Japan - September 2024

SPOTLIGHT
Savills Research

Japan Logistics

Temporary challenges persist, but the mid-term fundamentals remain sound

Summary

- In Greater Tokyo, the market has continued to loosen slightly as elevated new supply exceeds demand, with vacancy rates increasing by 1.6 percentage points (ppts) year-on-year (YoY) to 7.7%.
- Conversely, demand in Greater Osaka this year so far has been greater than new supply, with vacancy rates improving half-year-on-half-year (HoH) but still loosening marginally by 0.1ppts YoY to 2.7%.
- Rents in Greater Tokyo increased to JPY4,820 per tsubo, climbing by 4.3% HoH and 6.6% YoY.
- Rents in Greater Osaka contracted by 1.4% HoH, while remaining flat YoY at JPY4,180 per tsubo.
- Though demand has been strong overall, investment levels in the industrial sector in 1H/2024 were slightly lower than in the same period of the previous year. Indeed, rising vacancies, construction costs, and interest rates have led to increased caution in development and acquisition plans.
- Although supply levels in 2024 are expected to be lower than the peak from the previous year, 2025 is projected to witness an increase in new supply, with Greater Osaka reaching record-high levels.
- Overall, the logistics sector has loosened due to high levels of supply. Nevertheless, the fundamentals of the sector are solid, and investors who are able to brace the current storm of challenges should be rewarded once the market has calmed.

INTRODUCTION

The logistics sector in Greater Tokyo[1] and Greater Osaka[2] demonstrated contrasting performances over the past half-year. Supply continues to outpace demand in Greater Tokyo, resulting in a sustained uptick in vacancies. Conversely, the Greater Osaka market saw demand outstrip supply, leading to a reduction in vacancies.

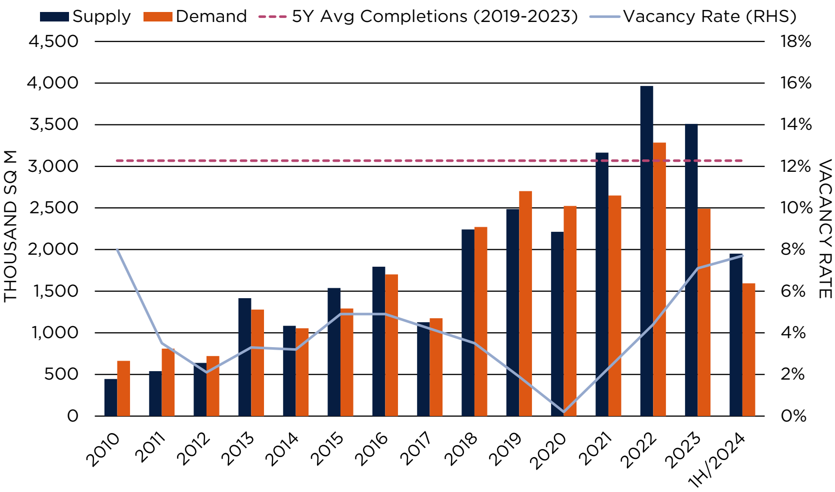
The logistics sector enjoyed heightened popularity during the pandemic era, but investor interest has waned in 2024 with lukewarm leasing markets due to the large supply, on top of interest rate hikes looking to depress net yields. Nonetheless, fundamentals of the sector remain strong, and interested investors could use this as an opportunity to break into the market. In the meantime, a range of corporate strategic shifts and innovations to address challenges in the market have been reported, which look to brighten prospects for the sector.

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

MARKET TRENDS

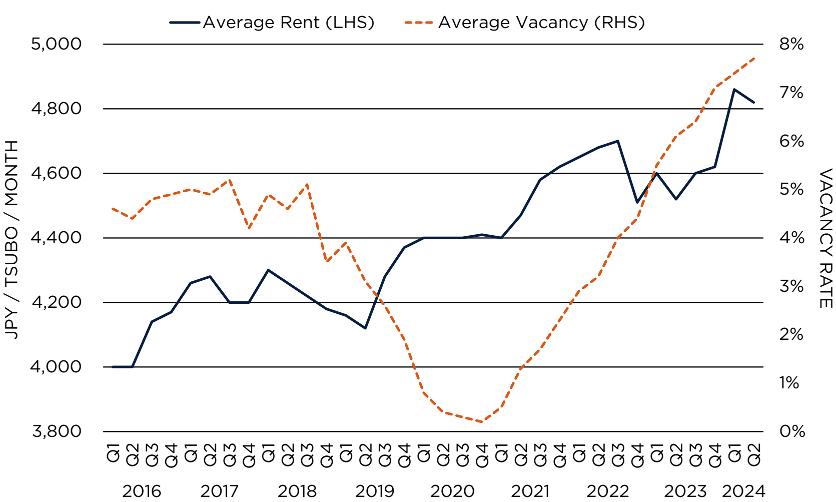
The Greater Tokyo market has continued to see significant new supply being added to the market in 1H/2024. While demand

Graph 1: Supply, Demand, and Vacancy in Greater Tokyo, 2010 to 1H/2024



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 1H/2024 is as of July 2024.

Graph 2: Greater Tokyo Rent and Vacancy, 2016 to 1H/2024



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

was sound, it was outpaced slightly by new supply, leading to another uptick in vacancy at 0.6 percentage point (ppts) over the past half-year and 1.6ppts YoY, reaching 7.7%. That said, 60% of the supply for 2024 has come to the market in the first half of the year, meaning that the market should have an easier time absorbing new supply for the remainder of the year.

Average asking rents in the Greater Tokyo market exceeded the previous 2022 record high, strengthening considerably by 4.3% QoQ and 6.6% YoY, reaching JPY4,820 per tsubo. This increment has been driven partly by rising construction costs, and also by a handful of listings of expensive properties in prime locations, namely Tokyo and Southern Saitama. Discounting these, market rents have been relatively stable with unnoticeable changes. Rental growth should nonetheless vary by property; prime facilities with desirable amenities will command higher rents with stronger growth, while older and less accessible properties have fewer chances to increase rents, especially with the market loosening in recent quarters.

In contrast, demand in Greater Osaka slightly outstripped supply in 1H/2024, with vacancy tightening by 0.3ppts HoH while loosening marginally by 0.1ppts YoY to 2.7%. The moderate supply forecast for the rest of the year should point to continued stability in the market in 2024. Due to the market's balance between demand and supply, rents have contracted 1.4% QoQ while remaining flat YoY at JPY4,180 per tsubo.

Overall demand in the logistics sector remains sound, but high levels of new supply in recent years have kept vacancies on a rising trend. In addition, many challenges, including global uncertainties, labour shortages, interest rates, and construction costs, have kept many players on their toes. That said, the logistics market is evolving, with strong fundamentals in a longer-term timeframe. In the interim, prime logistics facilities with modern amenities in accessible areas should continue to perform well, although older facilities in less convenient areas are likely to face challenges.

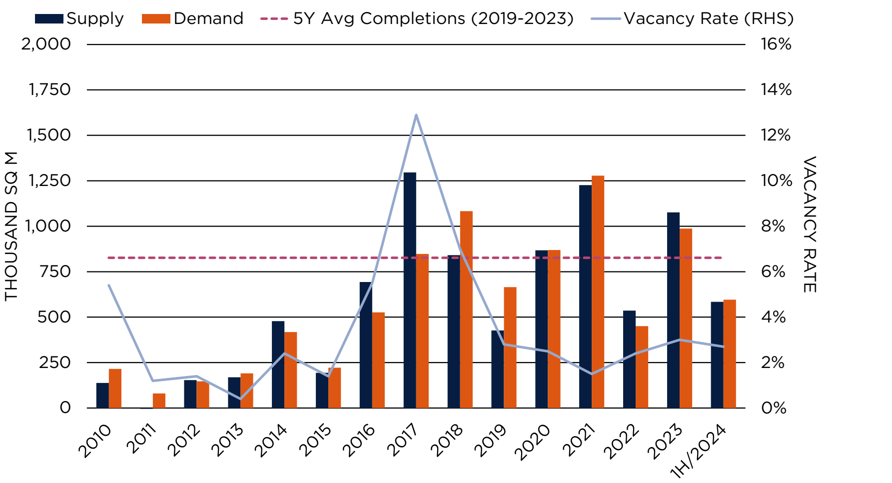
INCOMING SUPPLY

Greater Tokyo experienced an influx of nearly 2.0 million sq m of GFA into the market in 1H/2024, approximately 30% lower than the same period in 2023. The largest completion in the first half of 2024 was the Atsugi III Logistics Center, a multi-tenant logistics facility located in Kanagawa with a GFA of 182,000 sq m. The facility had reportedly secured five tenants upon completion, and began operations at full occupancy in May. Located near the Metropolitan Inter-City Expressway, which has access to the Tokyo Metropolitan Area, northern Kanto and western Japan, its accessibility will be even further improved when new connections via the Shin-Tomei Expressway are completed in 2027.

In the second half of 2024, the 256,000 sq m MFLP LOGIFRONT Tokyo-Itabashi will be the largest addition for 2024. Located in the 23W, this facility will be the first in the area to use its extensive site as a testing ground for drone flights, such as the delivery of goods in the final stage of the supply chain (last-mile delivery) and the transportation of relief supplies during emergencies. Overall, 2024 is expected to see approximately 3.2 million sq m of new logistics supply, about 25% lower than the peak in 2023. Additionally, lower supply levels are anticipated in subsequent years, driven by rising construction costs and labour shortages, which will further facilitate the absorption of existing elevated secondary vacancies.

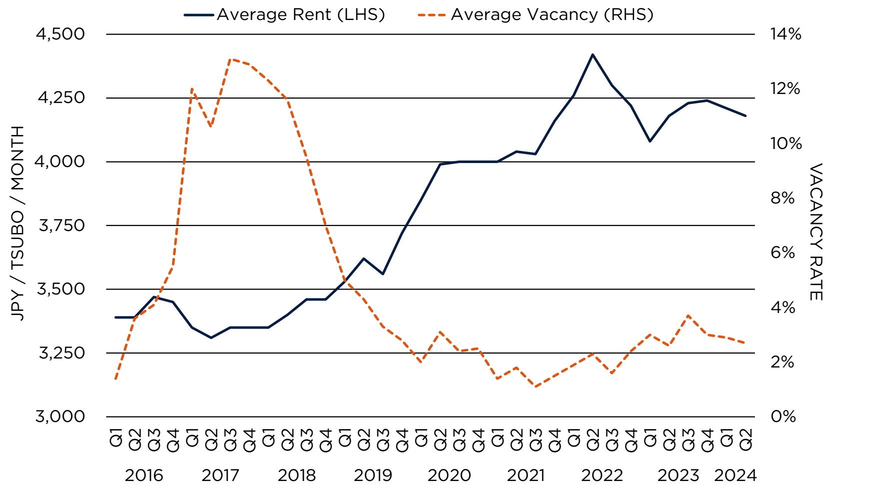
In Greater Osaka, the new supply forecast for 2024 has been revised down to just under 1 million sq m from 1.2 million sq m a year ago, due to rising construction costs and extended construction periods prompting developers to

Graph 3: Supply, Demand, and Vacancy in Greater Osaka, 2010 to 1H/2024



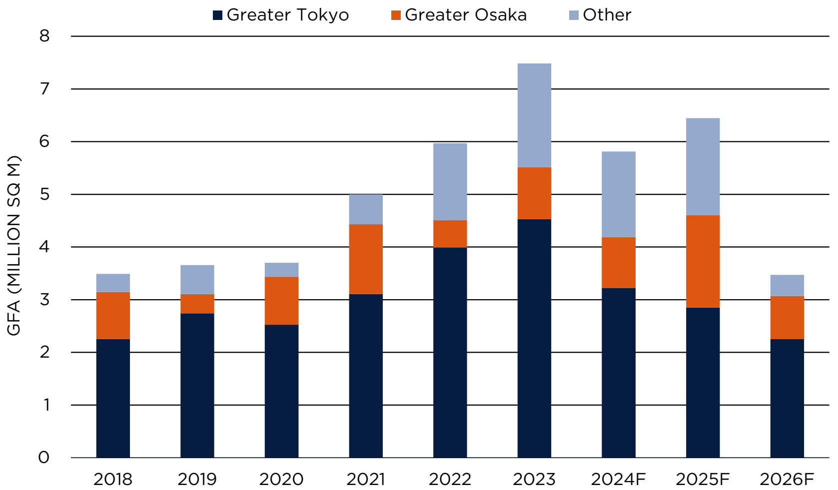
Source Ichigo Real Estate Service, Savills Research & Consultancy
Note Annual periods from February to January. Vacancy rates are as of the year end for each annual period, while the rate presented for 1H/2024 is as of July 2024.

Graph 4: Greater Osaka Rent and Vacancy, 2016 to 1H/2024



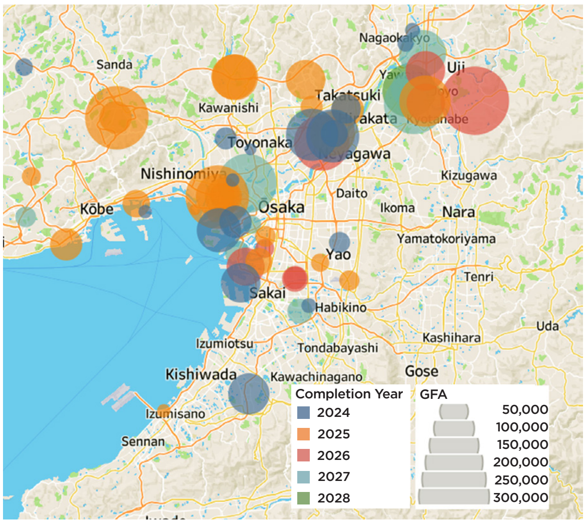
Source Ichigo Real Estate Service, Savills Research & Consultancy
Note Annual periods from February to January.

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 August 2024.

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



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

alter their development plans. The first half of 2024 accounted for 65% of the year's supply, with the largest contributor being the LOGI'Q Minami-Ibaraki by Tokyu Land, adding 162,000 sq m to the market. In the second half of 2024, new supply is forecast to be relatively subdued, with only one completion larger than 100,000 sq m - the 165,000 sq m GLP ALFALINK Ibaraki 1. This should provide room for absorption for the rest of 2024.

Looking ahead, 2025 will see a significant uptick in new logistics supply in Greater Osaka, approximately 1.8 million sq m, almost double the amounts seen in each of the two preceding years. The most notable upcoming completions in 2025 will be CPD Nishinomiya Kita I and II, with an aggregate GFA of 300,000 sq m. Located near the Chugoku and the Hanshin Expressways, this prime location offers excellent transportation access, supporting medium-to-long-term transport needs between Osaka and Kobe and should serve as a wide-area distribution hub for the Kansai, Chugoku and Shikoku regions. Given the much lower levels of existing stock in Greater Osaka, the limited supply is likely to stimulate demand, although it may cause temporary disruptions.

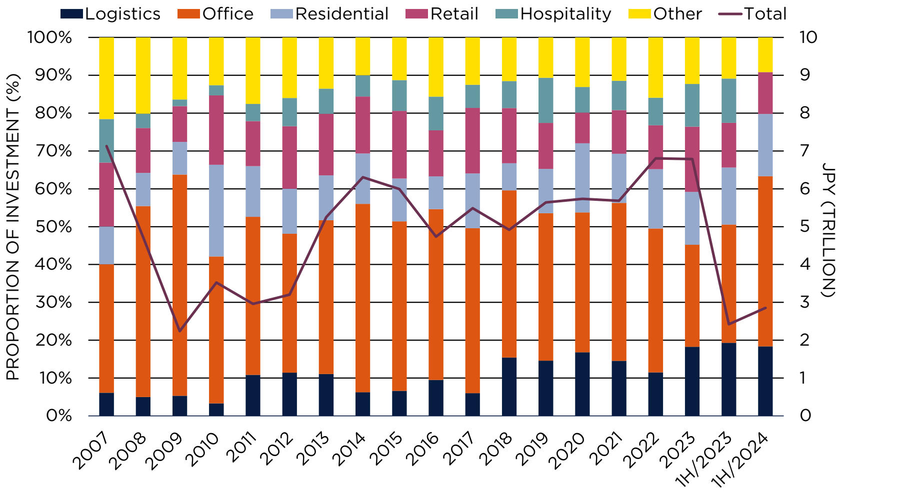
INVESTMENT TRENDS

According to preliminary data aggregated by MSCI, investment activity in Japan has been growing steadily, with the total investment volume in 1H/2024 around 18% greater than that observed in 1H/2023. That said, investment levels in the logistics sector in 1H/2024 are about 4% lower than the same period in the previous year, although it must also be noted that 2023 was a record year for the logistics sector. Transaction data is nonetheless preliminary and investment volumes will likely increase as more transactions are confirmed throughout the rest of the year.

The recent uptick in short-term interest rates and uncertainty over future hikes have created volatility in the equity capital market. Some bigger players have adapted in different ways. For instance, Mitsui Fudosan Logistics Park Investment Corporation plans to merge with Advance Logistics, with the former absorbing the latter, resulting in a projected 6.4% increase in distributions per unit from internal and external growth, and a slightly reduced Loan-to-Value ratio from 40.5% to 39.9%. However, the long-term benefits of the merger remain ambiguous and should be continuously monitored.

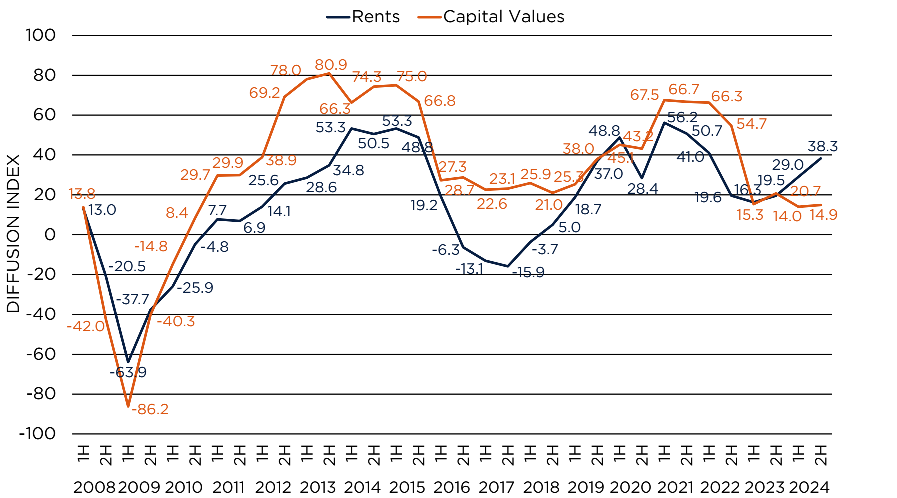
Nevertheless, significant transactions are still being observed in 2024, particularly among international investors. The largest transaction is the acquisition of DPL Yokohama Totsuka by GIC from Daiwa House for JPY59.8 billion. Significant transactions have also been recorded by domestic

Graph 6: Share of Investment Volumes by Asset Class, 2007 to 1H/2024



Source MSCI Real Capital Analytics, Savills Research & Consultancy

Graph 7: Six-month-ahead Expectations for Rent and Capital Appreciation, 2008 to 2H/2024



Source Ichigo Real Estate Service, Savills Research & Consultancy

Table 1: Selected Investments, Announced between March 2024 to August 2024

PROPERTY NAME	TRANSACTION VALUE (JPY BIL)	APPRAISAL DIRECT CAP RATE	BUYER	SELLER
DPL Yokohama Totsuka	59.8	-	GIC	Daiwa House Industry
Hino Motors Hidaka Dispatch Center	44.1	-	Amazon	Hino Motors
ESR Yatomi Kisosaki DC	38.0	-	ESR-LOGOS REIT	AXA IM - Real Assets
DPL Urayasu III	30.0	3.3%	Daiwa House REIT	SPC of Daiwa House Industry
Tama Technology Bldg	23.4	-	Keppel DC REIT, Keppel Capital	Mitsui Fudosan
Daiwa House REIT portfolio (3 properties)	22.6	4.0% to 5.3%	SPC of Daiwa House Industry	Daiwa House REIT

Source Company Disclosures, Nikkei RE, Savills Research & Consultancy

investors over the past half year. Daiwa House REIT acquired DPL Urayasu III in Chiba for JPY30.0 billion from its sponsor, Daiwa House Industry, and in a separate transaction, sold three logistics properties in Saitama, Chiba and Tochigi to its parent company for JPY22.6 billion. Elsewhere, Nomura Master Fund acquired the 50,000 sq m GFA Landport Tama in Tokyo for JPY17.5 billion.

The 33rd bi-annual market sentiment survey in late July by Ichigo Real Estate Service showed a shift to a more neutral outlook, with over 70% of the respondents anticipating stable capital values. Increased caution towards new investments has emerged due to uncertainty surrounding potential future rate hikes. Nearly half of respondents expect further rental growth, driven mainly by rising construction costs passed on to tenants and the ongoing inflationary environment. Facilities that have cold storage and hazardous goods storage continue to be able to fetch higher rents due to its higher demand from tenants.

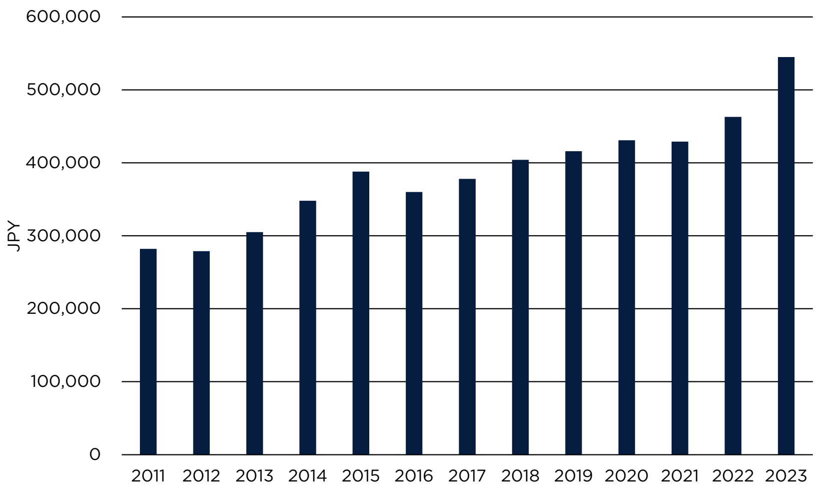
Overall investment appetite in Japan remains robust, despite challenges posed by market uncertainty and rising interest rates. The logistics sector continues to experience notable investment levels in 1H/2024, largely on par with 1H/2023. Despite the short-term challenges and uncertainties, including increased investor caution, larger players are observed to be making strategic moves to maximise yields. Additionally, cost pressures from elevated construction and land prices, increased wages and restrictions on overtime work will potentially eat into profits considering the limitations on raising rents, at least on a short-term basis, prompting investors to exercise greater caution. From a longer-term perspective, the fundamentals of the logistics sector remain strong, backed by strong and sustained e-commerce growth, and the sector should continue performing well after overcoming near term challenges.

CAUTION MATERIALISING

In our 2022 report [Japan Logistics - Evidence of caution], we cited potential reasons for caution in the logistics sector. During the pandemic, many investors shirked away from hotel, retail, and office assets, resulting in the logistics sector seeing very high levels of interest as an avenue to deploy capital. Consequentially, cap rates were rapidly and thinly compressed, giving the mien of some overheating at the time. As of 2024, with a glut of supply in recent years leading to rising vacancy levels, our concerns seem to have materialised.

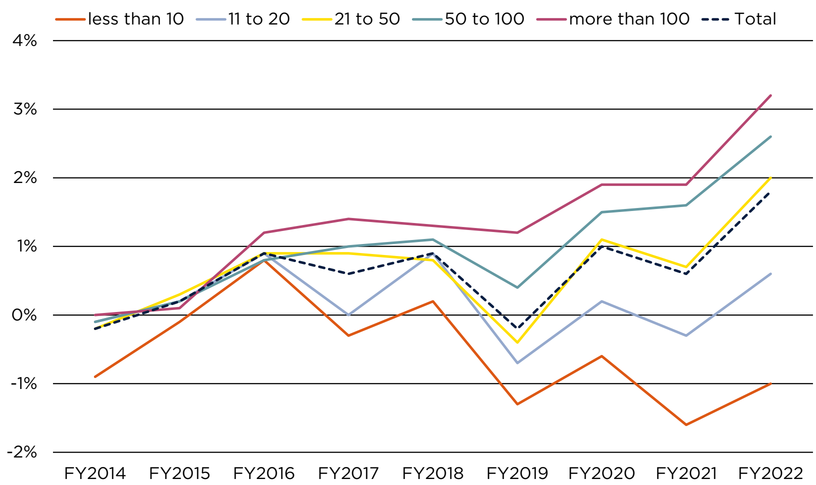
Observing the logistics market in mid-2024, it appears that some caution might have indeed been warranted. Voluminous

Graph 8: Average Construction Cost for RC Logistics Facilities in Japan per Tsubo, 2011 to 2023



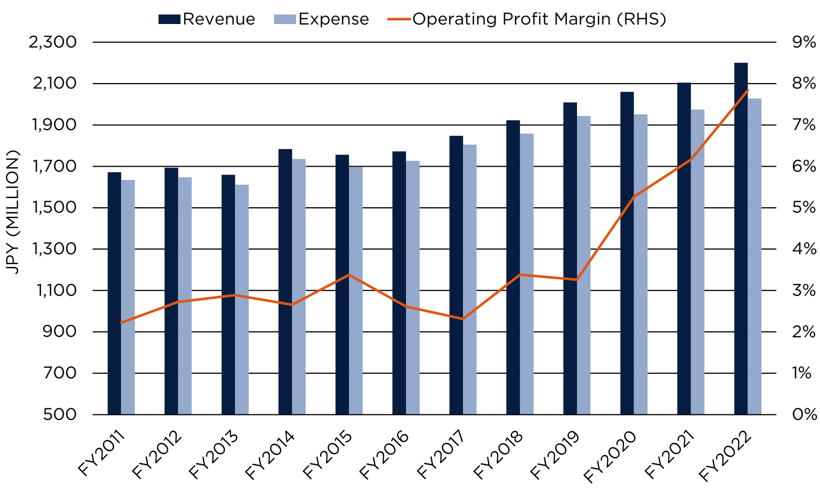
Source MLIT, Savills Research & Consultancy

Graph 9: Trucking Company Ordinary Profit Margin by Number of Trucks, FY2014 to FY2022



Source Japan Trucking Association, Savills Research & Consultancy

Graph 10: General Warehousing Company Profitability for Storage and Handling, FY2011 to FY2022



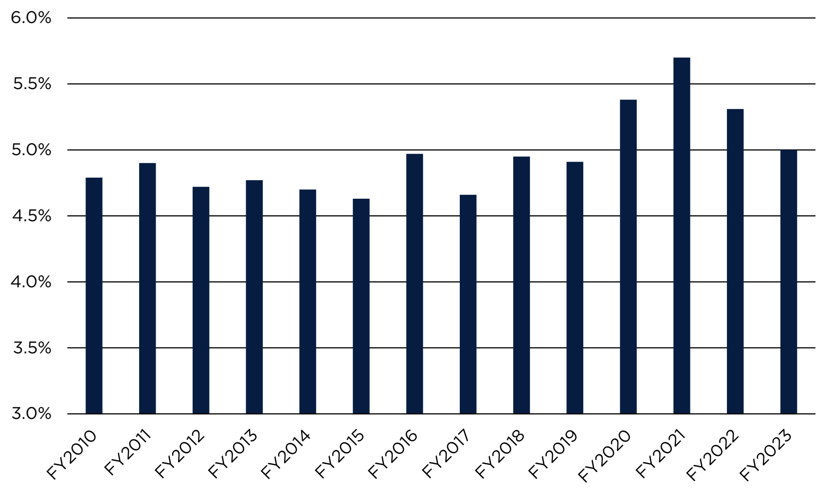
Source MLIT, Savills Research & Consultancy

amounts of supply have been added to the market since 2021, and this is forecast to continue, at least until 2025. This has contributed to the market loosening over the past few years, with vacancies seeing substantial increments. From a capital markets perspective, many players, in particular international ones, appear eager to reduce some exposure to the market, especially with interest rate increments looking to depress net yields. Indeed, in many cases, landlords are caught between a rock and a hard place – increasing rents is tricky because tenants are facing a myriad of challenges elsewhere, with rising labour costs exacerbated by newly introduced labour regulations, and heightened energy prices that have raised operation costs. On the other hand, for facilities with vacant space, discounting rents to attract tenants would also be a bitter pill to swallow, especially for those who entered the market at sharp prices.

That said, the rush to offload logistics assets also seems somewhat drastic. First and foremost, fundamentals of the industry remain strong; the e-commerce sector in Japan has been growing rapidly but still has room for further expansion, and the pandemic has prematurely sated only some demand in advance. Next, although considerable amounts of supply are forecast until 2025, this should decrease significantly beyond 2026. Indeed, construction costs for logistics facilities have seen marked increments, especially over the past few years, and the lead time for construction projects has noticeably lengthened, exacerbated by labour shortages; this has been apparent in other sectors, and is likely worse for the logistics sector as facilities are generally located in more rural areas. Furthermore, land prices even in rural areas have been increasing, although they are admittedly still low. However, when preparation costs are factored in, the total cost of land may not be that small. Given that average rents are in the JPY4,000 per tsubo range, and the elevated construction and land costs, the total yield could be too low to justify continued development. As such, supply beyond 2026 is likely to be limited.

Overall, for the next 18 months or so, current players in the logistics sector should brace for a bumpy ride ahead due to elevated levels of supply and a loosened market. At the same time, the road should gradually smoothen as the market is expected to tighten, and there should be room for potential rental growth once the dust settles. There are also some positive signs, including more trucking companies seeing healthier profit margins (Graph 9). Meanwhile, warehousing companies have seen

Graph 11: Logistics Cost Percentage of Corporate Revenue, FY2010 to FY2023



Source Japan Institute of Logistics Systems, Savills Research & Consultancy

improving levels of operational profitability for storage and handling (Graph 10). In addition, logistics costs do not appear to have increased as a percentage of corporate revenue in the past few years, suggesting that logistics firms could have some leeway to increase pricing (Graph 11). Admittedly, there are also multiple hurdles in the way, including the "2024 problem" which imposes significant limitations on driver working hours, whose repercussions may not have fully surfaced and will need to be monitored closely. Nonetheless, there are multiple potential deals on the market, and this could thus be a favourable point of entry for those that are able to stomach some level of initial vacancy risk.

OUTLOOK

While logistics fundamentals remain strong, various hurdles are impeding the growth of the sector in the near term. Firstly, large supply in recent years significantly loosened the market. This has been exacerbated by challenges from the broader market environment, such as heightened global uncertainty and Japan's interest rate hikes, which are dampening investors' appetite. The strategic shift from office to logistics facilities over the past few years is cooling off to more sustainable levels. Additionally, some developers have altered their development plans due to increasing construction costs, evidenced by the correction in supply forecast, especially, in 2025 in Osaka, compared to a year ago.

The "2024 problem" has made a significant impact on the logistics industry as long working hours are a norm, particularly for truck drivers in rural areas. This has prompted business owners to devise strategic solutions to address the reduced availability of drivers due to implementation of stricter regulations that were realised in April this year. Interestingly, competing convenience stores FamilyMart and Lawson began partnering on deliveries in the same month the regulations took effect, using the same trucks to deliver frozen food in Tohoku regions. Additionally, as transporting goods over long distances becomes more challenging due to shorter driver hours, regional cities, particularly those that are situated between major urban cities, are emerging as key relay hubs. Consequently, logistics facilities in regional areas such as Okayama and Shizuoka are likely to gain renewed attention. As the "2024 problem" continues to unfold, the logistics industry will also evolve, with emerging innovative solutions and a growing demand for logistics facilities in strategic regions to enhance supply chain efficiency and overcome truck driver shortages.

Despite the prevalence of short-term challenges, the outlook of Japan's logistics sector remains positive from a longer-term perspective. E-commerce during the pandemic seems to have satisfied some demand in advance, but the e-commerce penetration rate in Japan is still relatively low. Given the ageing population, demand is expected to increase steadily. Overall, the logistics sector is in the midst of an adaptation phase to address short-term challenges, though the longer-term outlook remains bright, supported by growing demand from various industries such as e-commerce, retail, wholesale, and manufacturing.

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