Japan - March 2024

SPOTLIGHT
Savills Research

Japan Logistics

Sound fundamentals but with challenges ahead

Summary

- In Greater Tokyo, the market has continued to loosen slightly in the face of new supply, increasing by 2.7 percentage points (ppts) year-on-year (YoY) to 7.1%.
- In Greater Osaka, vacancy has moved in a similar direction, increasing by 0.6ppts YoY to 3.0%.
- Rents in Greater Tokyo have recovered to JPY4,620 per tsubo, increasing by 2.2% half-year-on-half-year (HoH) and 2.4% YoY.
- Rents in Greater Osaka rose in tandem by 1.4% HoH to JPY4,240 per tsubo, translating to an annual increase of 0.5%.
- Investment levels in 2023 have surpassed those of 2022 for the logistics sector due to the large number of big-ticket transactions over the year.
- Supply levels are expected to remain high in 2024 and 2025, which is likely to loosen the market further.
- Increased construction costs should also limit upcoming supply, which should further contribute to achieving a supply and demand equilibrium in the mid-term.
- Data centres have been extremely popular amongst investors due to the growth of digital infrastructure in Japan. However, sharpened pricing may cause embedded risks to emerge.

INTRODUCTION

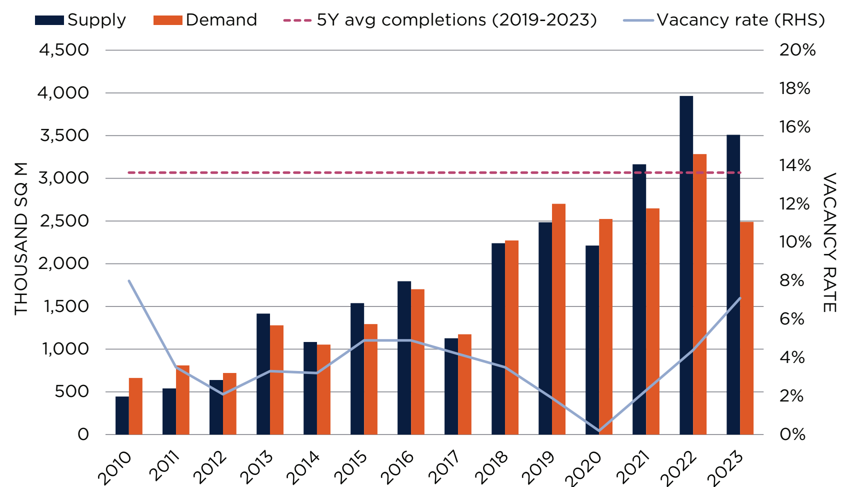
The logistics sector in Greater Tokyo[1] and Greater Osaka[2] has continued to receive heightened interest from investors over the past half-year, with 2023 seeing exceptionally large transaction volumes, especially from overseas investors. However, the market is not as tight on the ground as it was during the pandemic. Indeed, demand does not appear to have caught up with the large amount of supply that entered the market over the past year, leading to loosening vacancy rates which could potentially climb higher as more facilities are completed.

1 Greater Tokyo is defined as the region which consists of Tokyo, Kanagawa, Chiba, and Saitama
2 Greater Osaka is defined as the region which consists of Osaka, Kyoto, Hyogo, and Nara

The data centre sector is an area that has garnered a larger amount of attention due to the overall paradigm shift in the country toward digitalisation and cloud-based services. However, investors also should understand the risks surrounding the sector, especially considering sharpened pricing due to the robust popularity and limited stocks of the asset class.

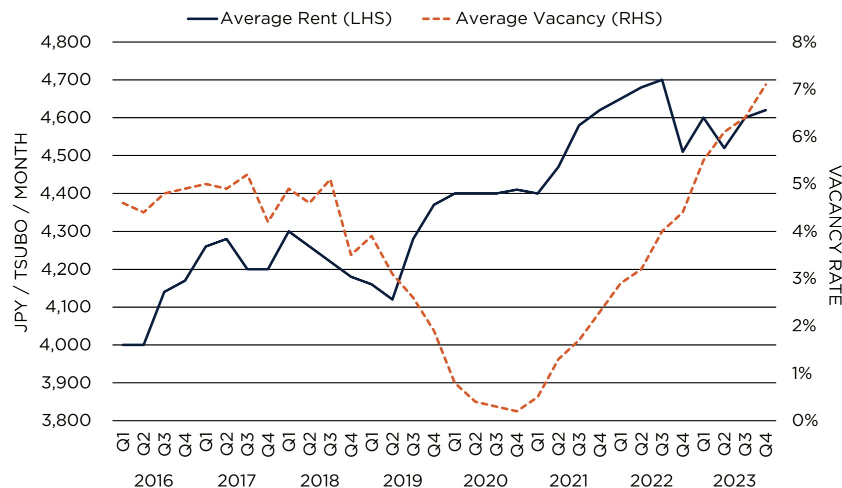
Going forward, greater bifurcation between prime and subprime logistics facilities is expected, given the large amount of upcoming supply, which will likely introduce greater competition to the market. As such, facility-specific features and location will play a growing role in determining a development's success.

Graph 1: Supply, Demand, and Vacancy in Greater Tokyo, 2010 to 2023



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, while the rate presented for 2023 is as of January 2024.

Graph 2: Greater Tokyo Rent vs Vacancy, Q1/2016 to Q4/2023



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

MARKET TRENDS

The Greater Tokyo market continues to face challenges rooted in the large amount of new supply added to the market, with 2023 having seen exceptionally high levels. As a result, vacancy has continued to loosen to 7.1% in Q4/2023, having increased by 1.0 percentage point (ppt) over the past half-year and 2.7ppts YoY. Indeed, vacancy levels in Greater Tokyo have risen significantly over the past few years from the extremely tight rate of 0.2% in Q4/2020, with the large amount of supply that arrived to the market in that timeframe being a major catalyst. Against this backdrop, pre-leasing for new supply entering the market is reportedly taking more time than it did previously, especially in the case of facilities that are located in less desirable locations.

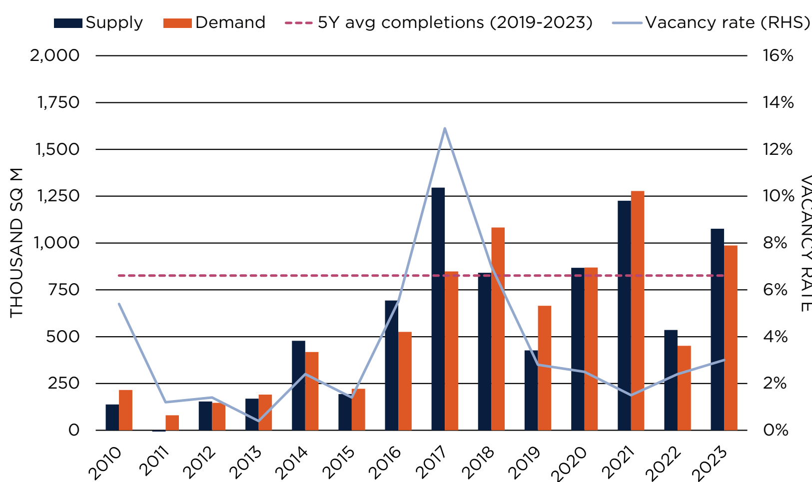
Meanwhile, rents in the Greater Tokyo market have recovered slightly to JPY4,620 per tsubo per month, having increased slightly by 2.2% HoH and 2.4% YoY. The large amount of supply introduced into the market has increased the competition among new market entrants, much of which is comprised of general multi-tenant facilities. Hence, with the exception of facilities that have advantages such as excellent location or unique features, it has become more difficult to increase rents due to the fear of losing competitiveness. As such, rental growth should remain bifurcated, with prime or unique facilities likely possessing a greater ability to command premium rents, while less popular facilities may have to resort to rental corrections or deals to attract tenants.

In Greater Osaka, the market has loosely mimicked the performance of Greater Tokyo. Vacancy has been on a general upward trend, having increased 0.4ppts HoH and 0.6ppts YoY to 3.0%, the highest levels observed since 2019. New supply in 2023 has risen from 2022 and is likely to increase even more over the next two years, which is likely to loosen the market even further. Meanwhile, asking rents in Greater Osaka increased by 1.4% HoH to JPY4,240 per tsubo, translating to an annual increment of 0.5%. While the current rental levels are considerably higher than pre-pandemic levels, they are also lower than levels observed a year ago, suggesting that further rental growth will likely be gradual for the market as a whole.

Going forward, the market looks to remain bifurcated, especially with the large upcoming supply. Strategically located facilities that are able to accommodate the

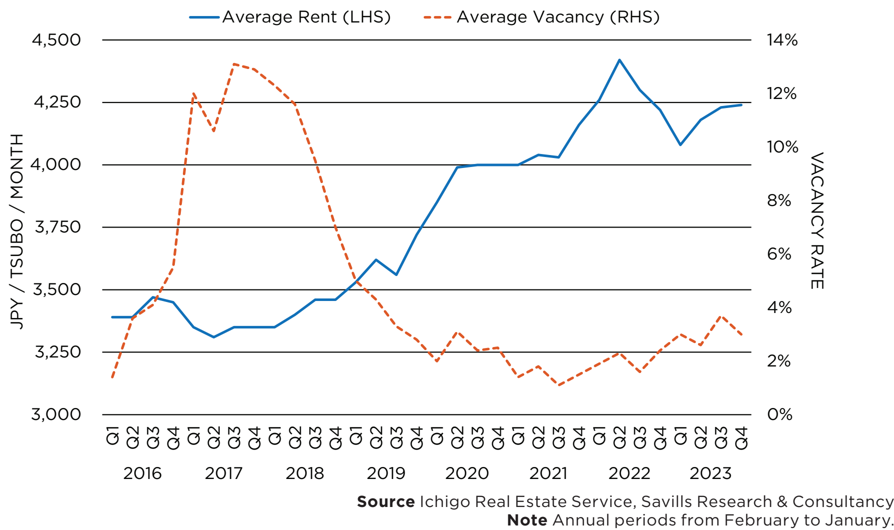
The logistics sector continues to perform well overall, but the large new supply over the past year has loosened the market, with vacancy rates rising as some new properties struggle to fill available floors. The industry will face a number of challenges moving forward, including the sustained influx of new supply and labour regulations that may dampen operations. While prime logistics facilities remain fully occupied and even display rental growth, older facilities with outdated specifications in less desirable locations are expected to keep struggling.

Graph 3: Supply, Demand, and Vacancy in Greater Osaka, 2010 to 2023



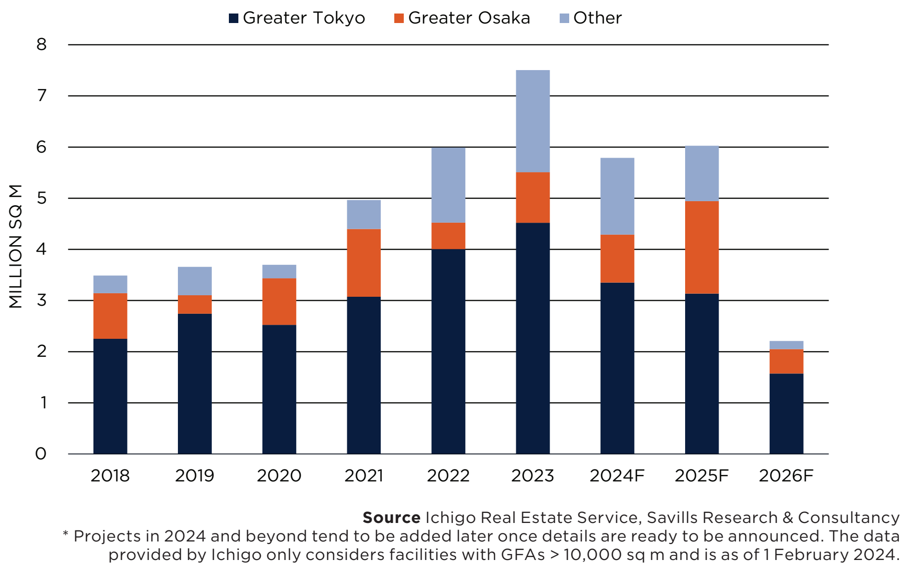
Source Ichigo Real Estate Service, Savills Research & Consultancy
Note Annual periods from February to January. Vacancy rates are as of the year end for each annual period, while the rate presented for 2023 is as of January 2024.

Graph 4: Greater Osaka Rent vs Vacancy, Q1/2016 to Q4/2023



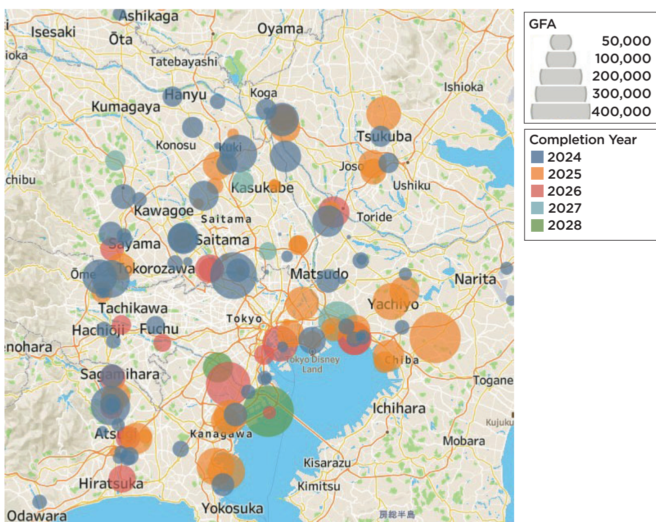
Source Ichigo Real Estate Service, Savills Research & Consultancy
Note Annual periods from February to January.

Graph 5: Annual New Supply* in Japan by Region, 2018 to 2026F



Source Ichigo Real Estate Service, Savills Research & Consultancy
* Projects in 2024 and beyond tend to be added later once details are ready to be announced. The data provided by Ichigo only considers facilities with GFAs > 10,000 sq m and is as of 1 February 2024.

MAP 1: Upcoming Completions in Greater Tokyo with GFA greater than 50,000 sq m, 2024 to 2028*



Source Company Disclosures, Ichigo Real Estate Service, Savills Research and Consultancy
* Projects where GFA and/or completion date are unavailable are omitted from the dataset.
New supply data is as of 1 February 2024.

needs of tenants by providing features such as cold storage will likely remain highly sought after, while less popular facilities are expected to struggle. Indeed, the logistics sector, already plagued with labour shortage problems, will face steeper challenges with the new labour laws for truck drivers that will take place from April 2024, and having an attractive workplace in a good location could be a key strategy in tackling the issue.

INCOMING SUPPLY

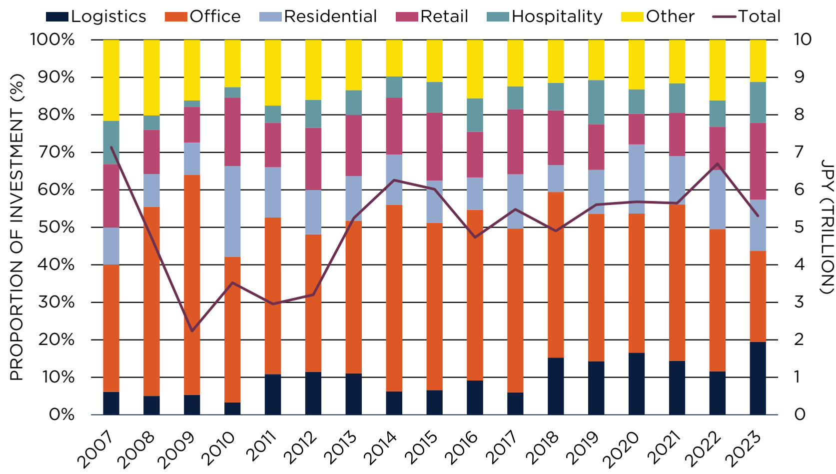
New supply in Greater Tokyo hit another high in 2023, introducing 4.5 million sq m of GFA into the market. The largest completion introduced in the second half of 2023 was Tokyo Ryutsu Center's reconstruction of Logistics Building A located in Ota ward. The facility is located directly next to Ryutsu Center station on the Tokyo Monorail, and is one kilometre away from the Heiwajima entrance of the Metropolitan Expressway. Such facilities that are located with good access to public transit systems as well as expressways are likely to be in high demand, and should not encounter difficulties attracting tenants as long as they are reasonably priced, especially if they also have features such as cold storage capabilities.

In the first half of 2024, the largest development to be added to the market is Orix Real Estate's Atsugi III Logistics Center in Kanagawa prefecture, with a GFA of 183,000 sq m. The facility is a 10-minute drive from the Ken-O Expressway and Harataima station on the Sagami line. This multi-tenanted facility has six floors and also has storage areas that can house hazardous goods. As of February 2024, the facility is reportedly around 70% pre-leased, and given its location and features, could be expected to perform well in the market.

In Greater Osaka, a total of around a million sq m of GFA came to the market in 2023. Developments were comparatively more spread out, with the largest additions being DPL Hyogo Kawanishi by Daiwa House and Fujita, which added around 89,000 sq m, and MCUD Minami-Suita by Mitsubishi Corporation Urban Development and Sankei Building, which added around 85,000 sq m. Both facilities are in good locations proximate to major stations and or expressways.

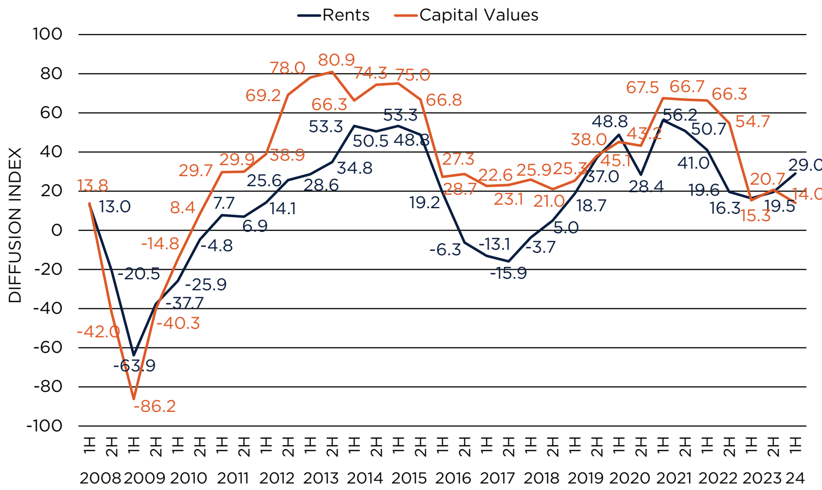
In the first half of 2024, the largest addition to the market will be LOGI'Q Minami-Ibaraki by Tokyu Land, which was completed in January 2024, adding around 162,000 sq m to the market. The facility is located close to the Meishin expressway and is a nine-minute walk from Senrioka station on the Kyoto line. The accessibility of the facility should make it easier to attract labour, which will be crucial in the industry, infamous for its labour shortages.

Graph 6: Share of Investment Volumes by Asset Class, 2007 to 2023



Source MSCI, Savills Research & Consultancy

Graph 7: Six-month-ahead Expectations for Rent and Capital Appreciation, 2008 to 1H/2024



Source Ichigo Real Estate Service, Savills Research & Consultancy

INVESTMENT TRENDS

According to preliminary data aggregated by MSCI, overall investment activity in Japan has been strong in 2023 at JPY5.3 trillion. Over the same period, investment levels in the logistics sector grew to a new high of JPY1.0 trillion, rising 35% from 2022 levels due to a number of large transactions. In addition, transaction data is preliminary and investment volumes will likely increase as more transactions are confirmed throughout the rest of the year.

In the current challenging capital market environment for J-REITs, which are theoretically interest rate sensitive, the unit prices of logistics J-REITs in particular are relatively weak. Nonetheless, a few large J-REIT transactions have been observed. Industrial & Infrastructure Fund Investment Corporation (IIF), a J-REIT managed by KKR announced two large deals in February 2024, one of which entails acquiring 28 logistics properties for JPY108.3 billion from LOGISTEED, which KKR has invested in. The other deal was a silent partnership investment into HK Logistics GK, an SPC which will acquire four logistics properties from LOGISTEED for JPY104.4 billion. IIF REIT will also be disposing of two logistics properties for JPY13.5 billion. Another notable J-REIT transaction was the sale of part of Logiport Nagareyama B by Lasalle Logiport REIT for JPY13.1 billion.

Domestic firms have also been active over the past half year, with Fuyo General Lease having reportedly acquired 50,000 sq m of land in Higashihama from Kobe Steel, which posted an approximate gain of JPY27.0 billion on the sale. While the purpose of the acquisition has not been disclosed, the site is located in the Tokyo Bay area where many logistics facilities are located. Meanwhile, looking at

Table 1: Selected Investments, Announced September 2023 to February 2024

PROPERTY NAME	TRANSACTION VALUE (JPY BIL)	APPRAISAL DIRECT CAP RATE	BUYER	SELLER
LOGISTEED Portfolio (28 properties)	108.3	3.5% to 6.2%	Industrial & Infrastructure Fund Investment Corporation	LOGISTEED
LOGISTEED Portfolio (4 properties)	104.4	-	HK Logistics GK	LOGISTEED
Kanto Logistics Center Higashihama Warehouse (Land Transaction)	27.0 (gain on sale)	-	Fuyo General Lease	Kobe Steel
ESR Aisai Distribution Centre	16.4	-	ESR Japan Income Fund	ESR
IIF J-REIT Portfolio (2 properties)	13.5	4.6%*	Undisclosed domestic operating company	Industrial & Infrastructure Fund Investment Corporation
Logiport Nagareyama B (37.5% quasi co-ownership)	13.1	3.9%	Undisclosed	Lasalle Logiport REIT

Source Company Disclosures, Nikkei RE, Savills Research & Consultancy
* Cap rate reflects only the transaction of IIF Yokohama Tsuzuki R&D Center.

international investors, ESR Japan Income Fund, in which investors such as AXA Investment Managers and GIC hold equity, acquired ESR Aisai Distribution Centre in Aichi for JPY16.4 billion, marking the fund's first entry in the Greater Nagoya area.

The 33rd bi-annual market sentiment survey conducted by Ichigo Real Estate Service has recorded some divergent views. Largely speaking, the majority believes that property prices remain elevated. On one hand, a larger proportion of respondents, albeit a minority at 10%+, have expressed more pessimistic views on the prospects of capital appreciation, with the diffusion index at its lowest since 2010, citing the likely normalisation of monetary policy, and the large upcoming supply as major concerns. However, there were also concessions that rising construction costs would also have an upward cost-push effect on prices, which was the primary driving factor that pushed the diffusion index for rents to the highest level since 2022. Other respondents have also indicated that needs for features such as cold storage and the ability to store hazardous materials would also drive rents up, suggesting that such features will indeed be key in attracting tenants going forward.

Overall investment appetite remains strong, especially among international investors, since many of them don't have sufficient exposure to the Japanese market yet. In the meantime, sharpened pricing and elevated land and construction costs make development more difficult, on top of labour issues. In addition, rather lukewarm leasing markets do not aid the situation. That said, the fundamentals are strong, especially from a mid-to-long-term basis, despite the ostensible short-term pain.

BLIND SPOTS IN THE DATA CENTRE MARKET

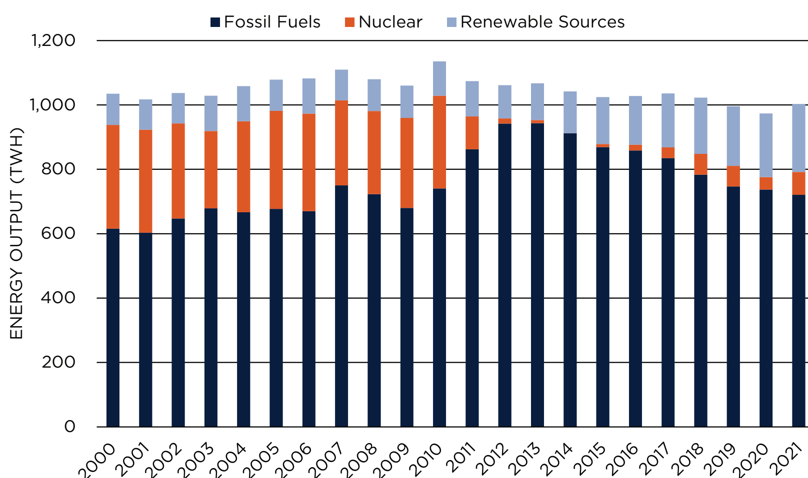
The data centre market has continued to grow robustly in Japan due to the continued growing demand for digital infrastructure to support the proliferation of cloud services and the development of artificial intelligence. In fact, the total power capacity of data centres in Japan is forecast to double over the next few years, demonstrating the rapid expansion of the market. Nonetheless, while data centres have received a great deal of attention and have become a hot topic of discussion with the large amount of capital directed at it, the sharpened pricing and difficulty in repurposing may pose risks.

The first major concern surrounding the data centre sector is the large amount of energy that it consumes. In FY2021, data centres in Japan alone are estimated to have consumed about 20 TWh of electricity, totalling more than 2% of the country's electricity consumption of 931 TWh in 2021, according to the International Energy Agency. The projected rapid expansion of the market and number of data centres being constructed is expected to see the sector's electricity usage skyrocket, and in 2020, the Japan Science and Technology Agency forecasted domestic annual energy consumption of data centres to rise to 90 TWh by 2030 using currently available technology. The enormous amount of energy that the data centre sector demands is already putting strains on Japan's power grid, and many development projects presently require many years to acquire sufficient power for operations. Furthermore, Japan uses fossil fuels to generate about 70% of its electricity, meaning that data centre investments are likely to solicit pressure from stakeholders that have grown to become increasingly environmentally conscious.

To be fair, technological advancements certainly have the potential to address concerns about energy usage, and the popularity of the sector has also drawn more funding for research and development. At the same time, technological advancements could also be a double-edged sword for present data centres. For example, before the proliferation of cloud technology, mainframe computers that were usually stored in-house or proximate to a company were considered the primary means of handling and processing the data of a large business. Japan had a large presence in the mainframe industry and the prevalence of legacy systems has made Japan slow to adapt to more modern technology. However, this technology has gradually come to be replaced by cloud storage or colocation services provided by data centres. Japan's success in this previous technology has delayed transition, and consequently fuelled demand for data centres now. Likewise, groundbreaking technological innovations could possibly render some level of obsolescence to either the current technology installed, or in an extreme scenario, the industry's broader concept. Indeed, the concurrent rise of artificial intelligence and the amount of energy it requires could fundamentally shift the function, design, and even choice of location of data centres, and put existing facilities in a more precarious position.

While the timing of such predicaments is impossible to predict accurately, capable asset managers should always have a range of contingency plans available. However, data centres have comparatively less room for strategic pivots as the land that many of them are situated on is usually located far from city centres, and has little value aside from being used as an industrial site. Moreover, the heightened interest in the data centre sector has led to many opportunities being acquired at sharp cap rates, only adding to the difficulty of finding suitable opportunities that have adequate returns. Indeed, there is a narrow margin for miscalculation or error at sub-4% cap rates for prime data centres, especially those with relatively long fixed-term contracts. Although many of the aforementioned scenarios are hypothetical, they are not implausible given the rapidly evolving environment and pace of technological advancements. As such, investors may need to be aware of the potential risks when venturing into the sector at sharp pricing levels; only a 50bps spread against the well-established logistics facility sector with a two-decade track record.

Graph 8: Japan Energy Output by Source, 2000 to 2021



Source International Energy Agency, Savills Research and Consultancy

OUTLOOK

Overall, the fundamentals of the logistics sector have remained strong even into the post-pandemic era with factors like the steadily growing e-commerce industry helping to prop it up. There have been many large transactions over the past half-year by both domestic and international investors. However, a few cracks have admittedly begun to show more clearly – vacancy rates have crept up over the past few years, largely due to the large volumes of supply entering the market, and rental growth appears to have slowed. The bifurcation between prime and subprime facilities is likely to widen even more going forward as tenants now have more choices available to them. As such, facilities without defining features such as cold storage, the ability to house hazardous goods, or those in comparatively less desirable locations, may encounter greater difficulties in attracting tenants.

There are also industry-wide headwinds on the horizon that look to add further pressure to operators, namely the limitations on the number of overtime hours that delivery drivers will be able to work, in an industry that had traditionally faced considerable labour shortage issues. That said, some nimble operators have come up with solutions to improve transportation efficiency in the face of the looming issue, like FamilyMart's partnership with Coca Cola Japan to use the latter's trucks in the delivery of the former's goods. Similar collaborations between companies of different industries have also been reported, like those of Nissin Foods and JA Zen-Noh. As such, tenant selection will likely become even more important going forward.

Overall, while the sector remains a very popular destination for real estate capital, there are challenges for both tenants and landlords ahead. However, prime facilities in good locations are still poised to do very well and should not face difficulties in securing tenants. On the other hand, older facilities with outdated specifications that are in less convenient locations are expected to struggle, especially with the large supply still to come over the next few years. One potential silver lining for underperforming assets may be that there have been delays and postponements of some upcoming projects due to construction costs that have skyrocketed, and supply chain constraints, on top of the ever-present labour shortage, which may give the market more breathing room to catch up. Moreover, the increased construction costs should also limit upcoming supply, which should further contribute to achieving an equilibrium between demand and supply on a mid-term basis. Nonetheless, investors in the sector will need to be able to distinguish between winning and losing assets.

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