Japan - February 2022

SPOTLIGHT
Savills Research

Japan Logistics - Evidence of caution

Potential weaknesses may slow growth

Summary

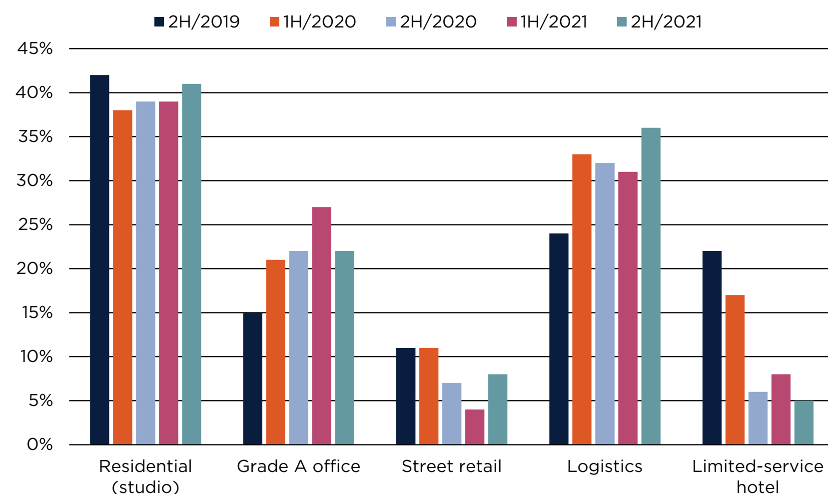
- Although the logistics sector's fundamentals remain sound, there are some signs of overheating.
- The cap rates for logistics facilities can now be lower than those of more established sectors with longer track records such as office and residential properties.
- Unique characteristics of the logistics sector, such as the low land value, the difficulty of tenant diversification, and chronic labour shortage may exacerbate market conditions when the market becomes strained.
- Potential increments in logistics-related costs may incentivise tenants of logistics facilities to negotiate with owners for lower rents.
- If the wave of supply in the coming years loosens the currently tight market conditions, tenants may gain more negotiation power.
- Investors should get ready to manage risks by diversifying their portfolios, making facility improvements, and strengthening relationships with tenants.

INTRODUCTION

The Japanese logistics sector has been booming over the past few years, with steadily growing demand pushing rental levels higher, and also absorbing the large supply coming to the market. Even the prolonged pandemic has served as a tailwind for the sector as the rise in online shopping has increased the amount of logistics space needed. Even though some demand might shift back from online to physical shops once the pandemic calms down, a gradual but steady transition toward e-commerce is likely to continue in the long-term, especially when considering that this trend preceded the pandemic and that Japan is behind other developed countries in terms of e-commerce penetration.

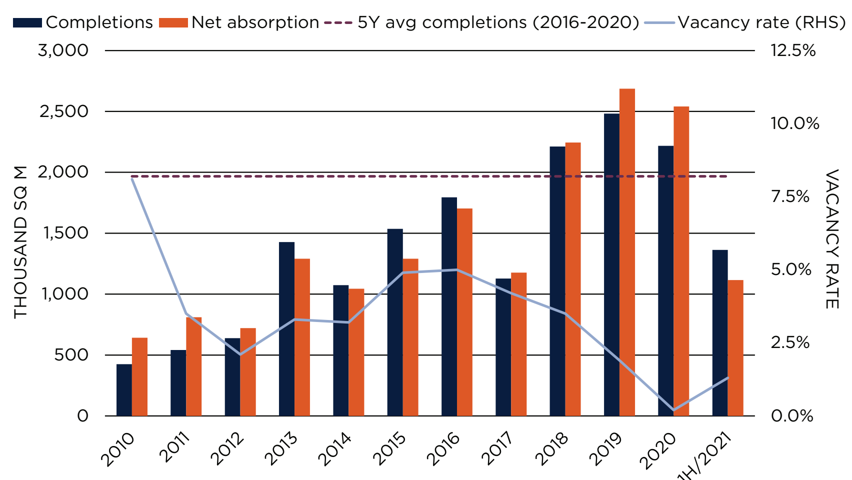
Nonetheless, while the fundamentals of the logistics sector are sound, there are looming risks that could disrupt the market. Cap rates in the sector have compressed significantly as a result of increased competition for assets, and the cushion to absorb a potential shock has therefore become thinner. Indeed, cap rates in the logistics sector have become even lower than more established sectors such as Grade B offices and residential. Furthermore, the unique characteristics of the logistics sector,

Graph 1: Type of Property Acquired Over the Past 6 Months, 2H/2019 to 2H/2021



Source Japan Real Estate Institute, Savills Research & Consultancy

Graph 2: Supply, Net Absorption and Vacancy in Greater Tokyo, 2010 to 1H/2021



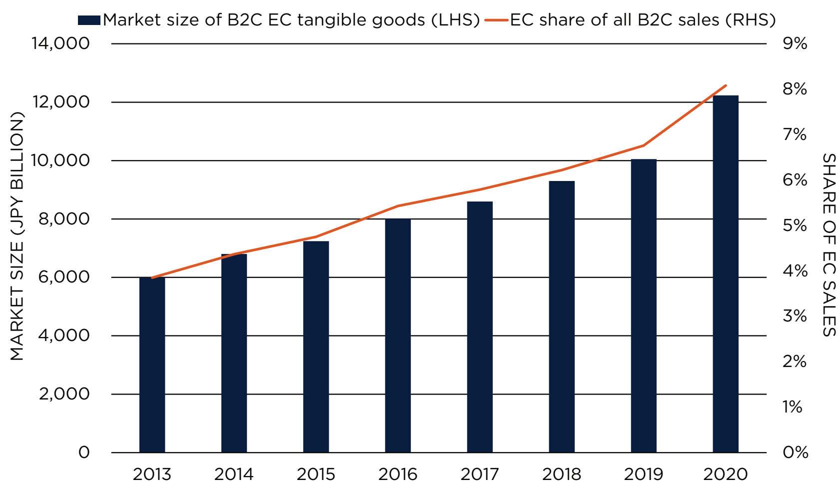
Source Ichigo Real Estate Service, Savills Research & Consultancy
Note: Annual periods from February to January. Vacancy rates are as of the year end for each annual period.

such as the low land value, the difficulty of tenant diversification, and chronic labour shortage could exacerbate the situation when market conditions become strained.

To be sure, experienced players with proven track records in this sector appear disciplined and better equipped for potential market corrections. Many of their transactions occur between related parties and at reasonable pricings. On the other hand, some new entrants, especially those under pressure to deploy capital, have been more aggressive, especially in fiercely competitive deals for properties, consequentially driving up prices. Some of them have even resorted to buying older or less strategically located properties at elevated prices. Although the market is still booming at present, these aggressive investors will be more vulnerable when the market sours.

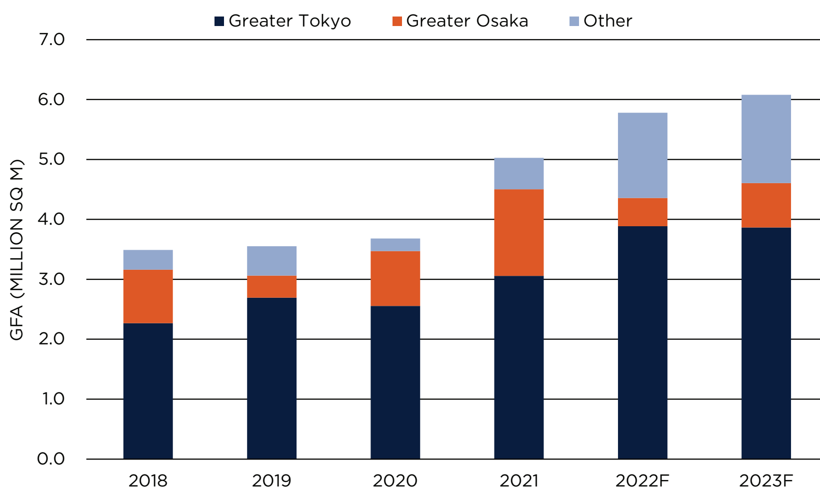
While the logistics market continues to demonstrate its strengths, risks are also looming larger. If these risks start to manifest, some cautious investors who were originally attracted to its stable prospects may look to exit the market.

Graph 3: Business-to-Consumer (B2C) E-commerce (EC) Market Size for Tangible Goods, 2013 to 2020



Source METI, Savills Research & Consultancy

Graph 4: Annual New Supply* in Japan by Region, 2018 to 2023F



Source Ichigo Real Estate Service, Savills Research & Consultancy
* Projects in 2022 and beyond tend to be added later once details are ready to be announced. The data only considers facilities with GFAs > 10,000 sq m and is as of February 2022.

BOOMING MARKET

Not long ago, the logistics market used to be a niche one. However, the growing supply of modern, high-quality logistics facilities, as well as its more diverse developer and investor base have made it into a mature market whose popularity has rapidly increased based on the sector's promising demand prospects.

Looking back at market trends over the past decade, annual volumes of new supply have been increasing yearly in Greater Tokyo. Although vacancy loosened between 2013 and 2016, it has tightened since then, even amidst the increasing supply added to the market in recent years. Rents have also grown by 14.5% since 2010, providing investors a boost of confidence.

The drivers of demand are mainly the 3PL and e-commerce industries. 3PL companies in particular comprise a large portion of the tenant pool (for instance, 70% of GLP J-REIT and 40% of Nippon Prologis REIT's portfolios), and major players such as Hitachi Transport System, Senko Group, and Nippon Express have expanded their logistics space over the past four years, consequently driving up demand. A closer look reveals that Senko Group increased its domestic logistics space by 22% from 3.2 million sq m in FY2016 to 3.9 million sq m in FY2020, and Nippon Express by 17% from 2.9 million sq m to 3.4 million sq m during the same period.

Elsewhere, while e-commerce players still make up a smaller portion of the tenant pool, they have been a significant beneficiary of increased online shopping amidst the pandemic and continue to contribute to the market growth. For instance, in 2021, Amazon has added two more fulfilment centres, Amazon Nagareyama Fulfilment Center and Amazon Ome Fulfilment Center, following the openings of four new fulfilment centres in 2020. Rakuten also added RFC

Ichikawa IV and RFC Narashino in 2020, and RFC Chuo Rinkan in 2021.

Going forward, however, about 4 million sq m of new space is expected to be built in Greater Tokyo in 2022, continuing the large influx of supply. Currently, the market has maintained tight conditions, and has exhibited few signs of softening. However, comparing the overall warehouse stock in Tokyo between 2008 and 2018, it appears that although the demand for larger facilities has increased notably, the increment in overall intrinsic demand was less significant (Graph 5). As such, newer and larger facilities have been filled up by some movements from smaller facilities. With the large number of modern, large-scale facilities already introduced to the market recently (Graph 6), the competition for tenants will likely become fiercer as more supply is added. When that happens, the logistics market may see a large correction.

RISKY ENVIRONMENT

Although the fundamentals of the logistics market appear sound, the rapidly compressed cap rates may reflect overly optimistic investor attitudes and leave limited room for correction. Based on Savills in-house surveys, logistics market cap rates in Tokyo have compressed from 3.9% in 2018 to 3.3% in 2021, mainly due to the large volumes of capital flowing into the sector.

On one hand, the tight cap rates can be justified by the long-term and stable leases that come with logistics facilities, as well as their positive prospects for demand. Additionally, the logistics cap rates in Japan have not yet reached the levels seen in countries in the west like Germany and the United Kingdom, which supports the view that rates can be compressed further. The robust levels of capital flowing into the Japan market may also allow cap rates to go even lower in the near future. Nevertheless, the logistics sector appears more overheated than other sectors.

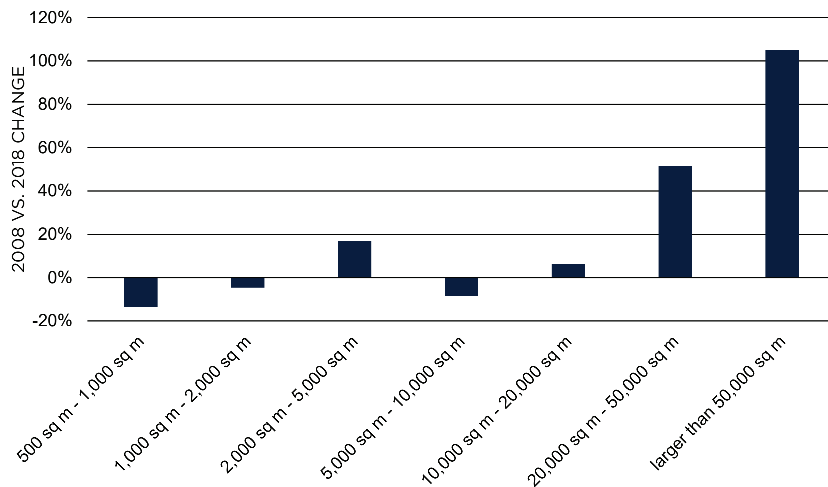
Indeed, the 3.3% cap rate of logistics properties is now below the 3.4% rate of Grade B offices and mid-market residential properties, whose sectors are considered more mature and have longer track records. Although our base-case scenario remains positive for the logistics sector, it is important to highlight the latent risks in this sector, especially when it appears clouded with optimism.

First, in comparison with urban properties like offices, logistics properties have significantly less land value because they are situated in areas that are unsuitable for many other uses. This means that value-add initiatives are limited, and logistics properties could quickly lose their value if the buildings suffer from functional or economic obsolescence. For instance, there has been greater demand recently for modern logistics facilities that are larger and more accessible to residential areas. Hence, older properties that do not meet these requirements may rapidly lose traction. The higher proportion of value attributed to the buildings also makes logistics properties more vulnerable to unforeseen damage from natural disasters or accidents like fires. To make matters worse, any devaluations of these properties may trigger loan covenants, worsening the situation and potentially causing a chain reaction which might affect other facilities.

Secondly, the difficulty of tenant diversification is another risk especially apparent in the logistics sector. The 3PL and e-commerce companies that have been driving demand are dominated by a few major players that are the primary tenants of many large-scale logistics centres. For instance, the top three 3PL companies[1] occupy close to a quarter of leased areas in the properties owned by GLP J-REIT. Furthermore, Nippon Prologis REIT leases about 15% of its properties to three e-commerce companies - ZOZO, Amazon, and Rakuten. This is the case for J-REITs with about 100 properties under their portfolios, and the situation could be even more acute for many other investors.

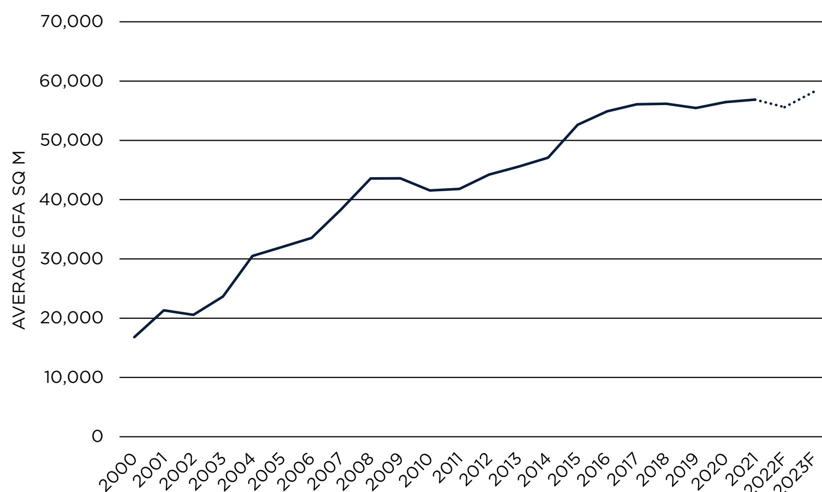
Indeed, both the 3PL and e-commerce industries effectively resemble oligopolies because operational scale provides a strong competitive advantage in both business models, hence prompting large players to become even larger. Specifically, 3PL

Graph 5: Tokyo's Warehouse Stock Change between 2008 and 2018



Source MLIT, Savills Research & Consultancy

Graph 6: Average GFA of Newly Built Logistics Facilities, 2000 to 2023F



Source Ichigo Real Estate, Savills Research & Consultancy
* The average GFA is calculated as a five-year moving average of logistics facilities.

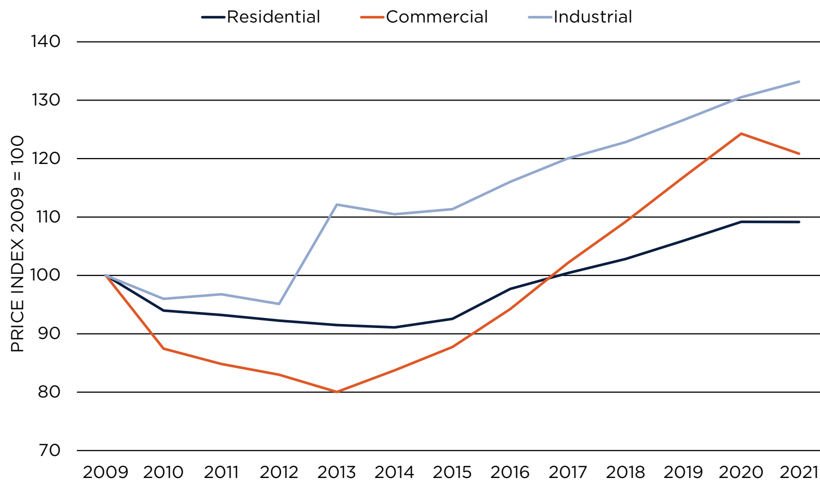
1 Hitachi Transport System, Nippon Express and Senko Group

companies with larger networks can win over a larger market share because they can provide integrated services in wider regions at a lower cost. For e-commerce, scale is also the primary differentiator as customers are generally drawn to platforms with a greater range of offerings. This can be overall problematic for logistics facility owners because these large tenants consequentially have strong negotiation power to lower rents when the market softens.

Additionally, heightened development costs, especially industrial land prices, have made the logistics market vulnerable to a potential shock. According to Koji Chika, an annual land price survey, since 2009, industrial land prices have grown over 30% on average - meaning that some sites have seen even greater appreciation. Indeed, some rumoured transactions indicate significant price premiums paid for logistics facility development sites. For instance, Tokyo Keizai reported that Mitsubishi Estate was rumoured to have paid about JPY1.7 million per tsubo for the development site of its planned Logicross project in Sagamihara, Kanagawa. Given that Koji Chika indicated about JPY300,000 per tsubo for industrial land in the area, the rumoured transaction was almost six times greater than the market average, putting it on level with residential land prices.

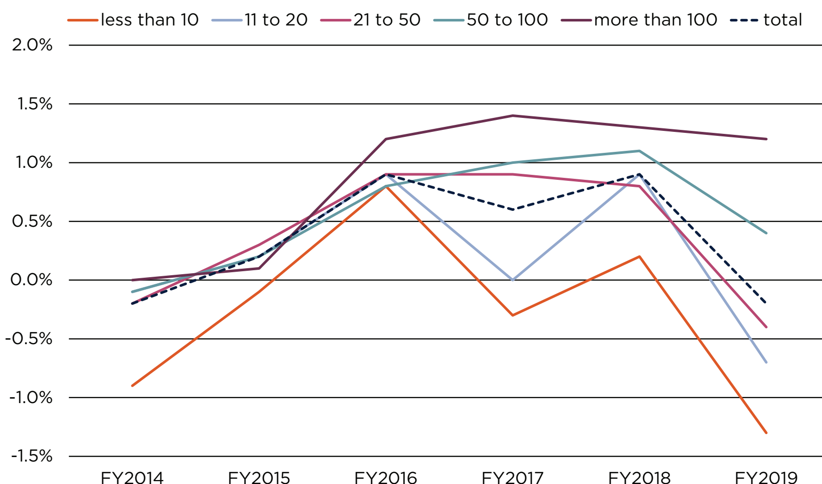
Heightened land prices are worrisome because they tend to lead to aggressive underwritings, and are likely accompanied with overly optimistic growth projections to support these projects. Although experienced developers are less likely to make such decisions, inexperienced players who have newly entered the market may be more susceptible to making unrealistic forecasts. It also seems that many investors, especially late entrants, are under pressure to spend large amounts of capital and have incentives to do so even if it results in aggressive underwriting. Additionally, due to high land prices, some may have compromised and developed facilities in unideal areas where accessibility is poor and attracting workers will be a challenge. When the market turns, these newer players could become a tinderbox, possibly destabilising the entire market.

Graph 7: Land Price Trends by Use in Greater Tokyo, 2009 to 2021



Source MLIT, Savills Research & Consultancy

Graph 8: Trucking Company Ordinary Profit Margin by Number of Trucks, FY2014 to FY2019



Source Japan Trucking Association, Savills Research & Consultancy

POTENTIAL TRIGGERS

Given the above, the logistics market is considered to embed some fragility despite its strong performance thus far. As such, if something goes awry, the robust trends seen thus far could reverse and dim future prospects.

One imminent issue that could disrupt the status quo would be a shortage of labour – especially truck drivers. This is a chronic ailment of the industry, and the government has been trying to address the issue but without meaningful success. The 2017 delivery crisis where Yamato increased delivery fees as a result of mounting stress caused by exploding delivery volumes truly highlighted this systematic problem. Although the issue appears to have subsided for a while, it has resurfaced again due to rapid increases in delivery demand during the pandemic.

According to the Ministry of Land, Infrastructure, Transport and Tourism, in FY2020, the number of home deliveries recorded their highest annual increase in 20 years at 12%, reaching 4.8 billion. However, even this eyebrow-raising figure underestimates the size of the problem because these statistics only reflect the deliveries conducted by the companies that were selected at the inception of this survey in 1985. For instance, the packages delivered through Amazon's own delivery network, which were reportedly about 350 million in 2021, are not included in this figure. Another hundred million packages delivered by other companies also appear to be excluded.

To make matters worse, e-commerce operators appear to be on a perpetual mission to make deliveries faster and cheaper. Surprisingly, Yamato has decided to partner with Amazon once again even after their fallout in 2017. With the competition for market share increasing (Rakuten is

partnering with Japan Post and Sagawa), they appear to have decided to put the past behind and work together. Many in the industry are worried that this could lead to another crisis.

On the surface, Yamato did well in FY2021, registering a record profit despite having reduced its average package delivery fees. However, a closer look at its financials reveals that Yamato seems to be managing the significantly increased delivery volumes by delegating tasks to external drivers. In FY2021, the company's outsourcing expenses increased by 15% YoY. Moreover, although the company initially expected a minor increase of 2.3% in its outsourcing expenses for FY2022, it significantly revised that forecast to a 35% increment in Q3 of FY2022.

The sustainability of this practice is questionable. First of all, small and middle-sized trucking companies operate in the red on average (Graph 8), and do not have capacity to take on work with low fees. In fact, some independent drivers have chosen to do food deliveries instead as they become more lucrative. Early signs of the predicament appear to have manifested in Yamato's financials in Q3 of FY 2022. The company revised down its overall operating profits forecast and now expects it to be 24% lower than the previous fiscal year largely due to the combination of the increasing outsourcing costs and lower average delivery fees.

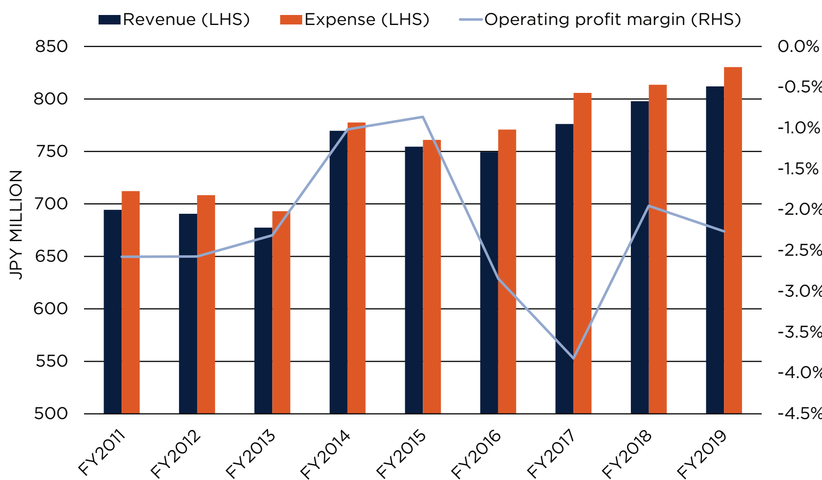
Despite recent increases in gasoline prices and labour costs, trucking companies have not increased fares since 2019. Due to the uncertainty from the pandemic, as well as increased shipping container fares, their clients are not willing to accept higher fees. Trucking companies have been tolerant so far, but their patience is likely to wear thin. Additionally, the government will impose a limit on overtime hours for truck drivers in FY2024, which could exacerbate the labour shortage and increase pressure to raise wages to attract more workers. Although some might argue that this change would actually increase the demand for more logistics space, the operation efficiency and already thin profit margins might decrease if operations become decentralised.

Given the above, delivery cost increments appear inevitable in the near future. Theoretically, if the increased cost is transferred to end-users or online retailers, logistics facility tenants may be insulated from the impact. However, in reality, transferring the cost to general consumers is very difficult, and online retailers are not willing to bear the costs either[2].

Indeed, tenants themselves also do not appear to have much capacity to take on additional costs. According to a government survey, general warehouse operators generally face negative operating profits for warehouse operations like loading, picking, and packaging (Graph 8). This may become even worse since the wages of warehouse workers had been rising due to openings of new logistics facilities. Although a temporary slack in the labour market from the pandemic has eased pressure, hourly wages for warehouse workers could become close to JPY2,000 in areas with high demand. Considering this, logistics facility tenants negotiating lower rents in the future appears to be a plausible scenario.

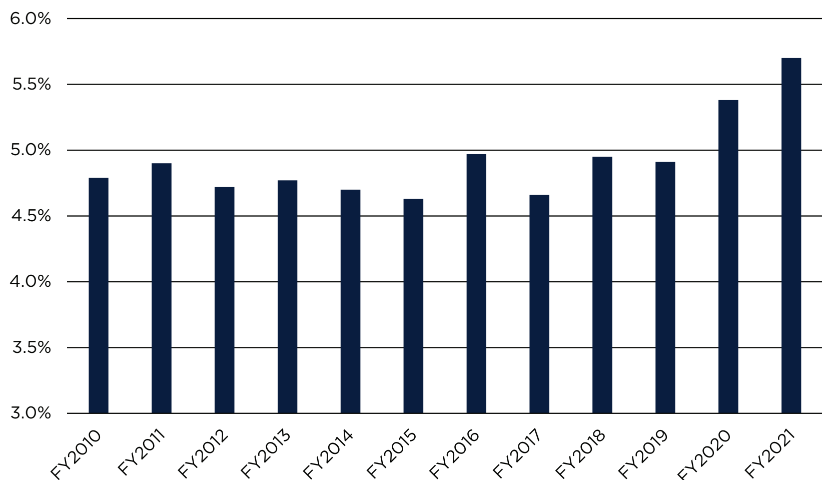
On top of this, the glut of supply in the coming years is another concern. To be sure, the market does not show many signs of softening as of now, and advantageously located, quality facilities should continue to see sound demand. However, older facilities that have not kept up with the evolving needs of tenants may face a hard time ahead with the number of new facilities increasing. Even amongst new facilities, some that have been built in less strategic locations due to the difficulty of procuring development sites and increasing land prices may struggle to secure tenants. This is especially so if target rents were too high due to aggressive underwriting. If these less competitive facilities start suffering, the overall market may also start weakening. Furthermore, due to the inherent risks discussed in the previous section, even a relatively small correction could lead to a significant consequence.

GRAPH 9: General Warehousing Company Profitability for Handling Stored Items, FY2011 to FY2019



Source MLIT, Savills Research & Consultancy

GRAPH 10: Logistics Cost Percentage of Corporate Revenue, FY2010 to FY2021



Source Japan Institute of Logistics Systems, Savills Research & Consultancy

2 Rakuten's initiative to guarantee free shipping for orders over JPY3,980 faced a strong backlash from shop operators on its platform and the government.

OUTLOOK

Although the logistics sector is booming and has a positive base-case scenario, risks are also looming over the sector. The pandemic has increased the uncertainty in other sectors including hotel, retail, and office, and investors are flocking to the logistics sector as a result. The rapidly compressed cap rates, which are currently lower than Grade B office and residential properties, reflect mounting interest and fierce competition for logistics facilities. While the growing demand from 3PL and e-commerce presents opportunities in itself, a thorough understanding of potential risks is necessary to facilitate prudent decision making, especially in a market overflowing with optimism.

The risks that are particularly relevant to logistics properties are their relatively low land value, the difficulty of tenant diversification, and increasing development costs. Although these risks by themselves will not likely be a cause of a downturn, they could amplify the consequences of a downturn when the market experiences corrections.

Possible triggers that could lead to a downturn could be categorised into demand-side and the supply-side triggers. On the demand side, potential cost increases for tenants could incentivise them to negotiate harder with owners. Given the tight labour supply, further increases in delivery demand, and the new regulation on overtime, logistics costs could rise in the near future. If this happens, large tenants may exercise their bargaining power and lower rents. Moreover, some tenants, like Nitori, may even develop their own facilities instead of continuing to lease. On the supply side, the glut of supply entering the market in the coming years is a concern. In particular, older properties, as well as the ones that have been built on inferior locations may suffer. Due to increasing land prices, there have been an increasing number of cases where developers use undesirable sites to develop new facilities.

Overall, although we believe that the logistics market remains sound and that experienced investors can still capitalise on the growing demand while managing risks, the market also appears to have some blind spots. When the market is strong, these weaknesses may seem irrelevant. However, in the current environment where cap rates are substantially compressed and development costs are significantly heightened, even a moderate correction could lead to significant consequences. Investors should be cautious and should not be too aggressive for underwriting new assets. Also, they should mitigate risks by diversifying their portfolios, making facility improvements, and managing relationships with tenants. More diligent investors should become better off when the market faces harder times.

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