Japan - September 2021

SPOTLIGHT
Savills Research

Japan Logistics

Rental growth slows but positives remain

Summary

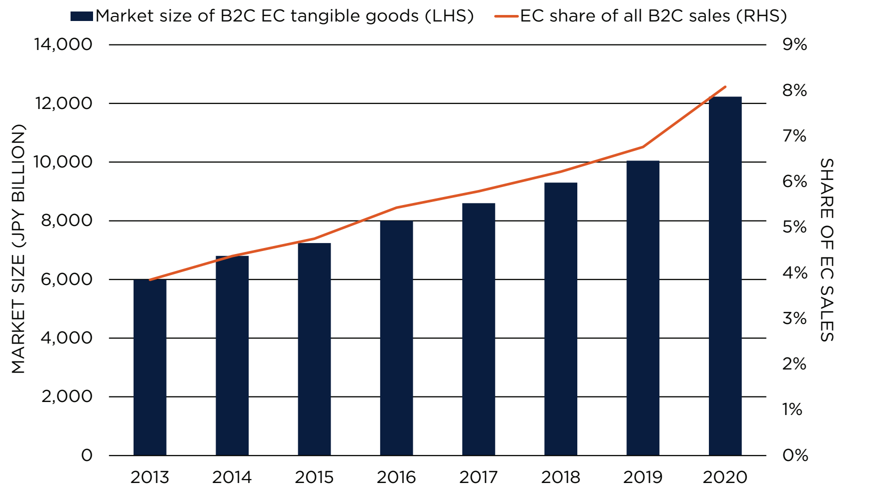
- Demand was unable to fully keep up with the high levels of supply in the first half of 2021 in Greater Tokyo, and as such vacancy rates have loosened to 1.3%.
- Greater Osaka's vacancy rates have shrunk to 1.9% as the region experienced positive net absorption.
- Rents in Greater Tokyo are now at JPY4,470 per tsubo, increasing 1.6% year-on-year (YoY).
- Greater Osaka has also seen mild growth, with rents rising 1.3% YoY to JPY4,040 per tsubo.
- Investment volumes into the logistics sector have slowed into 2021, although interest in the sector remains abundant with multiple new developments being announced.
- The data centre sector is booming and witnessing multiple large scale development announcements. Meanwhile, the logistics sector has evolved from niche to mainstream and is nearing maturity.
- Fundamentals remain robust, but there are some concerns over upcoming supply levels and some reversal of the accelerated growth seen in e-commerce.

INTRODUCTION

It has been over a year since the onset of COVID-19. Nevertheless, amid the struggles witnessed amongst its peers, the logistics sector has continued to exude stability. The rapid growth of e-commerce spurred a greater demand for logistics facilities to deal with the higher inventory turnover. Indeed, according to the Ministry of Economy, Trade and Industry (METI), the market size of Business-to-Consumer (B2C) e-commerce tangible goods has increased by more than 20% from 2019 to 2020. Rents remain at all-time highs and vacancy levels are low as a result, despite the already large supply.

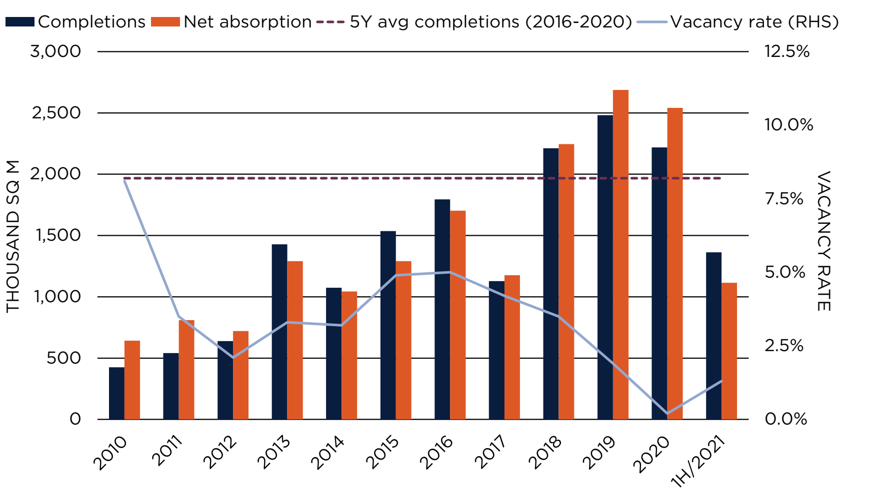
Somewhat tempering this optimism, however, is the fact that rental growth has slowed over the past few quarters – perhaps signalling a potential threshold as to what tenants are able to pay. Moreover, despite the expansion of the e-commerce market, the future growth of the logistic sector's profitability may also be hampered by the added competition from new players. At the same time, some consumers may turn their attention back to brick-and-mortar retail stores as the pandemic subsides, further weighing on the

Graph 1: Business-to-Consumer (B2C) E-commerce (EC) Market Size for Tangible Goods, 2013 to 2020



Source METI, Savills Research and Consultancy

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



Source Ichigo Real Estate Service, Savills Research and 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 1H/2021 is as of July 2021. Only facilities with GFA greater than 10,000 sq m are considered.

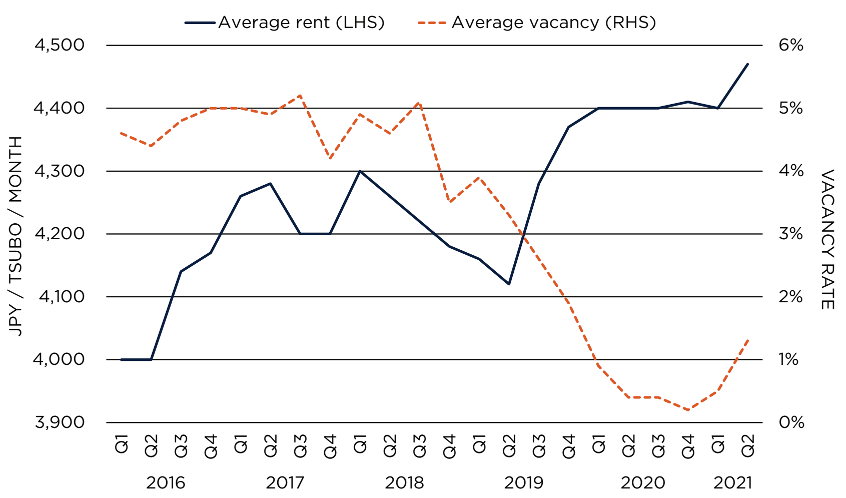
sector. Another caveat includes the upcoming pipeline of projects, which could destabilise the current status quo if the glut of supply weakens both vacancy rates and rental growth in the sector.

MARKET TRENDS

The logistics sector has held steadfast in Greater Tokyo over the past year. The strong demand present in the region has allowed for solid pre-leasing activity with many new facilities fully occupied upon completion, although some regions in Saitama reportedly required longer periods of pre-leasing activity due to its higher concentration of new developments. However, given the significant levels of supply during the first half of the year, new supply outpaced demand. As a result, while still at low levels, vacancy increased 0.9 percentage points (ppts) to 1.3%.

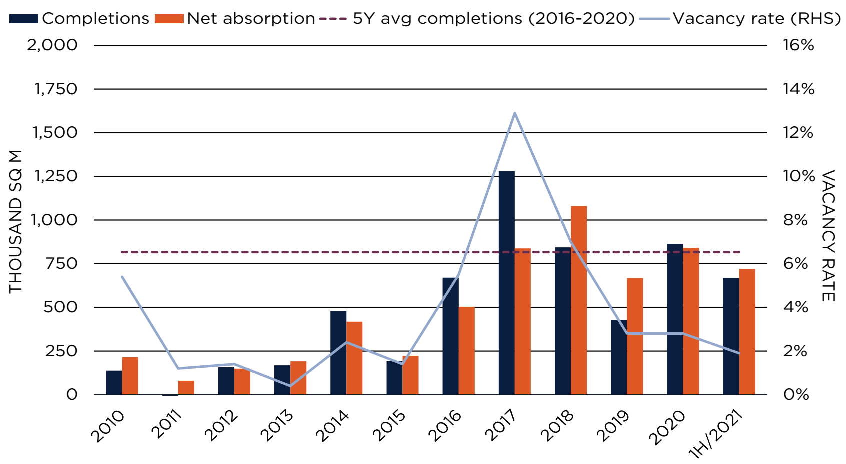
For now, the logistics sector is thriving. It does, however, face concerns over its substantial supply pipeline, as well as a potential reversal from e-commerce to brick-and-mortar retail once the pandemic subsides. Nonetheless, its strong fundamentals and long-term stable leasing structure make logistics assets attractive for prospective investors.

Graph 3: Greater Tokyo Rent vs Vacancy, Q1/2016 to Q2/2021



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

Graph 4: Supply, Net Absorption and Vacancy in Greater Osaka, 2010 to 1H/2021



Source Ichigo Real Estate Service, Savills Research and 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 1H/2021 is as of July 2021. Only facilities with GFA greater than 10,000 sq m are considered.

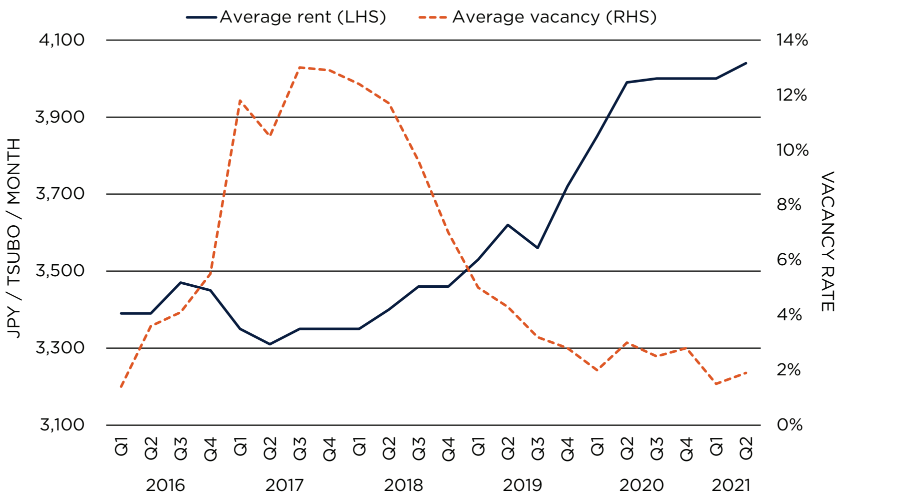
Average rents in the Greater Tokyo area currently stand at JPY4,470 per tsubo – an increase of 1.6% YoY. Over the year, rental growth has slowed as tenants appear to have become somewhat stretched financially. Nonetheless, rents for newer, better located facilities with advanced equipment can be much higher than older counterparts. In truth, this is to be expected considering that these facilities are more likely to be capable of adapting to the increasingly complex needs of tenants that aim to maximise efficiency and output. Moreover, potential tenants that have benefited from the growth in e-commerce should also have the purchasing power to afford the higher costs of such premium facilities.

Elsewhere, the logistics sector in Greater Osaka has also demonstrated its strength in the first half of 2021. In fact, the significant level of demand for these assets has markedly outpaced completions, and vacancy rates have consequently tightened by 0.6ppts YoY to 1.9%. Like Greater Tokyo, pre-leasing activity has also been strong with many large facilities coming onto the market fully occupied.

Rents in Greater Osaka have remained mostly unchanged over the past few quarters, although they saw some growth in Q2/2021 and now stand at JPY4,040 per tsubo. Looking back, unlike its Greater Tokyo counterpart that has seen ups and downs in rental levels since 2017, the region has seen rents rise continuously. Specifically, it boasts a 19.4% surge in rents from that period, compared to the 3.3% gain that Greater Tokyo saw, demonstrating the impressive growth that the region has seen.

Future rental growth will be affected by the strength of the e-commerce sector, whose tenants have specific demands regarding space, amenities, and management systems. Logistics facilities that are able to meet

Graph 5: Greater Osaka Rent vs Vacancy, Q1/2016 to Q2/2021



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

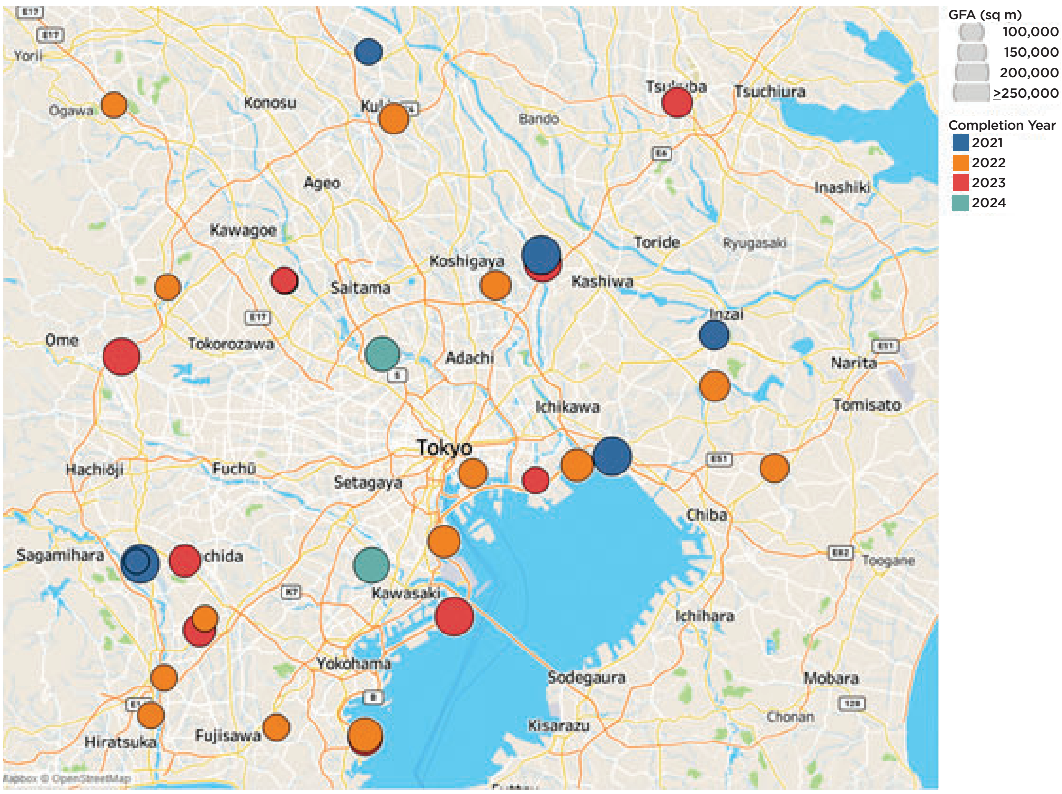
these needs can naturally charge higher rents. However, if brick-and-mortar retail manages to gain greater traction in a post-pandemic world, the need for these complex warehouses may simultaneously slow down, with traditional retail tenants turning to more affordable facilities that suit their needs and reduce costs. Nonetheless, the long-term nature of leases in the logistics sector should keep rents stable for the time being.

INCOMING SUPPLY

In Greater Tokyo, the large amount of new supply seen in 2020 appears to have carried on in 1H/2021, with over 1.3 million sq m of new space introduced to the market. The largest completion of significant scale[1] in the first half of 2021 was the Mitsui Fudosan Logistics Park (MFLP) Funabashi III in Chiba – completed in June 2021. The facility has eight floors and a GFA of over 270,000 sq m, and was the third and final instalment of the MFLP Funabashi town-type facility development. Indeed, in addition to equipping the facilities with state-of-the-art technology and systems, Mitsui Fudosan has gone to lengths to make the area feel like a town. The facilities are located close to a JR

1 Defined as exceeding 100,000 sq m in GFA

Map 1: Upcoming Completions in Greater Tokyo with GFA greater than 100,000 sq m, 2021 to 2024*



Source 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 as of 31 July 2021.

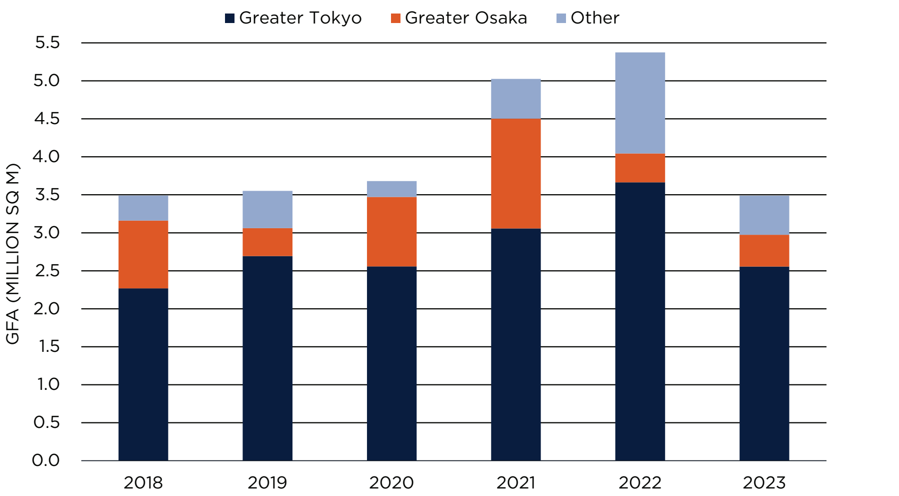
station and have large shopping malls and other amenities nearby. These considerations will undoubtedly make it easier for such large developments to attract workers in a sector where labour is scarce.

There are multiple large-scale projects in the pipeline for Greater Tokyo. Two developments that are planned to be completed later in 2021 will both have GFAs greater than 300,000 sq m. Furthermore, 2022 and 2023 are projected to have more than 20 developments with GFAs greater than 100,000 sq m each. However, most of these developments appear to be well spread out over different areas and are taking place in convenient locations such as along major expressways, making it easier for the market to absorb these high levels of supply.

In Greater Osaka, the pace of new developments being added in 1H/2021 has already outstripped that of the previous year, with the amount of GFA added in the first half of 2021 already at 75% of the total supply added in 2020. A few new developments with GFAs of more than 100,000 sq m completed this year include the Logista LogiCross Ibaraki-Saito (Building A) and the LOGIFRONT Amagasaki II. The latter is a Built-To-Suit (BTS) facility that is reported to have customised air-conditioning systems and storage space to fit the tenant's needs. It is worth noting that many other developments along the bay completed this year are reported to be BTS facilities that will likely have longer lease terms, showing that demand in the region should remain fairly strong in the mid-term.

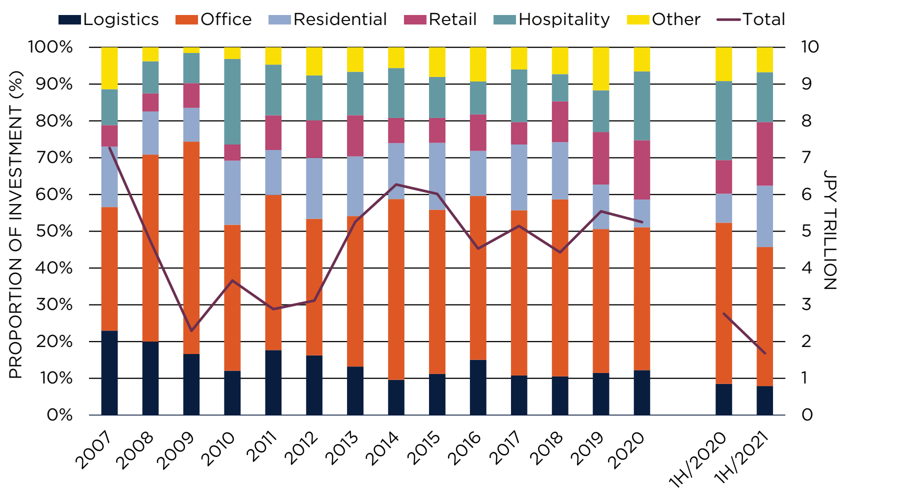
Greater Osaka is forecast to have record levels of supply in 2021, even surpassing the sum of supply seen in 2019 and 2020. For instance, Prologis Park Inagawa 1 and 2, both scheduled to be completed in the latter half of 2021, are two of the largest facilities to be built in the region and will have a total GFA of 370,000 sq m between them. Located in Inagawa Town, Hyogo – a convenient commute from Osaka and Kobe – the facility is expected to be able to attract labour needed for its operation with its proximity to residential communities. Further down the line, a new development in 2025 is GLP ALFALINK Ibaraki, which will add 320,000 sq m of GFA to the market.

Graph 6: Annual New Supply* in Japan by Region, 2018 to 2023F



Source Ichigo Real Estate Service, Savills Research and Consultancy
* Projects in 2022 and beyond tend to be added later once details are ready to be announced.
The data provided by Ichigo is as of 31 July 2021.

Graph 7: Share of Investment Volumes by Asset Class, 2007 to 1H/2021



Source RCA, Savills Research and Consultancy

INVESTMENT TRENDS

The global pandemic has yet to subside, extending the situation and problems seen last year into 2021. Investments in Japan have been slow, and according to data aggregated by Real Capital Analytics (RCA) the investment volumes in 1H/2021 are about 39% less than those seen in 1H/2020. The logistics sector has not been excluded from this trend, with investment volumes falling about 43% in the same period. It should be noted, however, that the data is preliminary and that investment volumes are likely to increase as more transaction details are confirmed. At the same time, the prolonged pandemic and multiple state of emergencies in 2021 may have delayed some deals and plans for on-site due diligence, explaining the overall slow pace of transaction volumes in 2021. Nevertheless, as discussed in the previous section, abundant capital is flowing into developments of new logistics facilities both in Greater Tokyo and Greater Osaka, reflective of continuingly strong interest in this sector. Investments may start picking up toward the end of the year if the pandemic is suppressed with the increased pace of vaccinations.

The logistics sector has been looked on favourably by many domestic companies. For example, JR West Real Estate & Development has started to develop its first logistics facility in Hyogo prefecture this year, and reportedly plans to actively develop more going forward. Furthermore, 2021 also saw the start of multiple mid-to-large sized logistics facilities developments by Daiwa House, Mitsubishi Estate and Nomura Real Estate.

A few big-ticket J-REIT transactions were observed in 1H/2021. GLP J-REIT has once again made a large acquisition, adding four logistics facilities into its portfolio in July for JPY49.3 billion. This comes half a year after acquiring seven logistics facilities for JPY98.2 billion. Other notable transactions include LaSalle Logiport REIT's acquisition of Logiport Osaka Bay for JPY40.0 billion and ESR's acquisition of Redwood Nanko Distribution Centre 1 for JPY29.5 billion. In addition, looking at international investors, M&G Real Estate has reportedly paid US$217.0 million for a 25% stake in the fund that owns the ESR Ichikawa Distribution Centre.

Confidence in the logistics sector remains strong. According to the 28th bi-annual survey market sentiment conducted by Ichigo Real Estate Service, more than half of respondents expect capital values and rents of facilities to increase. However, it should be noted that they were slightly less optimistic than half a year ago, suggesting that some areas of the market might see growth decelerate.

The logistics sector has seen more time in the spotlight especially since the pandemic, and it has evolved from being considered niche and has become part of the mainstream, leading to lower core and core-plus returns. Meanwhile, many investors are especially keen on the development of data centres in Japan to seek for more opportunistic returns, although this is already becoming increasingly competitive. In this respect, Goldman Sachs plans to increase property investments in Japan to around JPY250 billion a year from the current range of JPY100 to JPY150 billion, with a focus on logistic hubs and data centres.

A NEW HORIZON FOR DATA CENTRES

With the logistics sector seemingly nearing maturity in terms of new concepts and market entrants, the data centre sector has gained increasing interest amidst the pandemic. In particular, the market has seen a myriad of investments as demand soars, mainly for hyperscale data centres that cloud-based technologies require. As a result, overall capacity is expected to rise significantly and Tokyo is likely to become a gigawatt market by 2025.

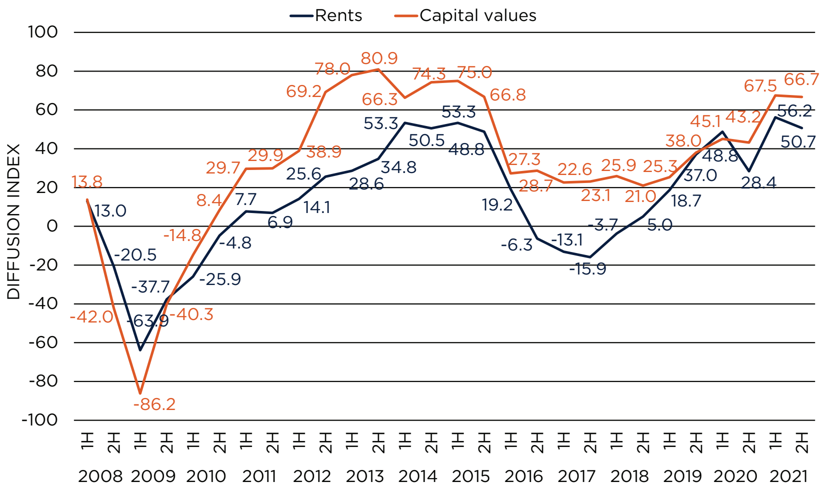
For instance, in July, Mitsui & Co. announced plans to invest JPY300 billion into developing and acquiring data centres in Japan. It will initially develop three data centres with Colt DCS, which currently manages 50 megawatts (MW) of facilities in Japan, with the aim of increasing its capacity to 140 MW after this joint venture. Meanwhile, Princeton Digital Group also announced an investment into a 100-MW hyperscale data centre in June, while last year, AirTrunk started the construction of a 300-MW data centre in Inzai, Chiba – an area known as the Ginza of data centres in Japan. With these investments, IDC Japan expects that the size of the Japanese data centre market will exceed JPY2 trillion in 2024 from JPY1.5 trillion in 2020.

In truth, the absence of a dominant domestic player presents Japan as an ideal market for international hyperscale cloud platform providers from both the U.S. and China to break into. Another consideration is Japan's strategic location as a connection and distribution hub for submarine cables from the west coast in the U.S. that extend to the Asia Pacific region. Furthermore, data communication volumes in Japan have doubled between 2017 and 2020, further bolstered by the increased implementation of digital transformation (DX) during the pandemic, and this is likely to have intensified the demand for data centres. Even once the pandemic is under control, it is doubtful that this trend will lose momentum as cloud-based technologies have become increasingly essential in society, by boosting productivity with advanced computing capacity, as well as providing streaming for popular games. All major cloud players having their own game-streaming brands or platforms is case in point.

The recent wave of investments has come on the back of increased support from the government. Building data centres requires government planning and assistance for national security measures and electrical grid improvements, given the impact that they have on the technological and security infrastructure of a country. In addition, submarine internet cables need to be strategically linked to the rest of the world to make the country into a data hub. Overall, the Japanese government has encouraged domestic and international data centre investments in order to strengthen its digital infrastructure – something that it is currently lagging behind other major nations.

There are other investment opportunities in Japan. Osaka, for example, is expected to become a major player over next few years, given its international business ties and the submarine data lines that run into the area. There are also opportunities for ESG investors, as Japan targets carbon neutrality by 2050. For FY2021, the country aims to subsidise 50% of the building costs of projects that introduce new zero-carbon data centres or upgrade

GRAPH 8: Six-month-ahead Expectations for Rent and Capital Appreciation, 2008 to 2H/2021



Source Ichigo Real Estate Service, Savills Research and Consultancy

Table 1: Selected Investments, announced March 2021 to August 2021

PROPERTY NAME	TRANSACTION VALUE (JPY BIL)	APPRAISAL DIRECT CAP RATE	BUYER	SELLER
GLP Logistics Portfolio (4 Facilities)	49.3	3.8% to 4.1%	GLP J-REIT	SNZ Properties GK. Undisclosed seller
Logiport Osaka Bay	40.0	3.9%	LaSalle Logiport REIT	SPC of LaSalle Investment Management
Redwood Nanko Distribution Centre 1	29.5	-	ESR	SPC of Angelo Gordon and ESR
Mitsubishi Logistics Portfolio (3 Facilities)	21.3	4.0% to 4.4%	Mitsubishi Estate Logistics REIT	SPC of Mitsubishi Estate
IIF IT Solution Center Portfolio (2 Facilities)	13.0	4.5% to 7.2%	Undisclosed	Industrial & Infrastructure Fund Investment Corporation REIT

Source J-REIT Disclosures, Company Disclosures, Nikkei RE, Savills Research and Consultancy existing facilities to be more eco-friendly, with initiatives totalling JPY757 billion. These incentives are attractive as global cloud platform providers are proactively prioritising carbon-free electricity. With this in mind, hyperscale data centres look set to attract further investment going forward, much like during the nascent stage of the logistics facilities almost two decades ago.

OUTLOOK

Fundamentally speaking, the logistics sector remains as strong as it was last year. Demand has effortlessly kept up with the ample supply entering the market, and the fact that there are numerous domestic and international players vying for assets demonstrates the sector's persisting popularity.

Nonetheless, rental growth in both Greater Tokyo and Greater Osaka has plateaued to some extent. Indeed, whilst the logistics sector caters to tenants that have benefited from the pandemic, such as those involved in e-commerce, there may be a limit to the premiums associated with prime assets. Meanwhile, with less fortunate tenants in the traditional retail and others that have been the hardest hit by the pandemic unlikely to be able to afford the elevated level of rents, this presents a potential roadblock for growth in the logistics sector at large, and developers of new facilities will have to be increasingly prudent in selecting tenants and understanding the capacity of their respective industries.

Admittedly, with the attention diverted away from industries suffering under the pandemic, like hospitality and retail, the increased interest shown in the logistics sector may have caused it to become slightly overheated. This exuberance, for instance, can be seen by the many new small and inexperienced players that have entered the market, bringing with them facilities that are likely to be less competitive. Moreover, the appreciating land prices of suitable locations would imply that rents are likely to remain high, and it is unclear if facilities with these elevated rents attached will be filled as smoothly going forward. Another thing to contend with is the reversal from the logistics sector into retail post-COVID. That said, the rise in new variants is likely to delay this process somewhat.

Despite the potential risks, the fundamentals of the logistics sector remain strong overall. In particular, investors should find some solace in the fact that the sector possesses stable long-term leases, with contracts typically five years or longer. Meanwhile, rental movements have generally been stable – an essential pillar to the strength of the industry. As a result, the sector is likely to continue attracting institutional capital with increased allocations as it becomes a mainstream asset class.

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