY190 billion.

In particular, 2015 was a year of "baku-gai", or shopping sprees. It can be assumed that a large proportion of this contribution came from Chinese tourists, who on average spend JPY175,000 on shopping, about 35% of total expenditure whilst travelling in Japan. Chinese tourists typically stay in Japan for a week for leisure.

Prospects for 2016 and beyond
Beyond the power of overseas tourists, the recovery in domestic household sentiment is significant.

Anticipating the consumption tax rate hike from 5% to 8% in April 2014, household confidence worsened from mid-2013. However, with March/April 2014 as the bottom, sentiment improved gradually. In particular, households' willingness to buy durable goods recovered more than 10 percentage points (ppt) between March 2014 and December 2015.

Moreover, as mentioned in the Macro Economy section earlier, the average hourly wage of irregular workers, such as part-time workers, has been on the rise. The further increase in wage levels will help retail sales this year, and eventually retail rents.

Shopping sprees by inbound tourists
China's per capita GDP has been steadily expanding and the number of Chinese tourists to Japan has increased significantly since 2013. While the growth in Chinese tourists is expected to continue, the recent China market volatility and a potential further slowdown might result in more moderate growth. Any meaningful depreciation in the RMB may also have an impact on numbers.

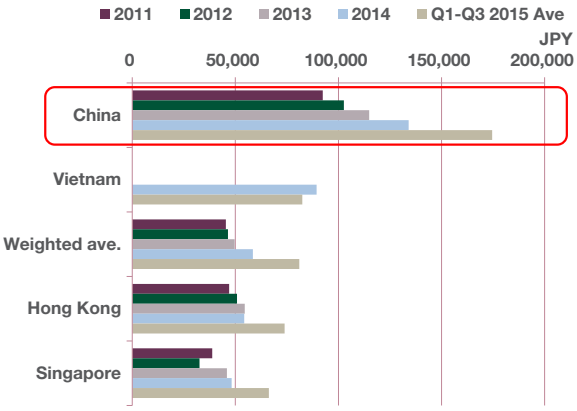
Redevelopment to absorb inbound tourism demands
The retail industry is adapting to new tourist demand. For example, department stores in Ginza now provide language services, foreigner-only shopping space, and concierge services. Not only department stores but also drug stores are very popular, especially when the product range of duty free goods was expanded to cosmetics and medicines in October 2014. This fuelled demand from Chinese tourists whose appetite for such products is significant.

In order to develop inbound tourist consumption, policy support is likely to continue. It can only be assumed that the number of tourists, not necessarily only from China, will increase as a result.

Partly with the purpose of accommodating a large number of overseas visitors, there are currently two large-scale redevelopment projects in Ginza, including a landmark project on the ex-Matsuzakaya site.

GRAPH 21

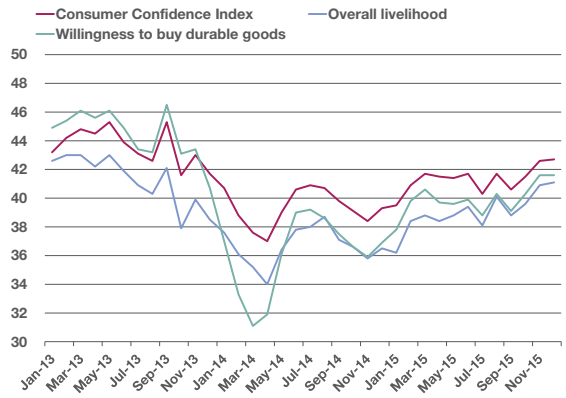
Expenditure on shopping by nationality, 2011–Q3/2015



Source: Japan National Tourism Organisation

GRAPH 22

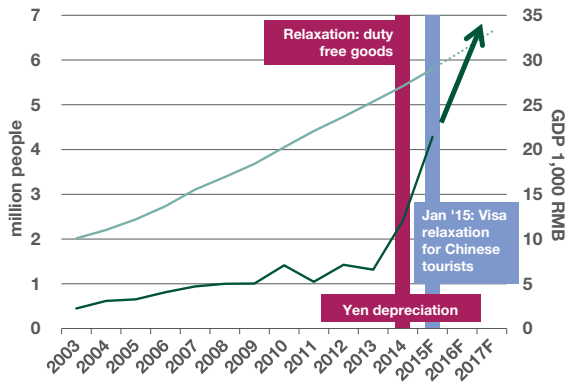
Consumer Confidence Survey, Jan 2013–Dec 2015



Source: Cabinet Office

GRAPH 23

China's per capita GDP and Chinese tourists to Japan, 2003 – 2017F



Source: World Bank, JINTO

Hospitality

The dramatic growth in inbound tourism has kept the hospitality sector buoyant and attracted investors' attention along with their capital.

Robust growth in inbound tourists

According to the Japan National Tourism Organization (JNTO), almost 20 million international tourists visited Japan in 2015, a record number. This is a 47% increase compared with last year. The Abe administration previously set a goal of 20 million by 2020 and this has almost been achieved. This December, the government raised the goal to 30 million by 2020. With an annual growth rate of 8.5%, Japan will have 30 million international arrivals in 2020. Considering the past three year growth rate, this should be attainable with additional effort such as more hotel supply.

Strong performance in the hospitality sector

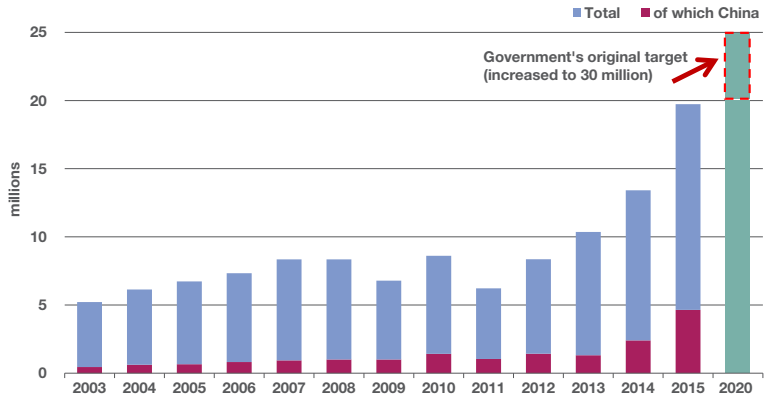
The tourist growth is significantly impacting the hospitality sector especially as the market is already very tight with a high occupancy rate. Average Daily Room Rates (ADRs) and occupancy rates continue to improve, especially in Osaka and Tokyo. It should be noted, however, that there is increasing supply towards 2020, when the Tokyo Olympics will be held – more than 1,300 rooms (seven hotels) are expected to be added in Ginza alone. This is more than a 40% increase compared with the current total number of rooms as of October 2015 (3,000 or 14 operating hotels). This new supply is expected to operate at a high occupancy, given the strong momentum in the sector.

New horizons for inbound tourists

A larger number of international tourists have begun to visit regional cities. During their first trip to Japan, tourists typically visit Tokyo and Osaka/Kyoto, the 'golden route'. As Japan welcomes more tourists as repeat travellers, many tourists start to travel off the beaten track. Occupancy rates in Tokyo and

GRAPH 24

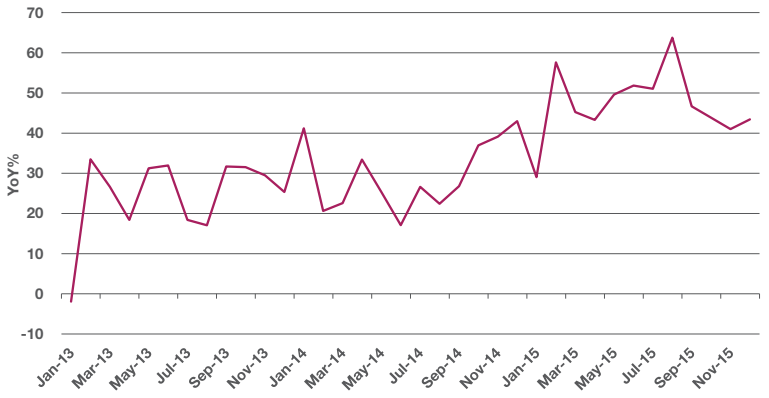
The number of inbound tourists to Japan, 2003–2020F



Source: JNTO, Savills Research and Consultancy

GRAPH 25

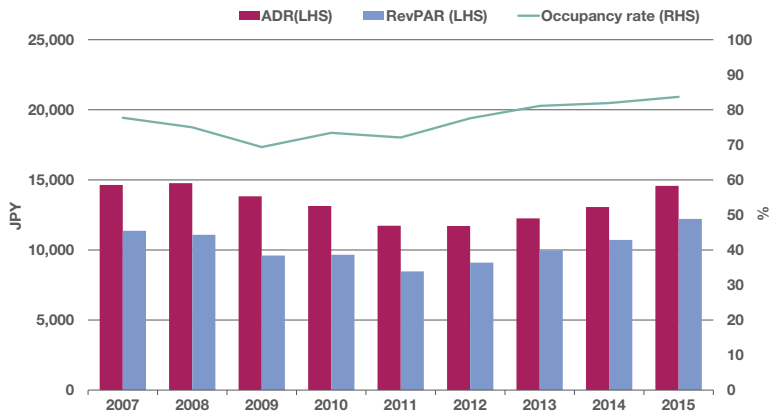
Annual growth rate of inbound tourists to Japan, Jan 2013–Dec 2015



Source: JNTO, Savills Research and Consultancy

GRAPH 26

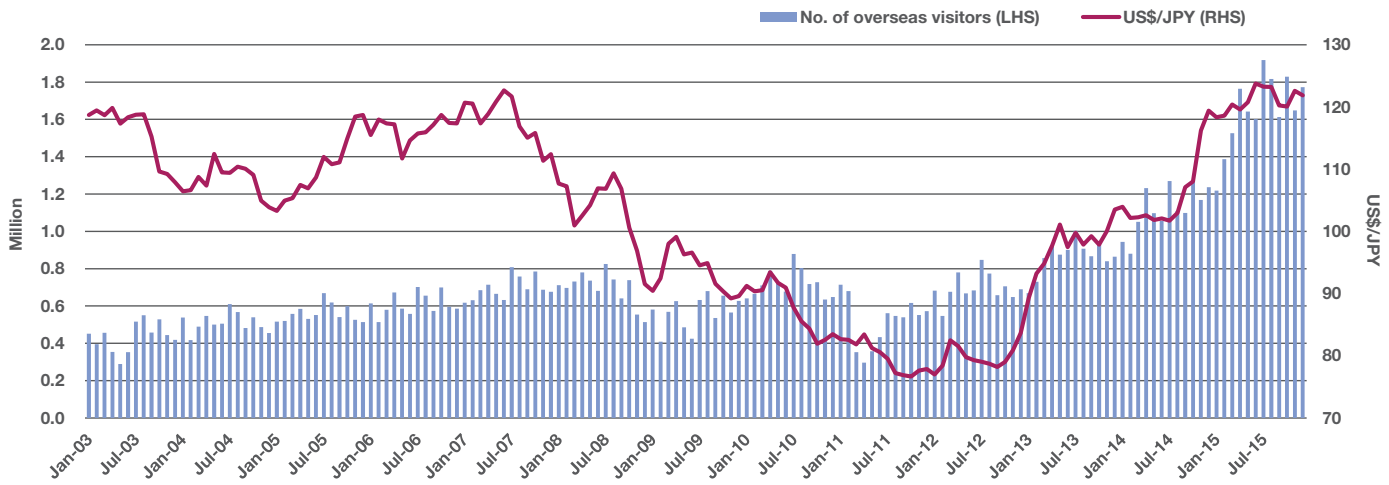
Key operating indicators in the hospitality sector throughout Japan, 2007–2015



Source: STR Global, Savills Research & Consultancy

GRAPH 27

Relation between the monthly number of inbound tourists and foreign exchange, Jan 2003–Dec 2015



Source: JNTO, Savills Research and Consultancy

Osaka are already at 90% or higher, and regional cities are likely to see more visitors in the coming years.

The number of Chinese tourists has not slowed down, even after the Chinese economy showed signs of a slowdown. In August 2015, the number of Chinese tourists reached almost 600,000, a third of the entire inbound number. In September and October, the number stayed at almost half a million, the largest nationality among visitors to Japan. Almost five million Chinese tourists visited Japan in 2015, a 107% growth against 2014.

Hotel J-REITs as active investors

To capture the dynamic growth of the hospitality sector, hotels were a popular asset class in 2015. Cap rates have compressed and for budget hotels in prime areas reached as low as 4%. J-REITs in particular have been active investors in the hospitality space. Many J-REITs have struggled to increase dividends through accretive property acquisition in the fierce acquisition market; therefore the increase in ADRs provides hotel REITs with a good opportunity to boost dividends.

On November 30 2015, Ichigo Hotel REIT Investment Corporation was listed on the Tokyo Stock Exchange (TSE). The opening price was JPY104,100, 1.79% below the initial public offering (IPO) price, but closed at JPY109,200 on the first day of trading. Its initial portfolio consisted of nine hotels worth a total of JPY20.4 billion on an acquisition price basis. This is the latest listed J-REIT and now the number of J-REITs has reached 52 with the total market capitalisation exceeding JPY10 trillion as of November 2015. Mori Trust also announced it is to set up a hotel J-REIT. It intends to list the J-REIT in autumn 2016. The details of the new REIT are currently under consideration. The target asset size has not yet been disclosed, but Mori Trust owns several reputable hotels including the Tokyo Marriott Hotel, Conrad Tokyo, and Laforet Hotels & Resorts. It is rumoured that the Mori Trust hotel J-REIT will start its operations with some of these hotels. Mori Trust itself will provide hotels as the developer to the J-REIT, and its subsidiary Mori Trust Hotels & Resorts will support the J-REIT as the hotel operator.

Industrial

The logistics markets in Tokyo and Osaka saw stable growth in 2015 and there are currently high levels of new supply forecast for the coming years. Strong demand in the sector should fully utilise these upcoming logistics facilities, although supply may outpace demand in the short-term.

Market overview

According to Ichigo Real Estate Service, the total rentable area of large-sized logistics facilities in Tokyo increased from 9.5 million to 10.8 million sq m for the 12 months ending October 2015 (a 14% increase). In the same period the vacancy rate decreased from 4.1% to 2.2%, while rents stayed flat, moving from JPY3,990 to JPY4,000 per tsubo. In Osaka, the total rentable area grew from 2.8 million to 3.1 million sq m, translating into a 12% increase. Vacancy rose from 0.9% to 2.3% alongside average rents that saw a slight increase from JPY3,390 to JPY3,500.

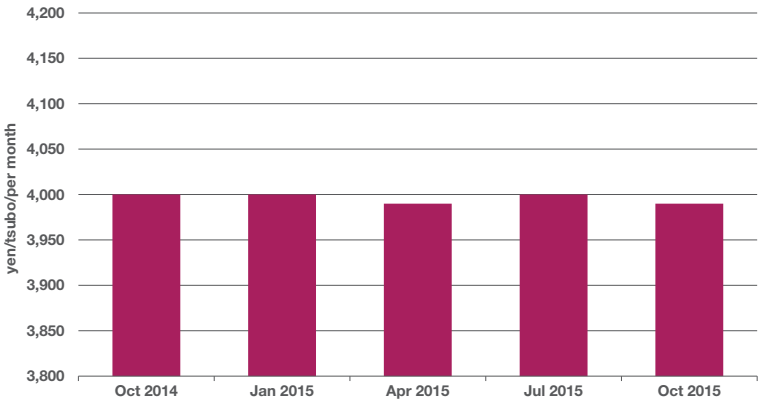
There have been several large transactions and developments in 2015. The cap rate for prime assets has continued to compress to a low 4%.

Expected supply

It is expected that 41.1 million sq m of rentable area will be added to the market in Tokyo and 22.7 million sq m (55% of Tokyo) in Osaka from November 2015 to December 2018.

GRAPH 28

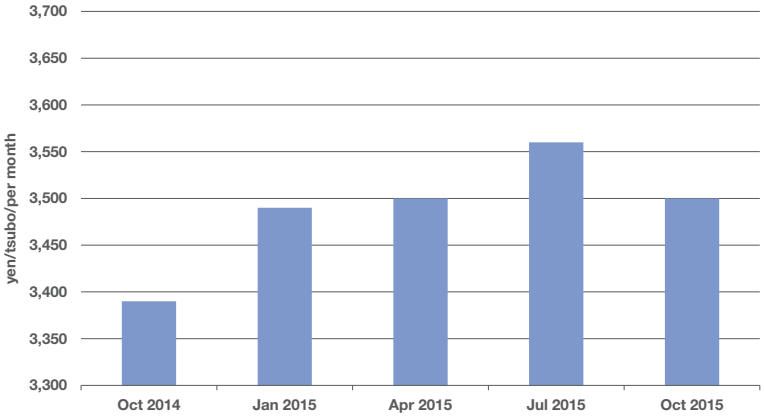
Rental movement in Greater Tokyo, Oct 2014–Oct 2015



Source: Ichigo Real Estate Service, Savills Research and Consultancy

GRAPH 29

Rental movement in Greater Osaka, Oct 2014–Oct 2015



Source: Ichigo Real Estate Service, Savills Research and Consultancy

TABLE 5

Logistics market comparison: Tokyo vs. Osaka

Development pipeline (million sq m)		Rentable area (million sq m)	Regional GDP (JPY trillion)	Population (million)
Greater Tokyo	4.1	10.8	173	39
Greater Osaka	2.3	3.1	65	17.1
Osaka/Tokyo	55%	29%	38%	44%

Source: Ichigo Real Estate Service, Savills Research and Consultancy

Considering the current market size (total rentable area, 29%), regional GDP (37%), and population (44%), supply in Osaka looks much larger and the balance between supply and demand in Osaka may therefore be thrown out of equilibrium compared with Tokyo. On a medium-term outlook, growing demand will likely take up any slack.

Positive environmental change
The improvement of road networks around large cities has continued. As an example, the ring road system in the Greater Tokyo area is being enhanced. This enhanced transport infrastructure will help the existing logistics network further evolve and new logistics markets emerge. A better transport network is also likely to alleviate labour shortages.

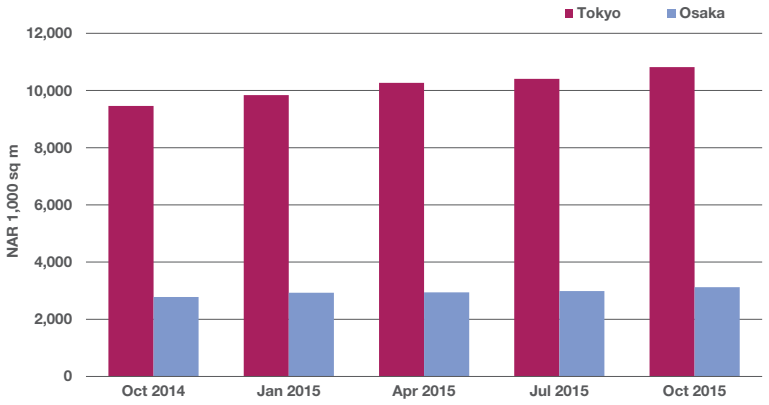
Possibility of rental growth
Both land acquisition and construction costs are on the rise, leading to expanding project costs; on the other hand ultra-low funding costs are likely to remain. Considering the tight budgets of new developments and the expected growth in logistics demand, rental growth should be anticipated, as it is likely to be more difficult for tenants looking for new prime facilities to resist a rent increase in the coming years.

Robust demand of door-to-door delivery service
The rapid growth for sales over the Internet has increased small-lot home delivery. The speed of home delivery through internet transactions has become more and more important, especially in large cities. It is now common to deliver the following day or even on the same day.

More channels to receive packages are also available. For example, Yamato has an alliance with FamilyMart and Sagawa with Lawson. Customers can pick up their packages at convenience stores or post offices, which significantly improves convenience. These collaborations will further contribute to expansion of home delivery and internet sales, leading to stronger demand for logistics space.

GRAPH 30

Rentable Area in Greater Tokyo and Osaka, Oct 2014–Oct 2015



Source: Ichigo Real Estate Service, Savills Research and Consultancy

This implies a greater need for logistics facilities in prime locations and with good access to major roads. Such competitive facilities are likely to enjoy rental premiums as demand increases.

New movement in the logistics space
In the midst of an increase in logistics expenses and stronger customer demand, optimisation for the logistics business has played an essential role in the retail sector. For example, Nitori, a furniture retailer, has started to provide its own logistics services to other companies, including competitors.

Other industrial assets – infrastructure
Infrastructure in Japan seems to be a great way to monetise public sector assets. Japan has lots of assets which are well managed and the government is heavily debt ridden. For the purposes of this report, infrastructure is broadly defined as concessions, large hard assets, and energy.

Concessions: Currently there are a few deals going on in the airport sector, which is a good start. It should come with other deals and the timing is good for the local government to dispose of concessions thanks to robust inbound demand.

Large hard assets: This is a promising space but is very complicated in terms of governance because each different minister covers a different aspect of the same asset. Ports are a notable example; however some companies are making efforts to pave the way.

Energy: This effectively means solar. The Tokyo Stock Exchange would like to list open infra funds and a few companies have announced their intentions to list. This could be an interesting start but there exists the same issue in governance, where sectionalism makes it difficult to coordinate ideas. Additionally a strong promoter in the TSE has recently left, however if these issues are overcome there may exist good opportunities for investment.

Healthcare (including elderly housing)

The healthcare industry will find emerging business opportunities in aging Japan. The number of elderly people has been increasing, and will increase considerably in the future. In particular, baby boomers[2] are now retiring.

Healthcare J-REITs as new asset class

Given an increasingly elderly population, the healthcare industry, and in particular senior housing, has attracted a lot of investment attention. 2015 saw three IPOs for REITs focusing on healthcare assets: Healthcare & Medical REIT on 19 March; Japan Senior Living REIT on 29 July; and Japan Healthcare REIT on 5 November.

Future demand, both mid and long term, for senior housing can only increase. The issue, however, is a lack of bankable assets. For instance, the typical asset size is in the range of JPY1 to 2 billion. As investment attention is directed towards such an asset class, there is potential for this industry to grow in both quantitative and qualitative terms. However, because of a shortage of assets, cap rates are likely to further compress for the time being, which are currently on average about 5-6%.

Growing elderly population

The elderly population has been increasing, and is expected to expand in both absolute and relative terms. As of 1 January 2015, the number and share of the elderly population over the age of 65 stood at just under 34 million people, 15.2%. The National Institute of Population and Social Security Research forecasts that the number of elderly people will increase by over 3 million to 37 million by 2030, and will further increase to 39 million by 2040, or over 35% of the total population.

Particularly noticeable is the rise in the share of the population over the age of 75 from 2025, when the so-called baby boomers fall into this category. For example, between 2015 and 2025, the number of people aged between 65 and 74 is expected to decline by 1.5% to 12.1% of the population (15.5 million people), before it increases to 16.5 million (15.3% of population) in 2040. In contrast, the number of people over the age of 75 is expected to keep increasing, by 5.1% to 21.7 million between 2015 and 2025, then to over 22 million by 2040.

Henceforth, the share and absolute number of the elderly population (over 65 years old) will continue to rise to 35.6 million (30% of total population) in 2025, and 38.7 million (36%) in 2040.

Demand for senior housing

Demand for senior housing in Japan is expected based on the elderly's housing preferences.

Whilst nearly 80% of the elderly population (over 60 years old) in the US and Germany prefer to live in their own accommodation, in Japan it is over 10% lower. On the other hand, the share of the elderly wishing to move into senior housing, nursing homes or hospitals in Japan is roughly 30%, whereas in the US and Germany it is below 15%.

Privately owned and run facilities for the elderly

In October 2011, the Revised Act on Securement of Stable Supply of Elderly Persons' Housing was enacted to resolve a shortage of housing facilities for the elderly population. Currently, privately owned and run facilities for the elderly are fee-based homes or rental housing[3].

The fundamental difference between fee-based homes and rental housing is the type of contract. At the fee-based homes, the elderly contract a right to stay, whereas for the latter, the elderly person rents rooms with additional services (e.g. meals).

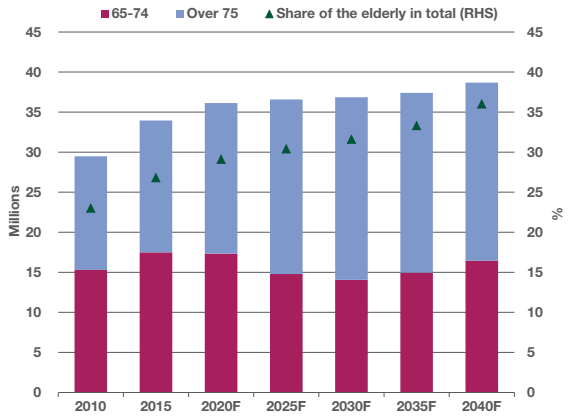
Furthermore, policy support has been provided to expand the healthcare industry. For example, Basic Policies for Economic and

2 Population born between 1947 and 1949.

3 Excluding group homes for older adults with dementia.

GRAPH 31

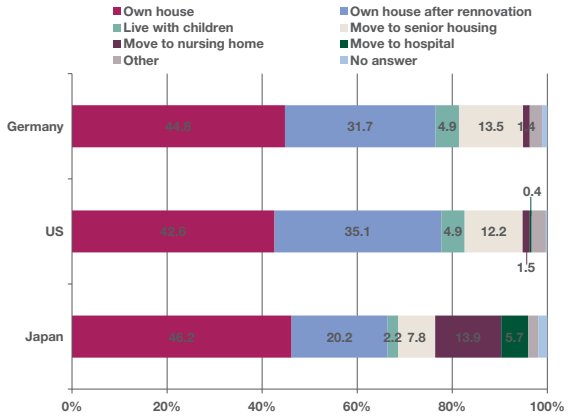
Elderly population, 2010 - 2040F



Source: National Institute of Population and Social Security Research

GRAPH 32

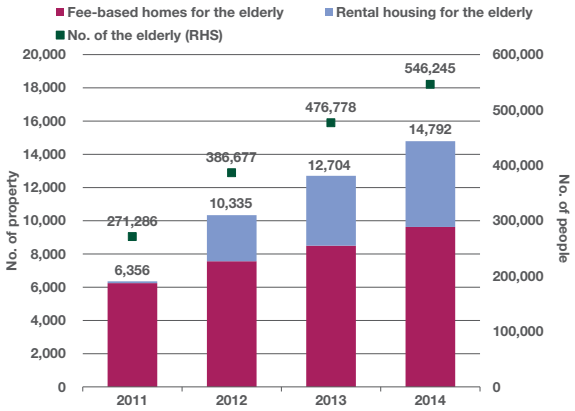
Housing preference of the elderly - Japan, US, Germany, 2010



Source: Cabinet Office

GRAPH 33

Privately owned facilities for the elderly population, 2011 - 2014



Source: Japanese Association of Retirement Housing, Ministry of Health, labour and Welfare

Fiscal Management and Reform, revised in June 2015, plans to expand and improve the quality of the healthcare industry for the elderly population.

Rental housing for the elderly comes with tax breaks – a reduction in income and corporate taxes until the end of March 2016, and in fixed asset and property purchase taxes until the end of March 2017.

Although the amount of housing for the elderly has increased significantly during the past few years, it does not seem to be enough to accommodate the forthcoming explosion of the elderly population.

Hypothetically, if 30% of the elderly population wishes to live in senior housing, there would be demand for roughly 11 million people from 2020 onwards. However, even including publicly run senior housing, capacity in 2014 was only 1.7 million. Hence, given the expected increase in the number of elderly, demand for housing should increase considerably going forward.

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