

October 2009

## Japan Real Estate Third Quarter 2009

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### Summary

Japan's economy has been in contraction since October 2007 but it started to show some signs of recovery in the first half of 2009 due in part to stimulus spending and inventory corrections. We anticipate, however, that the recovery in 2010 could be very weak as stimulus spending winds down amid high unemployment, record consumer price deflation, and an unfavourable exchange rate for Japanese exporters. With this economic environment as the backdrop, dramatic political changes have unfolded as well, with the opposition Democratic Party of Japan taking the reins of power in September 2009 from the long-ruling Liberal Democratic Party.

This quarterly review of Japan's property markets begins with the 'Third Quarter Market Outlook 2009'. This section explains the latest fundamentals of each property sector with particular focus on the tight finance market, declining transaction volumes, widening cap rates, declining returns, and deteriorating leasing markets. It also provides a short-term outlook for each of the major property sectors.

The 'Research Topic' section explores a real estate-related issue in detail each quarter, focusing on relevant subjects that are either under-reported or not well understood outside of Japan. The topic this quarter is "History Repeats Itself?" and it compares the current downturn in Tokyo's office market with the previous supply-driven downturn which is referred to in Japan as the "Year 2003 Problem". We compare and contrast patterns in vacancies, rents, and transactions across both cycles to illustrate how the Tokyo office market is currently positioned within a historical context. There are, indeed, cursory similarities but it is the underlying differences that matter most. We conclude this cycle could ultimately differ from the previous one in duration.

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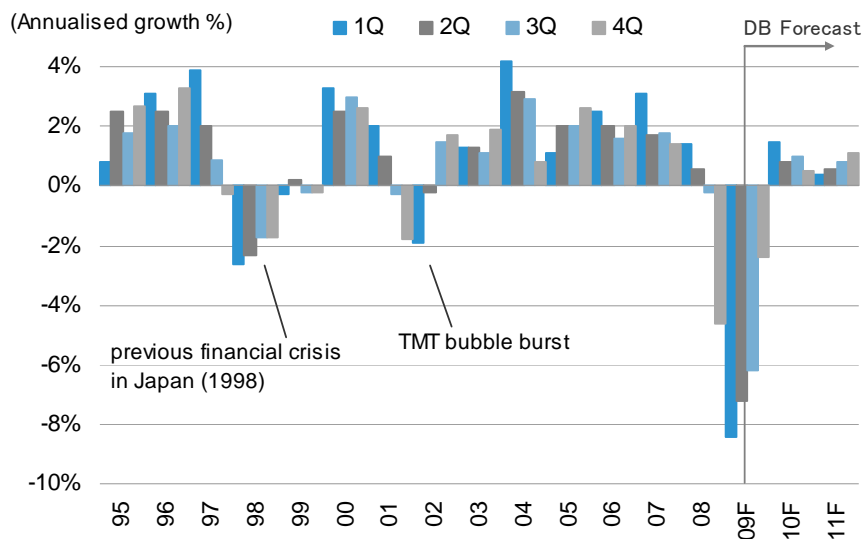
## Third Quarter 2009 Market Outlook

### Macro Economy

The unprecedented steep decline in economic activity in Japan has begun to ease. Deutsche Bank economists revised upward Japan's GDP growth forecast, with 2009 now expected to post a contraction of 6% compared to the previous forecast of 8% in the Japan Real Estate Second Quarter 2009 publication. Although the growth rate was negative in second quarter 2009 on a year on year basis (Exhibit 1), GDP actually posted 2.3% growth on a quarter on quarter basis. The signs of recovery arose due to the contribution of public spending, the increase in external demand (exports) and the end of inventory corrections.

Amid this economic uncertainty, Japan's leading opposition party, the Democratic Party of Japan (DPJ), scored a landslide victory over the long-ruling Liberal Democratic Party (LDP) in the general election in August 2009 and formed a new cabinet in September 2009. However, there are still uncertainties for the economy. The ongoing appreciation of the Japanese yen against major currencies is causing negative effects on the export-led economy. Because of the high level of unemployment and the expected end of the stimulus effect on private consumption and public investment, a plateau in economic activity is predicted with less than 1% p.a. growth expected from second quarter to fourth quarter 2010.

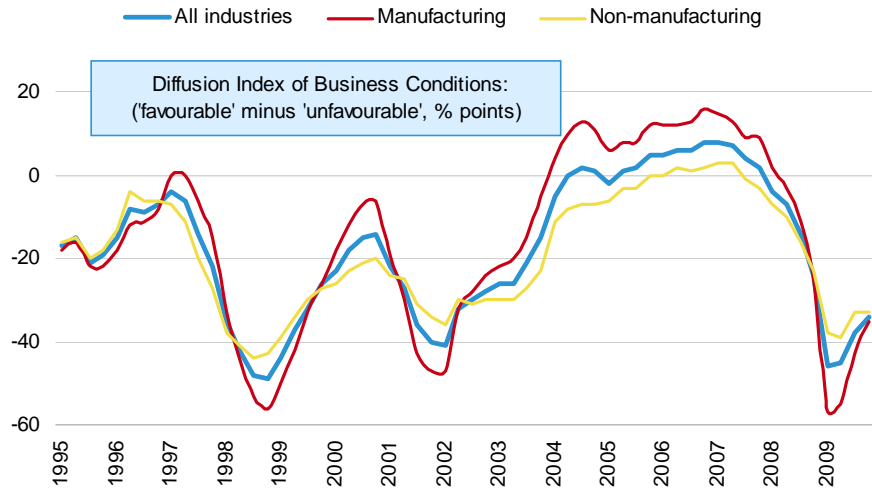
**Exhibit 1: GDP growth outlook for Japan**



Source: Deutsche Bank, October 2009 (F = forecast by Deutsche Bank economists; TMT = technology, media, and telecommunications)

The Tankan Survey conducted by the Bank of Japan confirms the trend of gradual improvement, albeit from a very low absolute level. The diffusion index (DI) of business conditions for all industries rose 7 points from negative 45 in second quarter 2009 to negative 38 in third quarter 2009 with the outlook for fourth quarter 2009 at negative 34. Manufacturers show an even clearer outlook for improvement because of the end of steep inventory corrections and an increase in demand in foreign economies. The DI for manufacturing climbed from negative 55 in second quarter 2009 to negative 43 in third quarter and the outlook for fourth quarter 2009 is negative 35, indicating 20 points of improvement in two quarters.

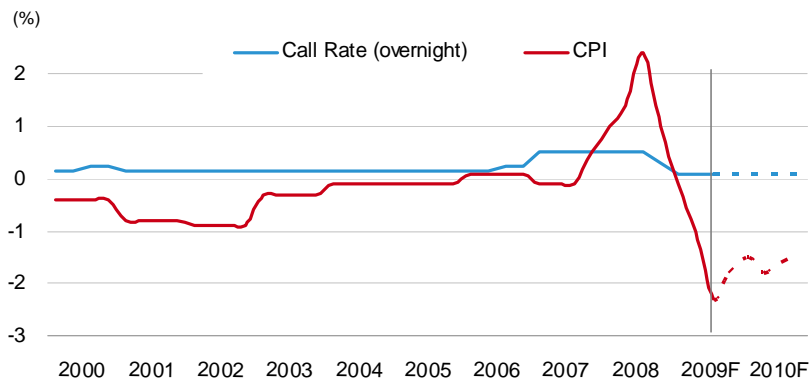
**Exhibit 2: Tankan Survey: Diffusion index of business conditions**



Source: The Bank of Japan, October 2009

Japan's CPI is falling rapidly on a year over year basis. Consumer prices fell by 2.4% for August 2009, Japan's worst deflation rate on record. This sudden worsening can be attributed to lower energy prices as a result of mandated reductions in electricity fees (which are indexed to fuel price levels) as well as lower gasoline prices and falling food prices. While much of this deflationary trend is a negative payback after the surge in international commodity prices last year, stagnant domestic demand and the declining household income are also playing key roles in pushing down prices. Deutsche Bank economists do not expect any further interest rate cuts in 2009.

**Exhibit 3: Forecast of short-term interest rate and CPI**

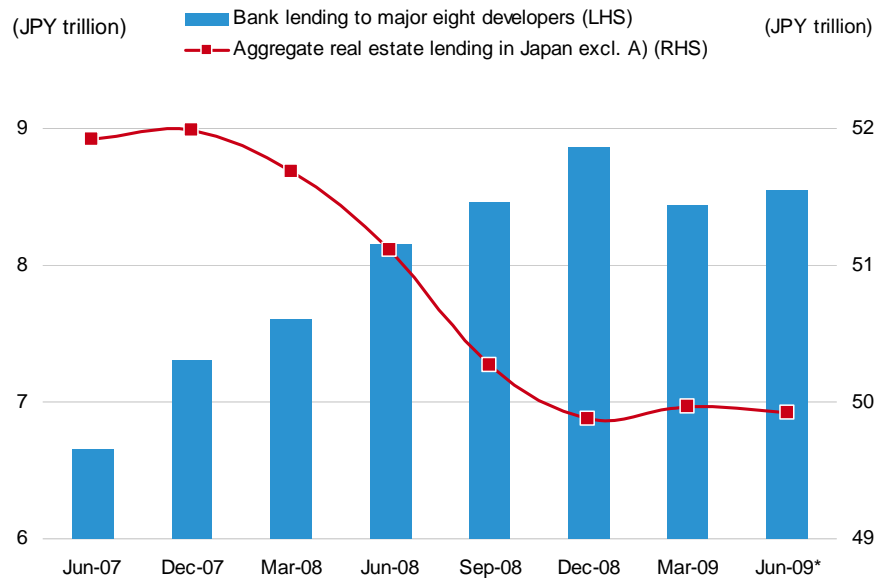


Source: Deutsche Bank, October 2009 (F = forecast by Deutsche Bank economists)

## Capital Market and Pricing

The credit market is still tight in Japan, but the bank lending to the real estate sector indicates signs of modest loosening. Stock prices have recently recovered, and major banks (which need to meet terms of the Basel II Accords) are now gradually easing credit compared to the beginning of 2009. Japan's eight major developers<sup>1</sup> increased their bank borrowing by JPY0.2 trillion (tn) in second quarter 2009 while the aggregate bank lending to all the other developers and managers seems to have declined only marginally by JPY0.1 tn in the same period according to RREEF Research estimates. Even though the equity value can be negative in most of the cases, banks tend to extend the terms of existing loans and do not choose to trigger the events of defaults at maturity. Similarly the number of bankruptcies has levelled off – at least for a while – and there have been no reported bankruptcies among listed real estate companies in Japan since June 2009, compared to 12 bankruptcies reported in the first five months to May 2009. However, new money borrowings are still limited to very selective transactions in central Tokyo.

**Exhibit 4: Real estate lending by Japanese banks**

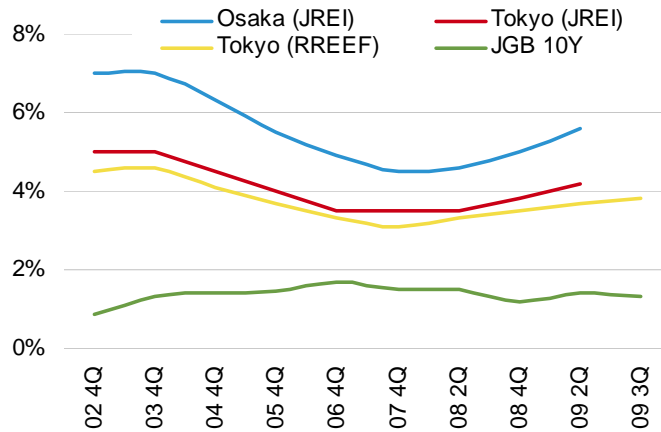


Source: RREEF Research, The Bank of Japan, Annual Reports, October 2009

According to the Japan Real Estate Institute (JREI), cap rates for prime offices in CBD Tokyo (i.e. the Marunouchi Otemachi area) rose by 40 basis points (bp) from October 2008 to 4.2% in the first half of 2009. In Osaka, cap rates rose by 60bp over the same period to 5.6%. We expect cap rates to widen slightly more in 2009 because of the lacklustre economy.

<sup>1</sup> The eight major developers in Japan include Mitsubishi Estate, Mitsui Fudosan, Sumitomo Realty & Development, Tokyu Land, Tokyo Tatemono, Nomura Real Estate Development, Mori Building, and Mori Trust.

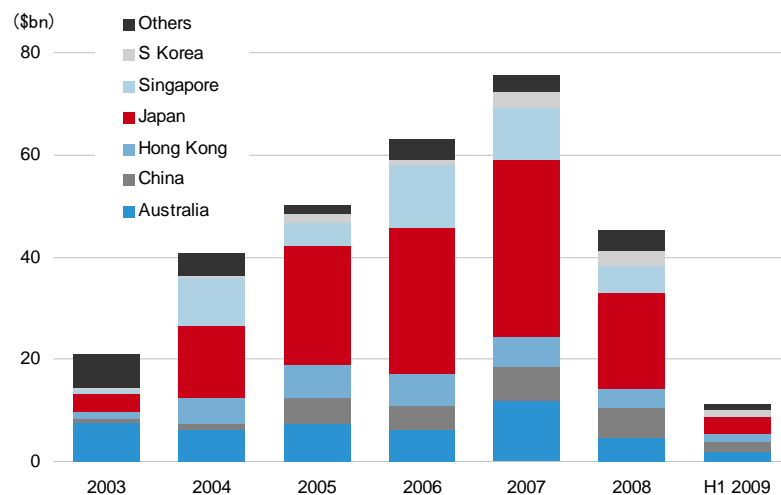
**Exhibit 5: Cap rates and government bond rate**



Source: RREEF Research, JREI, Deutsche Bank Global Markets, October 2009

Amid the stagnant sentiment prevailing in global real estate investment, the Asia Pacific region is hardly an exception. The volume of identified commercial real estate transactions<sup>2</sup> in the region in the first half of 2009 was about US\$11 billion, only about a quarter of the overall volume of 2008. Within the region, Japan is still the largest investment destination with a share of about 30%, but most of the purchasers are domestic corporate and individual investors while real estate funds (including foreign funds) and J-REITs have been quiet. The number of distressed sales has been very few so far, partly because the lenders eased credit conditions and extended the terms of existing loans at maturity.

**Exhibit 6: Real estate transaction volume in major APAC countries**

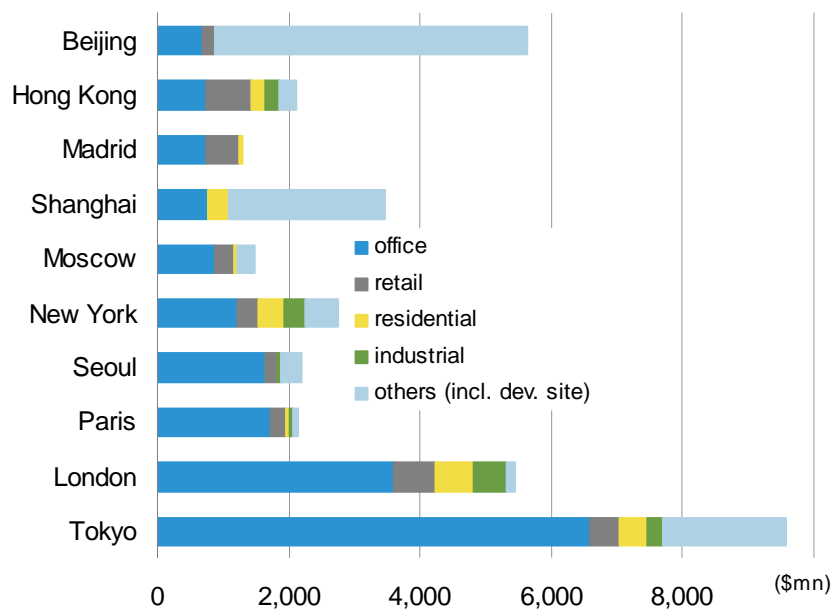


Source: JLL, RREEF Research, October 2009

<sup>2</sup> The volume of transaction in Exhibit 6 only includes identified deals by RREEF Research and does not include non income producing assets (such as development site transactions).

Despite this weak market, Tokyo maintained top global ranking<sup>3</sup> in terms of the volume of office transactions and also overall real estate transactions closed during the first half of 2009, ahead of its rival Western and Asian cities. The relatively healthy banking system in Japan, the replacement of foreign capital with domestic capital and the greater drop in transactional levels elsewhere helped maintain Tokyo's top spot, and it proved the size of the market and the depth of the investor base for real estate assets in the city. However, real estate prices have corrected faster in some other markets such as London, and major Chinese cities are expanding newly created large development-rights deals, so the rank could change in the second half.

**Exhibit 7: Real estate transaction volumes by city and by type in first half 2009**

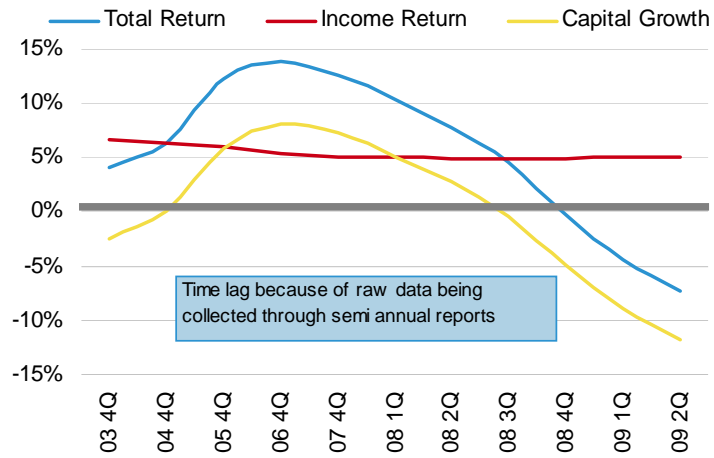


Source: Real Capital Analytics, RREEF Research

Based on IPD, Japan's monthly indicator, the average annual total return for direct real estate investment (unlevered basis) in Japan peaked at 13.8% in 2006 and has since been pulled downward in line with a steep decline in capital value. With 12-month rolling capital growth falling to negative 11.1% in May 2009, the rate of total return was squeezed to negative 6.5% (preliminary), and there is still no sign of levelling off. Given the continuous deterioration in capital values and the weakness in the rental market, returns are likely to decline further in the short to medium term.

<sup>3</sup> Tokyo ranked first globally in office transaction volume in 2008. See Japan Quarterly First Quarter 2009, "Tokyo Office Market in its Global Context".

**Exhibit 8: Return of unlevered direct investment (all types of property)**

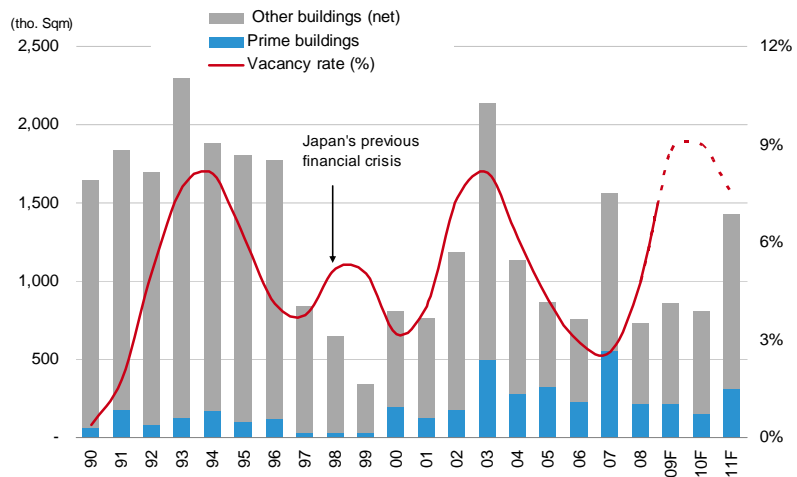


Source: RREEF Research based on IPD Japan Monthly Indicator, October 2009

**Market Fundamentals: Office**

Because of the rapid deterioration of the economy in the first half of 2009, the office vacancy rate in Central Tokyo<sup>4</sup> increased very rapidly during the period but the sharp deterioration seemed to be slowing in third quarter 2009. At the end of September 2009 the office vacancy rate in Central Tokyo was 7.6%, a significant increase from 2.7% at the end of 2007. This is the highest level in the last six years but almost the same level as the previous two months (July and August 2009). We expect the average office vacancy rate to exceed the level of the previous peak in 2003 in this downturn cycle, with the new peak occurring in 2010 (also see Research Topic for more details).

**Exhibit 9: Office vacancy rate in Central Tokyo (5 wards)**

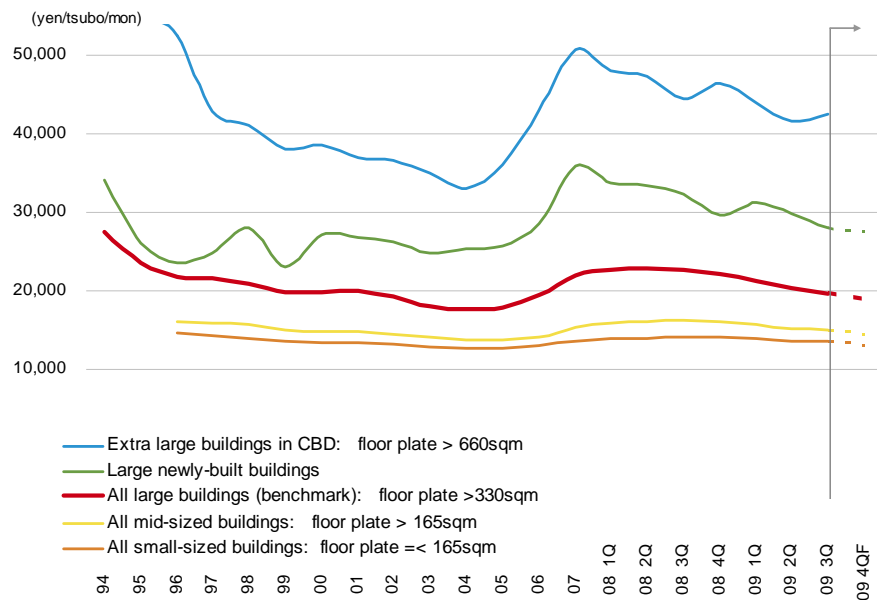


Source: RREEF Research, Miki Shoji, October 2009 (F = forecast by RREEF Research)

<sup>4</sup> Central Tokyo is defined here as the central five wards (or “ku”) of Chiyoda, Chuo, Minato, Shinjuku, and Shibuya.

Following a rapid increase in asking rents in 2007, the uncertainty over the economic outlook has since caused asking rents in Central Tokyo to fall. Average asking rents for extra large buildings in the CBD<sup>5</sup> as well as large-scale newly built offices started to decline in first quarter 2008 and by the end of September 2009 had dropped 16% and 21%, respectively. Average asking rents for all large buildings (i.e. the benchmark) in Central Tokyo started to decline in third quarter 2008 and have dropped 9.7% since. Rents for smaller buildings also started to decline in fourth quarter 2008 albeit at milder paces. While it is asking rents that are reported in public statistics, it is important to differentiate asking and effective rental trends. Tenants tend to receive discounts and/or several months of free rent when signing or renewing rental contracts. Because these incentives are typically negotiated privately, they are not reflected in the statistics, but we can infer that if asking rents are falling, then actual effective rents would be falling even more rapidly. Given the high vacancy rate and the uncertainties in the economy, we don't expect a rental recovery for benchmark buildings before 2011 while the prime assets could recover earlier than the benchmark.

**Exhibit 10: Office asking rents in Central Tokyo by building size**

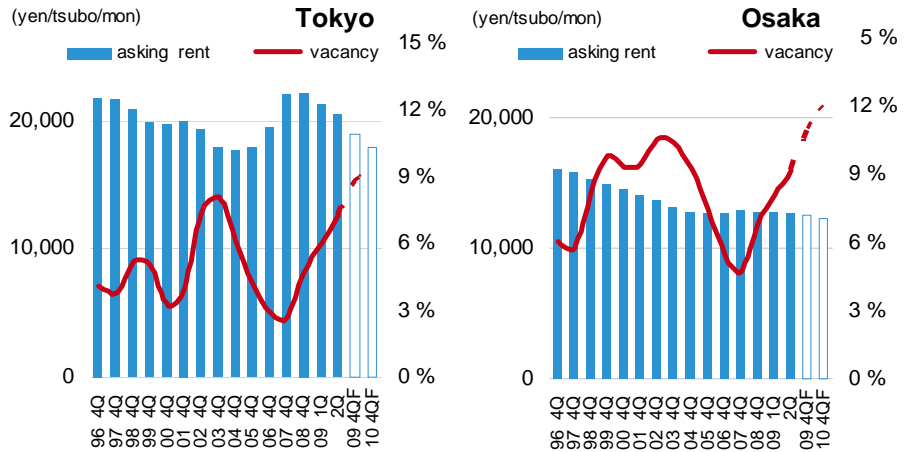


Source: RREEF Research, Miki Shoji, Sanko Estate, October 2009

Unlike the Tokyo market, office rents have not risen substantially in regional cities in the past real estate cycle. Therefore, the downward pressure on rents in Osaka is not as strong as it is in Tokyo. The vacancy rate in Osaka rose to 9.9% in September 2009 from 4.7% in December 2007 while the average asking rent fell only 2.4% during the period. Given the ongoing downward momentum in the economy and multiple large-scale reconstruction projects to be completed in 2011 in the city, the office leasing market in Osaka is expected to remain soft in the short to medium term.

<sup>5</sup> CBD: Marunouchi and Otemachi area near Tokyo Station in Chiyoda-ku.

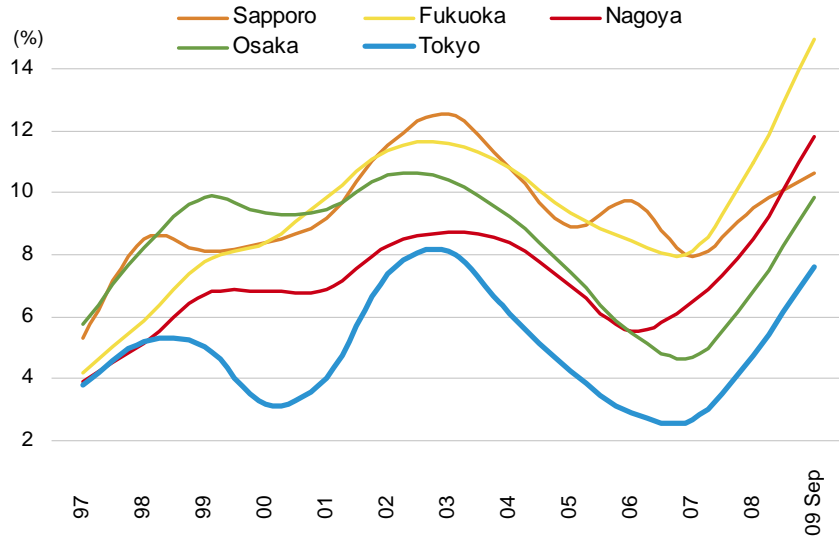
**Exhibit 11: Office rents and vacancies in Tokyo and Osaka**



Source: RREEF Research, Miki Shoji (F = forecast by RREEF Research), October 2009

The vacancy rates in other regional cities are rising even higher, with rates exceeding 10%. In September 2009 the vacancy rate rose to 14.9% in Fukuoka, 10.6% in Sapporo, and 11.8% in Nagoya, compared to 7.6% in Tokyo. In these regional cities, tenants have a greater tendency to avoid buildings developed by burgeoning asset managers or foreign funds, so these buildings tend to have higher vacancy rates than those owned by well-established local companies. Given weakening demand in these regional markets, the vacant space is not likely to be absorbed in the near future.

**Exhibit 12: Office vacancy rates in major cities in Japan (all grades)**

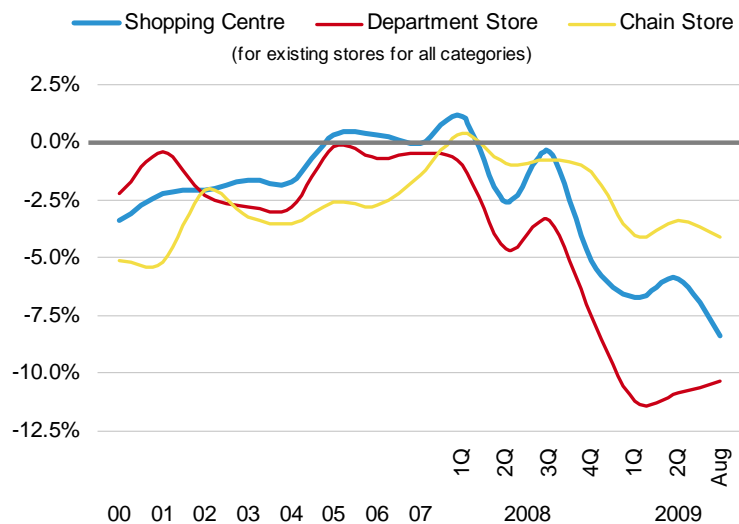


Source: RREEF Research, Miki Shoji, October 2009

## Market Fundamentals: Retail

The economic turmoil and the ongoing job cuts in the past several months have further eroded consumer demand in Japan. Department stores (existing store basis) have been the worst hit subsector. Sales figures of department stores in July and August 2009 continued to disappoint, with same-store sales falling 10.3% from the same period last year, which followed continuous double-digit declines of 11.2% in first quarter and 10.8% in second quarter 2009 on a year over year basis. Sales at shopping centres (existing store basis) also declined 8.4% in July and August from the same period a year ago. Chain stores (existing store basis) seemed to perform relatively better among the three categories with a decline of only 4.1% in the period but this was only because a number of unprofitable stores were closed down, which boosted the sales of the remaining stores.

**Exhibit 13: Retail sales in Japan (year on year % growth)**

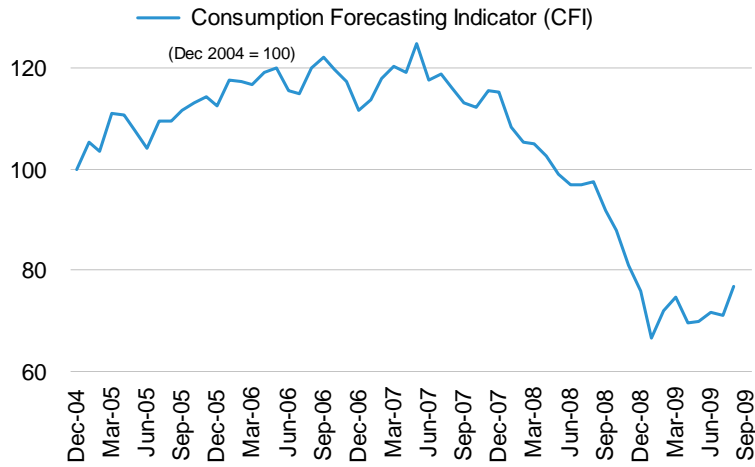


Source: RREEF Research, JCSC, JDSA, JCJA, October 2009

Nikkei RIM's consumption forecasting indicator (CFI)<sup>6</sup>, a survey that predicts future consumption trends six months in advance, shows signs of levelling off, although the absolute level is still very weak. In August 2009 CFI was 76.8, a 10.1 point increase from the trough recorded in January 2009, but it is still 20.7 points below the level recorded in August 2008 just before Lehman Brothers collapsed. Given the ongoing harsh employment situation we expect it will take a while until consumer confidence recovers.

<sup>6</sup> The CFI is based on a weighted monthly survey of up to 600 working-age adults (age 20 to 69) in the Tokyo metropolitan area.

**Exhibit 14: Consumption forecasting indicator**

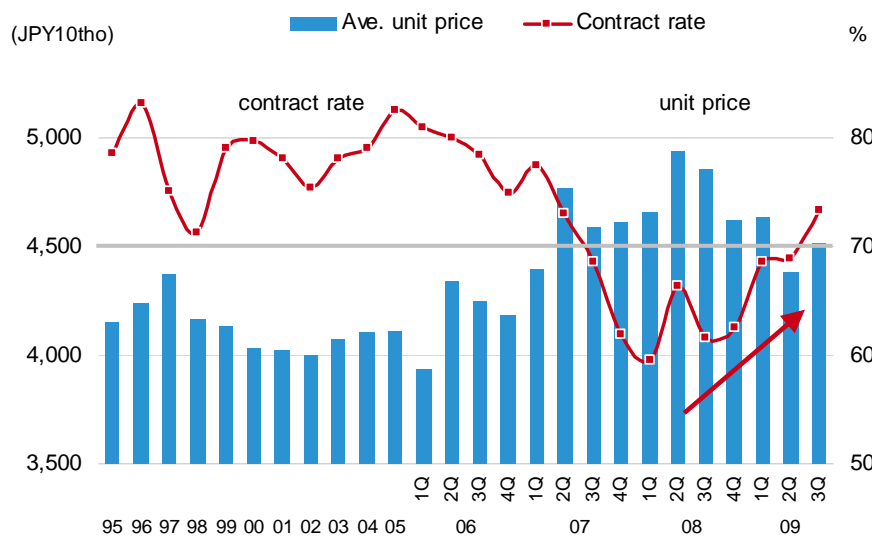


Source: Nikkei RIM, October 2009

**Market Fundamentals: Residential**

The average newly developed built-for-sale condominium (condo) price in Greater Tokyo had been above the JPY45 million threshold for the eight consecutive quarters to first quarter 2009. This trend constrained housing affordability and, as a result, the condo contract rate fell below 70% for about two years. Beginning in 2009, however, housing developers started to lower their sales prices, with further unofficial discounts offered to home buyers through negotiations. Because of this price cut, the enhanced mortgage tax breaks and the scarcity of supply, the contract rate has been increasing gradually from about 60% in first quarter 2008 to above 70% in 3Q 2009.

**Exhibit 15: Condominium unit price and contract rate in Greater Tokyo**

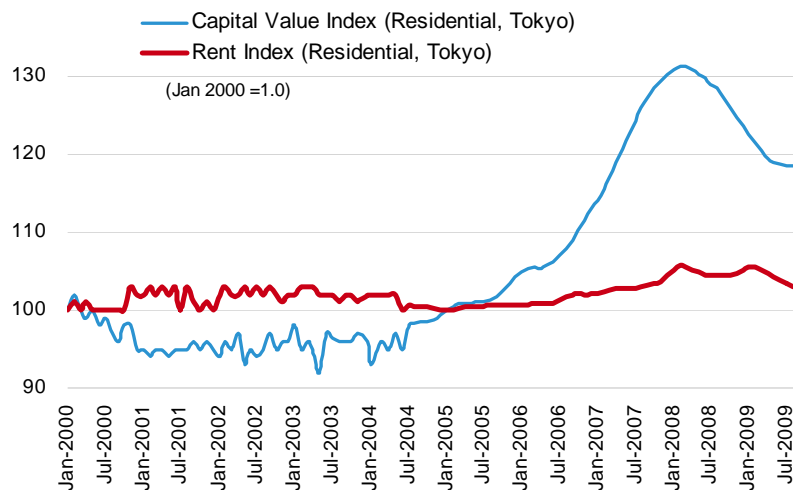


Source: REEI, October 2009

The capital values of existing condos (i.e. the re-sale price) began to soften in April 2008, several quarters earlier than the price decline experienced for newly developed condos. The capital values for existing condos fell by 9.7% between March 2008 and August 2009<sup>7</sup>. On the contrary, residential rents remained relatively stable during the same period. This is because without legitimate reasons, the landlord can neither reject the leasing contract renewal nor significantly increase existing in-place rents even when the market is tight. Lowering rents occurs only rarely during a market downturn. Therefore, with traditional Japanese leasing contracts, rents have a strong tendency to remain stable in economic booms as well as in recessions. In this cycle, however, residential rents started to show signs of weakening in 2009 and have declined by 2.6% to date. Granting free-rent periods for a month or two for new tenants is becoming popular.

The amount of take-up in the residential leasing market in Greater Tokyo started to bounce back in March through to May 2009, but it started to decline again in June and July with declines of 0.9% and 7.9%, respectively from the same month a year ago.

**Exhibit 16: Residential capital value and rent index in Tokyo**



Source: IPD RECRUIT Residential Index, RREEF Research, October 2009

<sup>7</sup> IPD changed the statistical methodology of its RECRUIT Residential Index publication so the numbers may differ slightly from the previous edition of "Japan Quarterly".

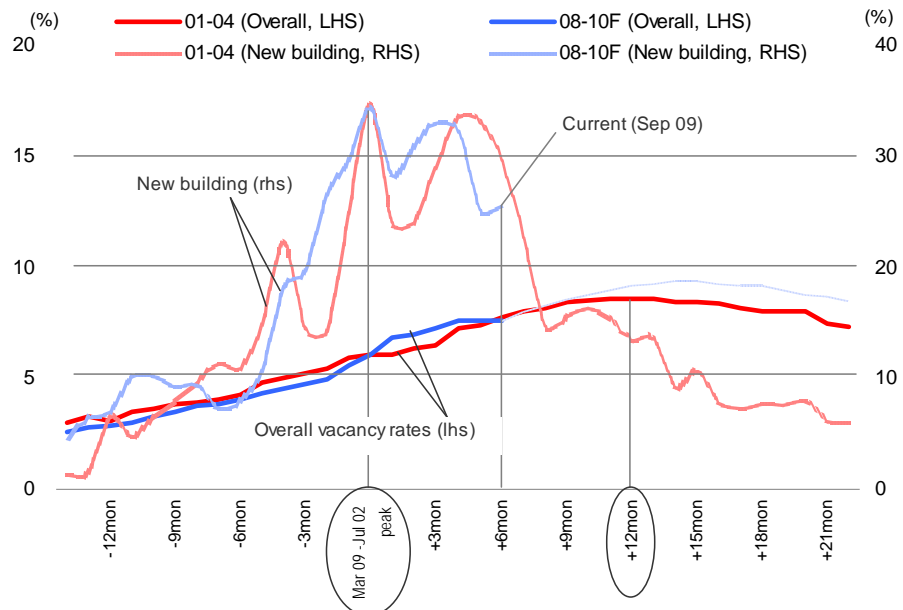
## Research Topic: History repeats itself? A Comparison of the 'Year 2003 Problem' with 2009

There are both similarities and differences between the previous cyclical downturn of the office market in Tokyo and the current rapid deterioration. This section compares and contrasts these two cycles in key office market fundamentals including vacancy, rent and capital value in order to contextualise where in the cycle we are as of late 2009.

The office vacancy rate in central Tokyo has been increasing since the beginning of 2008 and the pace of the deterioration so far is similar to the last cycle in 2001-2004. The previous cycle was dubbed the 'Year 2003 problem' and was characterised by a lot of large office completions in the Marunouchi, Roppongi and Shiodome submarkets, while this time the vacancy increase is led solely by demand softening rather than supply surge (see Exhibit 9).

In the previous cycle, the vacancy rate for new office buildings<sup>8</sup> in Central Tokyo peaked in July 2002 at 34.5% and the overall vacancy rate peaked in summer 2003 at 8.6%. In this cycle it now appears that the office vacancy rate for new buildings peaked in March 2009 at 34.3%, almost exactly the same level as the previous peak. Historically the overall vacancy rate for all buildings has followed the trend of the new building vacancy rate with a time lag of about nine to 12 months. This indicates the overall vacancy rate recovery should occur in early 2010, but we expect that the ongoing prolonged recession may drag on the momentum of the overall vacancy rate's recovery, pushing it further out than would normally be expected.

**Exhibit 17: Comparison of Tokyo office vacancy, 2001-04 and 2008-10F**

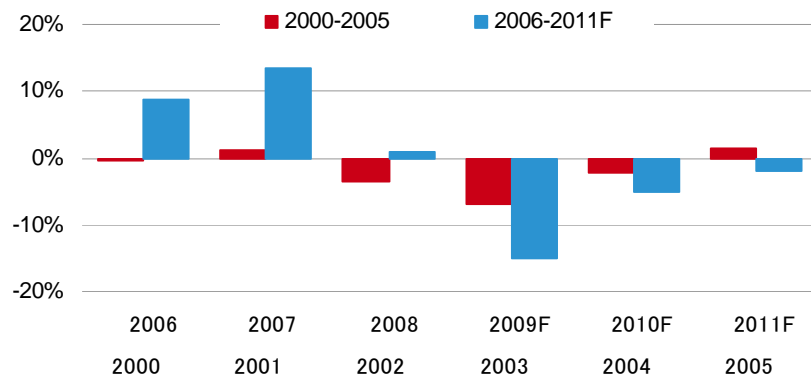


Source: Miki Shoji, RREEF Research 2009, f=forecast

<sup>8</sup> The vacancy rate for new buildings includes buildings completed within the past 12 months.

Unlike the vacancy trends, the office rental growth trends differ between the previous cycle and this cycle. At the time of 'Year 2003 Problem', the average asking rents for office (benchmark) in Central Tokyo had been continuously declining for almost a decade<sup>9</sup> and the absolute level was already at a 15-year low, so the annual rate of decline was negative 7% even at the trough in 2003. This time we expect rents to drop by around 15% in 2009 with a further decline in the following year. We expect that rental levels could drop to the trough level recorded in 2004, which is also the lowest level in the last two decades.

**Exhibit 18: Comparison of Tokyo office rental growth, 00-05 and 06-11F**



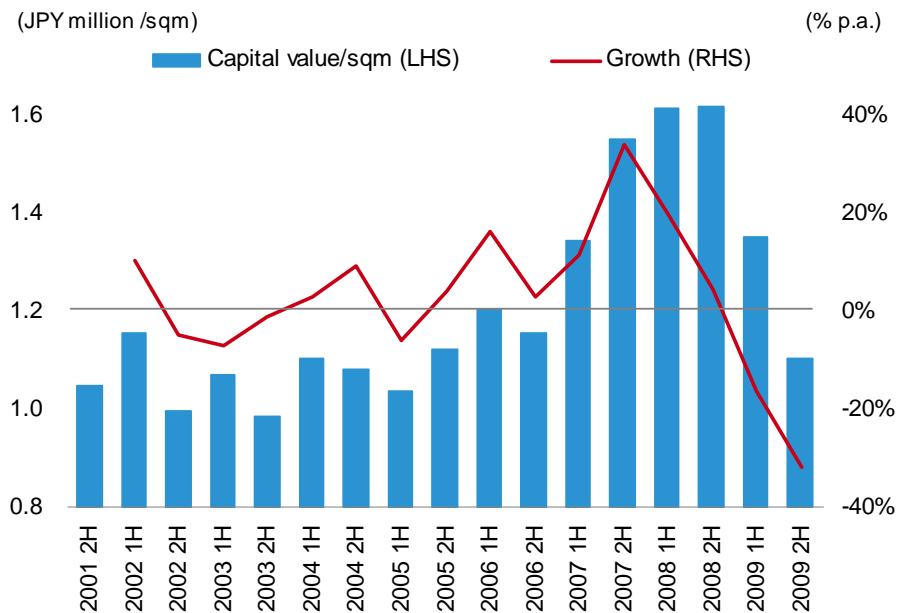
Note: F=Forecast  
Source: Miki Shoji, RREEF Research 2009

Exhibit 19 shows the average sale price (JPY million per square meter) for all the office building sale transactions above US\$30 million reported during consecutive six-month periods in Tokyo's 23 wards<sup>10</sup>. Similar to the office rent trends, the average office sale price in Tokyo declined steadily throughout 1990s, thus limiting the speed of decline in the previous cycle to only negative 7% p.a., even at the trough that occurred in the first half of 2003. This time the downward momentum is much greater. The average office sale price has declined by 32% p.a. in the second half of 2009 so far, which is the payback for the peak 34.3% growth rate in capital values in the second half of 2007. The average office transaction value in Tokyo has been about JPY 1.3 million per sqm since 2001, but it is currently JPY1.1 million per sqm, 15% below the historical average while still 12% above the bottom recorded in the second half of 2003.

<sup>9</sup> The only exception was 2001.

<sup>10</sup> The "city" of Tokyo technically ceased to exist in the 1940s when the government merged with the provincial-level Tokyo prefecture. The 23 wards that make up the eastern half of Tokyo prefecture have special governing status and are collectively considered the city-level equivalent Tokyo.

**Exhibit 19: Transacted office capital value per sqm in Tokyo's 23 wards**



Source: Real Capital Analytics, RREEF Research 2009

Although the 2003 and 2009 office cycles appear similar at first glance, we think understanding the differences may be more important than the similarities because this cycle will ultimately differ from the previous one in duration. There are at least two reasons to believe this is true. First, none of the three key indicators – vacancies, rents, capital values – have yet reached their cyclical turning points nor have they yet matched the levels of the 2003 cycle.

Second, the Japanese economy is in a very different position to last time. In 2003, Japan's GDP rose 1.4% for the year. In 2009, the comparable figure is expected to be a 6% contraction. As previously noted, the last cyclical downturn was supply driven, but it happened amid an expanding economy with increasing levels of demand that eventually absorbed the surplus office construction. This time around, it is the demand that has receded and, until economic conditions re-ignite office leasing activity, the effect on the office market may be prolonged, especially given the likelihood of a sluggish recovery in 2010. For these reasons, it is unlikely that the current cycle will turn as quickly as it did in 2003.

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I-014437-1.1