Japan - September 2020

SPOTLIGHT
Savills Research

Japan Logistics

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Logistics sector reigns supreme

Summary

- Despite supply continuing to grow in Greater Tokyo, thanks to solid pre-leasing activity and substantial demand, vacancy rates have dropped to a historic low of 0.4%.
- The vacancy rate in Greater Osaka experienced a slight uptick following the completion of the huge ESR Amagasaki Distribution Center. Even so, a recent stabilisation of market fundamentals should mean that this trend is fleeting.
- Given the airtight conditions, rental growth in Greater Tokyo was close to 7% over the year. Facilities along the bay still attract the highest rents and this is unlikely to change going forward.
- Rents in Greater Osaka experienced historical growth of over 10% YoY, and now surpass the highs set before the financial crisis.
- Competition for assets has become even more fierce, leading to valuations appearing more stretched, including in the J-REIT market.
- Facilities in subsectors such as those catering for last-mile delivery services and cold storage capabilities have garnered further attention of late. Even so, these remain a small segment within the broader market.

INTRODUCTION

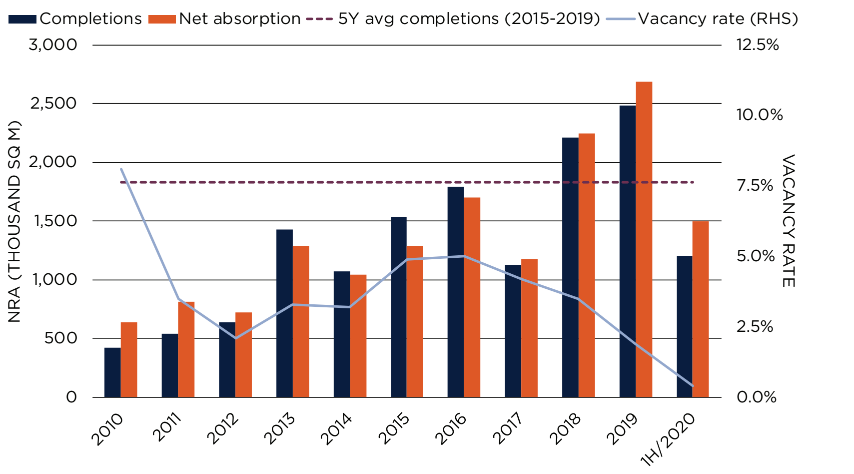
Even amid a global pandemic, the logistics sector appears to be in good shape. Indeed, with demand supported by the proliferation of e-commerce during the outbreak, the sizeable supply expected over the next few years has done little to deter the market. Yet, whilst some turbulence could emerge over the short-term as the financial resilience of some tenants starts to be tested, the long-term prospects of the sector continue to be driven by the structural changes that e-commerce presents, and as such, rents should follow suit.

MARKET TRENDS

Having achieved the milestone of posting the lowest level of vacancy on record in Q1/2020, the Greater Tokyo market repeated the trick in Q2/2020. Specifically, the vacancy rate stands at an even lower 0.4% following a 2.9 percentage points (ppts) tightening year-on-year (YoY).

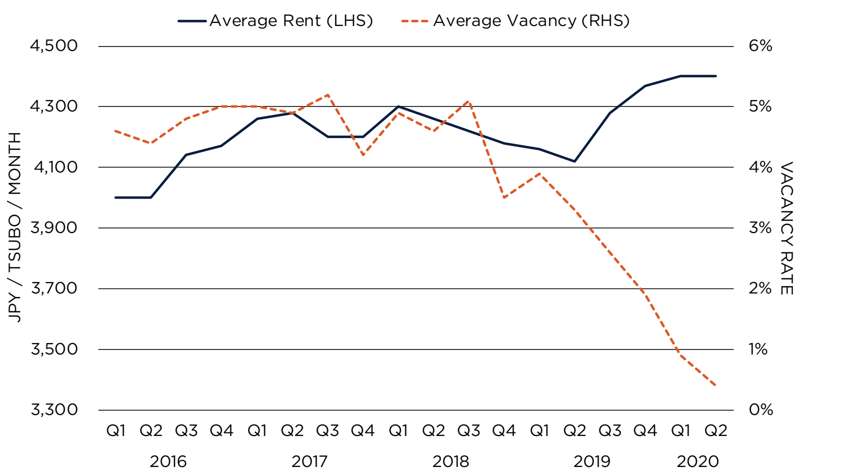
Pre-leasing activity remains sound, all things considered, with over 80% of new facilities fully occupied upon completion in 1H/2020. Demand for existing facilities was also strong. In fact, whilst the total leasable area has continued to expand, much of this

Graph 1: Supply, Take-up And Vacancy In Greater Tokyo, 2010 to 1H/2020



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/2020 is as of July 2020.

Graph 2: Greater Tokyo Rent Vs Vacancy, Q1/2016 to Q2/2020



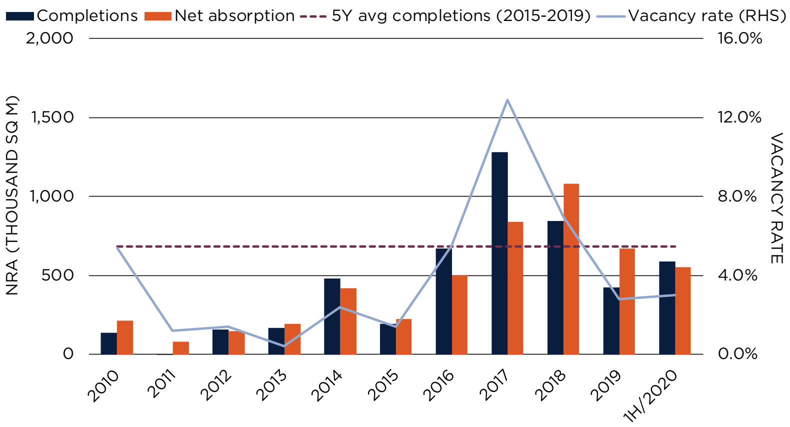
Source Ichigo Real Estate Service, Savills Research and Consultancy
Note: Annual periods from February to January.

tightening in vacancy can be attributed to the continued absorption of supply, which has been positive every year since 2017 (Graph 1). This period, for instance, saw net absorption total almost 1.5 million sq m – the most in any half-year period in recent history.

Supported by these tight market conditions, rents grew by 6.8% YoY to JPY4,400 per tsubo. Whilst they remained unchanged over the quarter, annual growth was at the highest level in three years. When looking at the submarkets in more detail, the Tokyo Bay area remains the most expensive by some way. Whilst the scarcity of modern large-scale facilities plays an important role in this trend, rents appear to have found a limit, however. Nonetheless, rental prospects for this submarket remain optimistic. Elsewhere, locations defined by their access to the city centre and proximity to transport links, such as the Gaikan Expressway, continue to attract demand. Rents have duly responded, demonstrating solid

The global pandemic has reinforced the importance of e-commerce to everyday life, and the logistics sector has been a prime beneficiary of this trend. As such, market fundamentals appear sound. Whilst the uncertainties surrounding COVID-19 could cause some unrest going forward, the sector continues to be underpinned by structural changes driven by e-commerce. In the meantime, valuations are likely to continue to be put under pressure.

Graph 3: Supply, Take-up And Vacancy In Greater Osaka, 2010 to 1H/2020



Source Ichigo Real Estate Service, Savills Research and Consultancy
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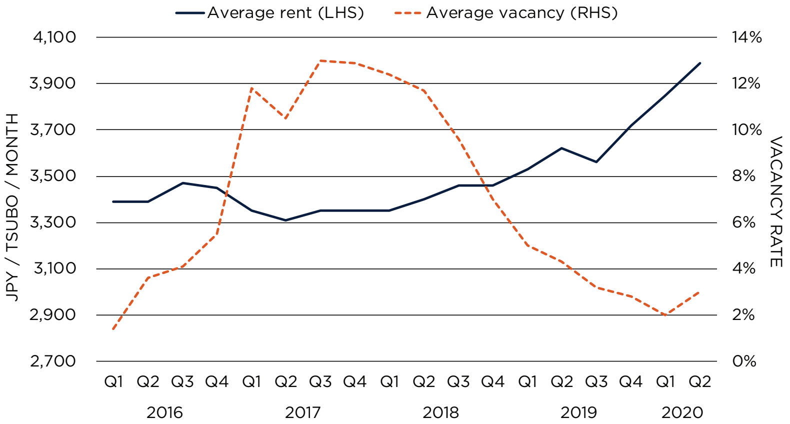
Graph 4: Greater Osaka Rent Vs Vacancy, Q1/2016 to Q2/2020



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

growth recently. This has been particularly evident in Saitama Prefecture, for instance, where rents have reportedly surpassed the JPY4,000 per tsubo mark for the first time in over a decade.

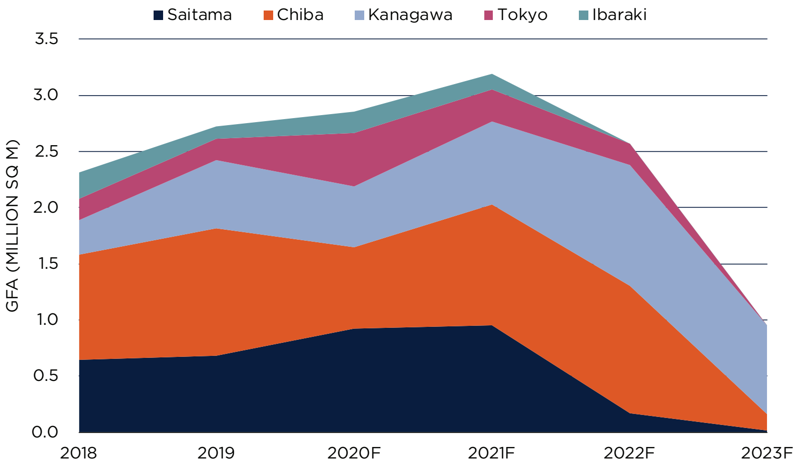
Vacancy rates in Greater Osaka have recovered remarkably since Q3/2017. To wit, the vacancy rate currently stands at 3.0% – a 10ppts decline over the period and a 1.3ppts contraction YoY. More recently in 1H/2020, despite six of the seven projects completed being fully occupied, completions have exceeded net absorption – for the first time since 2017 – and the vacancy rate has slightly increased as a result. Indeed, this change is attributed to some vacancy in the newly completed ESR Amagasaki Distribution Center. Even so, with leasing activity ongoing this uptick should be temporary.

Unlike its Greater Tokyo counterpart, rents in this region have surpassed pre-2009 highs. Specifically, they lie at JPY3,990 per tsubo on the back of a historical 10.2% YoY surge. What's more, following nine consecutive quarters of annual growth, rents in Greater Osaka are only around 9% below rents in the capital. The spread was as wide as 22% only two years ago, further emphasising the recent improvement in market conditions.

The momentum in rental growth observed in both regions is encouraging. That said, tenants in the thriving e-commerce sector represent a part of the overall pool. Indeed, some tenants in other constituent industries such as the apparel and manufacturing sectors continue to suffer. Thus, while rents are expected to continue upward, it is not a foregone conclusion.

Looking further ahead, when determining rental growth prospects, it is important to consider how the benefits created by the

Graph 5: Annual New Supply* In Greater Tokyo By Prefecture, 2018 to 2023F



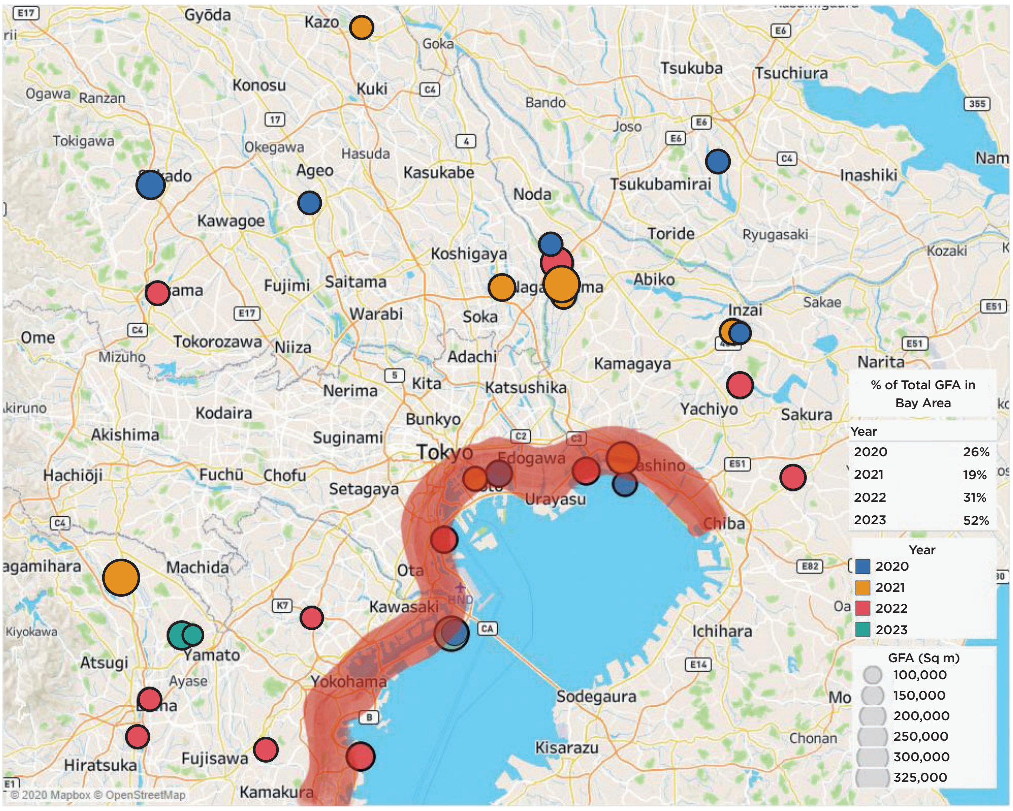
Source Ichigo Real Estate Service, Savills Research and Consultancy
*Projects in 2022 and beyond tend to be added once details are ready to be announced. The data provided by Ichigo only considers facilities with GFAs > 10,000 sq m and is as of 31 August 2020.

structural changes from e-commerce interact with the ongoing issues caused by a national labour shortage. Indeed, notwithstanding the easing concerns over the latter for now, worries are likely to resurface before long.

INCOMING SUPPLY

In terms of new supply in Greater Tokyo, 1H/2020 appears to have carried on where 2019 left off. Among the many completions, multiple were of significant scale (exceeding 100,000 sq m), with the largest of the group being DPL Sakado. Completed in March this year, the huge 4F multi-tenant facility, based in Saitama Prefecture, has an NRA of over 150,000 sq m and is said to have capacity to house up to 24 tenants. For Daiwa House, the developer of this project, 2020 is predicted to be a packed schedule. They have a total of six facilities planned, with an aggregate GFA of almost 500,000 sq m spread across Greater Tokyo. Meanwhile, in an attempt to capitalise on the growth in online shopping, Amazon has also announced the opening of

Map 1: Upcoming Completions in Greater Tokyo with Leasable Area > 100,000 Sq m, 2020 to 2023*



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 August 2020. The % of GFA calculation includes projects that are <100,000 sq m.

four new logistics facilities by October 2020 with a total GFA of 350,000 sq m. As a result, the level of supply expected to be added this year will likely exceed 2019, with Saitama Prefecture accounting for the highest proportion (Graph 5).

When looking at areas of most potential, bay-side locations continue to top the list. For instance, according to a bi-annual survey[1] of industrial market players compiled in August 2020, respondents, when asked this question, saw the most upside in Tokyo Bay, Kanagawa Bay and Chiba Bay, in that order. It is no surprise that developers also share this view and this is evident when looking at the line-up of projects leading up to 2023 (Map 1 in Red).

Even so, an indication of market instability in Greater Tokyo, if any, is likely to manifest next year, especially considering the levels of supply predicted in 2021 and beyond. In 2021 alone, for instance, nine projects of significant scale have already been announced, with two of them over 300,000 sq m in GFA. In a pre-COVID-19 world, this marked upswing in supply would not have been a large concern, with demand more than able to compensate. Yet, without a clear idea of a post-COVID-19 world and economy, the reaction to this supply over the next few years remains somewhat murkier. As such, the health of the market next year will certainly be a harbinger for what is to come thereafter, especially considering that the spectre of a national labour shortage continues to linger.

1 This relates to the 26th bi-annual survey of industrial market players (81 respondents), conducted by Ichigo Real Estate Service.

In Greater Osaka, whilst the market instability experienced in 2017 remains fresh in memory, there is the sense that it is slowly returning to normal. As such, with the underlying fundamentals in better shape this time around, the upcoming pipeline should be viewed more favourably. Indeed, completions in 1H/2020 have already outpaced the whole of 2019, with much of this attributed to the completion of ESR Amagasaki Distribution Center (discussed further below). As for the rest of this year, with the main bulk of supply already completed, it should be relatively quieter.

Based on projects where the completion date and the GFA have been confirmed, the level of supply anticipated in Greater Osaka during 2021 will be significant. Indeed, the amount witnessed in 2017 could be matched, or even surpassed, especially when considering that over a quarter of the planned facilities have GFAs greater than 100,000 sq m, with Prologis Park Inagawa 1 being chief among them. Developed by Prologis and set to be completed in November 2021, plans call for the huge 6F facility in Hyogo prefecture to have a GFA of nearly 220,000 sq m. Whilst the marked uptick in projects is a vote of confidence for the region, and a sign that market fundamentals have become more robust, careful consideration is necessary to avoid a repeat of 2017.

INVESTMENT TRENDS

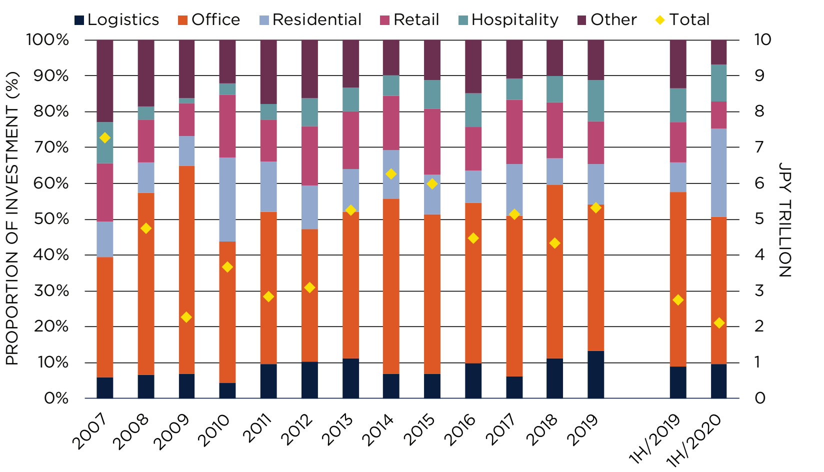
Whilst the logistics sector has been one of the few in-vogue sectors during this global pandemic, investment flows across the nation in 1H/2020 declined compared to the same period last year. According to data provided by Real Capital Analytics (RCA), inflows this time around amounted to just over JPY200 billion – a near 20% YoY drop. This is unsurprising on two fronts. First, the decline is credited to the elevated levels of investment that took place last year, rather than a worsening of investor sentiment this year. Second, international travel bans continue to play havoc for overseas investors hoping to conduct due diligence. That said, 1H/2020 remains on par with the average 1H investment volume over the past decade.

Still, examples of big-ticket item transactions were observed in 1H/2020, including Prologis REIT's acquisition of three logistics facilities in February for JPY59.3 billion. Meanwhile, GLP's establishment of a JPY280 billion private fund specialising in logistics facilities also signals a strong investment pipeline ahead. Indeed, the logistics sector should be able to maintain its appeal for investors over the remaining months of 2020, especially considering the contrasting prospects for the sectors most impacted by COVID-19.

Whilst funds continue to flow into the sector, the aforementioned bi-annual survey appears to temper some of this optimism, at least over the next six months (Graph 7). In the previous questionnaire six months ago, for example, with the extent of the global pandemic yet to be fully understood, market sentiment towards both capital values and rents hit four-year highs. As the crisis has developed, however, market participants have understandably downgraded their views.

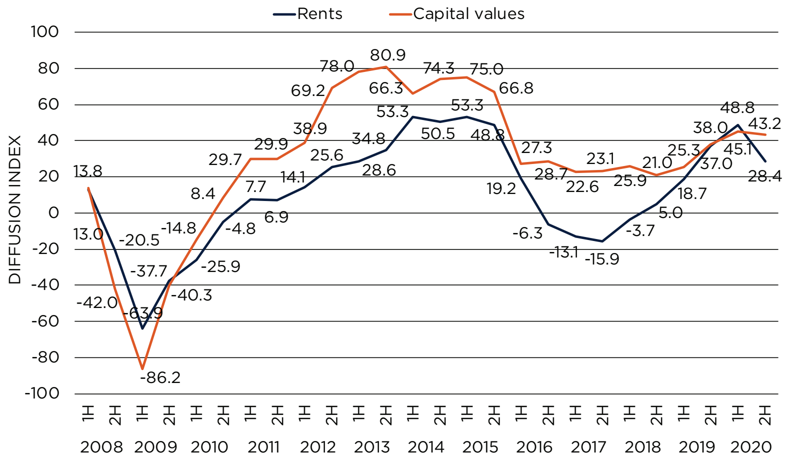
Driven by the economic difficulties facing tenants and the subsequent weakening of demand, as well as the health of the Japanese economy in general following the onset of COVID-19, the prospects for rents saw the greatest deterioration as shown by the index falling by almost 20 points to 28.4. As for capital values, despite a slight drop in market sentiment, the proportion of respondents who believe that values will appreciate during the next six months has marginally risen this period, with the increased attention the sector has been receiving from investors cited as the main factor.

Graph 6: Share of Investment Volumes By Asset Class, 2007 to 1H/2020



Source RCA, Savills Research and Consultancy

GRAPH 7: Six-month-ahead Expectations For Rent And Capital Appreciation, 2008 to 2020



Source Ichigo Real Estate Service, Savills Research and Consultancy

Table 1: Selected Investments, Announced February 2020 to July 2020

PROPERTY NAME	TRANSACTION VALUE (JPY MIL)	APPRAISAL DIRECT CAP RATE	BUYER	SELLER
Prologis Logisitics Portfolio (3 Facilities)	59,300	4.3% to 4.6%	Nippon Prologis REIT	Various SPCs of Prologis
Daiwa House Logisitics Portfolio (4 Facilities)	55,000	n/a	Blackstone Group	Daiwa House Industry
Logistics Portfolio (4 Facilities)	38,400	3.7% to 4.3%	GLP J-REIT	Various
DPL Nagareyama I	32,600	4.3%	Daiwa House REIT	Nagareyama Kyodo Kaihatsu (subsidiary of Daiwa House Industry)
CRE Logisitics Portfolio (3 Facilities)	17,910	4.4% to 5.4%	CRE Logistics REIT	CRE

Source J-REIT Disclosures, Company Disclosures, Nikkei RE, Savills Research and Consultancy

Table 2: Largest Logistics Facilities In Greater Osaka, As Of August 2020

FACILITY NAME	DEVELOPER	PREFECTURE	YEAR	GFA (SQ M)
ESR Amagasaki Distribution Center	ESR	Hyogo	2020	390,000
Logiport Amagasaki	LaSalle Investment Management	Hyogo	2009	259,000
MFLP Ibaraki	Mitsui Fudosan	Osaka	2017	242,000
Redwood Fujiidera Distribution Center	ESR	Osaka	2017	178,000
GLP Suita	GLP	Osaka	2017	165,000
Prologis Park Ibaraki	Nippon Prologis REIT (Prologis)	Osaka	2016	161,000
Redwood Nankou Distribution Center	ESR	Osaka	2018	158,000

Source Ichigo Real Estate Service, Savills Research and Consultancy

NEW OPPORTUNITIES ON THE HORIZON

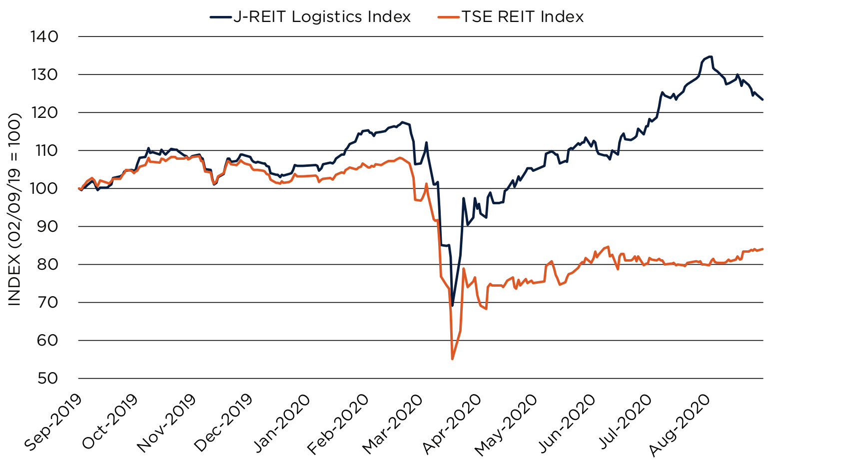
Given its sheer scale, the ESR Amagasaki Distribution Center is hard to ignore. Completed in June this year and costing around JPY90 billion, the mammoth facility, located in Hyogo Prefecture, has a GFA of almost 390,000 sq m (Table 2). As such, it is now the largest logistics facility in Japan. Despite its size, the property's location – alongside a major expressway, national ports, international airports and within reach to Osaka's CBD – has attracted strong demand, with around 70% leased. Indeed, this indicates that demand for high-quality facilities such as this appears sound, even during these difficult times.

Developers are not the only ones being active, however. Investors are also becoming lured by the potential returns to be made from the logistics sector, creating fierce competition for assets. As well as the usual suspects, namely the J-REITs, deep-pocketed private equity firms have also entered the fray. Blackstone Group's JPY55 billion acquisition of Daiwa House Industry's logistics portfolio in July, for instance, is case in point. Elsewhere, there is an expectation that sale and leaseback arrangements will further popularise with retailers such as Fast Retailing and Aeon. Apparel and supermarket companies, such as these, have been late to integrate e-commerce into their business strategies and are now playing catch up. With plans to expand their online presence, they may subsequently choose to offload some logistics facilities to increase capital efficiency.

Yet, for those unable to get direct exposure to the sector, the J-REIT market has also proved fruitful. Specifically, over the year ending August 2020, logistics focused J-REITs returned close to 25% compared to a fall of 15% for the TSE J-REIT index. Year-to-date, meanwhile, the spread between these two stands at around 35%. Ultimately, therefore, valuations have started to appear more stretched.

Amid this heightened competition, some developers have turned to other subsectors that may further take advantage of the rise in e-commerce. For example, as part of its "Prologis Urban" series, Prologis has announced three new fulfilment centres within Tokyo City that cater to the growing last-mile delivery market. All three projects are expected to be completed by 2021 and the largest is the 26,000 sq m GFA facility in Shinagawa. Moreover, this fledgling trend could gain further traction as locations currently occupied by sectors under significant stress, like retail, may cede space for such facilities going forward. In truth, however, the scale of this nascent sector remains insignificant compared to

GRAPH 8: J-REIT Annual Performance, September 2019 to August 2020



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy
*The J-REIT Logistics index is equally weighted between the eight main logistics focused J-REITs. The SOSiLA Logistics REIT has been excluded due to insufficient data.

the broader market and, as such, investors in general are unlikely to be enticed until it reaches critical mass.

Meanwhile, facilities that satisfy the need for cold storage have also seen more demand, especially in concert with the rise in online grocery shopping. That said, this subsector is likely to remain niche for now given the difficulties facing investors when exiting positions. Specifically, REITs, who would often be the first port of call at such a time, are likely to find the high capex required for these types of facilities unappealing.

OUTLOOK

Despite being in the midst of a global pandemic, the logistics sector is in an envious position. Buoyed by the increasing importance of e-commerce in daily life, the wind is very much in the sector's sails. Indeed, 2020 has essentially been a continuation of the year before, with both rental growth and vacancy rates continuing to move in a positive direction.

In an economic environment starved of yield, more and more players with deep pockets have entered the market. Thus, competition for logistics assets has unsurprisingly become fierce. At the same time, for those unable to access direct investments, the equity capital markets have provided some opportunities. Whilst all this attention towards the sector is welcome, it has also led to valuations becoming more stretched.

Broadly speaking, though the logistics sector has fared well thus far, it is unlikely to make it through the pandemic completely unscathed. Despite the optimism surrounding the solid pre-leasing activity for the upcoming pipeline of significant supply, COVID-19 continues to weigh on some tenants, especially those in hard-hit industries such as apparel and manufacturing, as well as overall economic conditions. That said, the prospects for the sector for the rest of the year are unlikely to change. Instead, the true impact of COVID-19 on the logistics sector may emerge next year.

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For more information about this report, please contact us

Savills Japan

Christian Mancini
CEO, Asia Pacific
(Ex. Greater China)
+81 3 6777 5150
cmancini@savills.co.jp

Savills Research

Tetsuya Kaneko
Director, Head of Research & Consultancy, Japan
+81 3 6777 5192
tkaneko@savills.co.jp

Simon Smith
Senior Director
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk