

January 2010

## Japan Real Estate Fourth Quarter 2009

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### Summary

After an unprecedented steep decline in economic activity in first quarter 2009, the Japanese economy has posted continuous growth on a quarterly basis since second quarter 2009. However, the recovery in 2010 is expected to be weak as stimulus spending winds down amid high unemployment, and an unfavourable exchange rate for Japanese exporters.

This quarterly review of Japan's property markets begins with the 'Fourth Quarter Market Outlook 2009'. This section explains the latest fundamentals of each property sector and illustrates trends affecting the finance market, transaction volumes, cap rates, returns and leasing markets. It also provides a short-term outlook for each of the major property sectors. The current recovery in the property markets rests on a tenuous foundation, with decelerating momentum already evident in the investment markets along with further gradual deterioration observed in the leasing markets.

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 "Introducing unit pricing analysis in Japan". Price per square metre (sqm) analysis is rarely used in commercial building transactions in Japan despite its ease of use, its ready availability, its broad international acceptance, and its objectivity. Employing this simple tool can also help investors avoid mispriced acquisitions. To demonstrate the versatility and usefulness of the unit pricing tool, we compare Central Tokyo's office market to its suburbs, to regional cities in Japan, and to its European peer, Central London. We conclude that investors in Japanese real estate would benefit from the widespread use of unit price comparisons when determining transaction prices.

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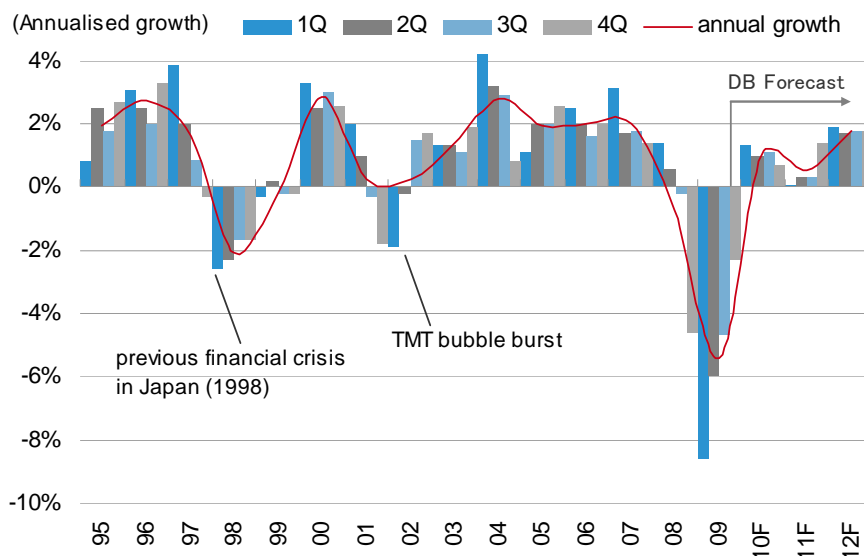
## Fourth Quarter 2009 Market Outlook

### Macro Economy

After an unprecedented steep decline in economic activity in first quarter 2009, the economic situation started to ease by second quarter 2009 in Japan. Deutsche Bank economists revised upward Japan's GDP growth forecast, with 2009 now expected to have posted a contraction of 5.4%. Although the growth rate was still negative in fourth quarter 2009 on a year on year basis (Exhibit 1), GDP has actually been posting positive growth on a quarter on quarter basis since second quarter 2009 due to the contribution of public spending, the increase in external demand (exports), and the end of inventory corrections.

However, there are still uncertainties for the economy. The ongoing appreciation of the Japanese yen against major currencies is negatively affecting the export-led economy. A high level of unemployment and the expected end of the stimulus effect on private consumption and public investment are anticipated to produce a plateau in economic activity, with only 1.0 and 0.5% year on year growth expected for 2010 and 2011, respectively.

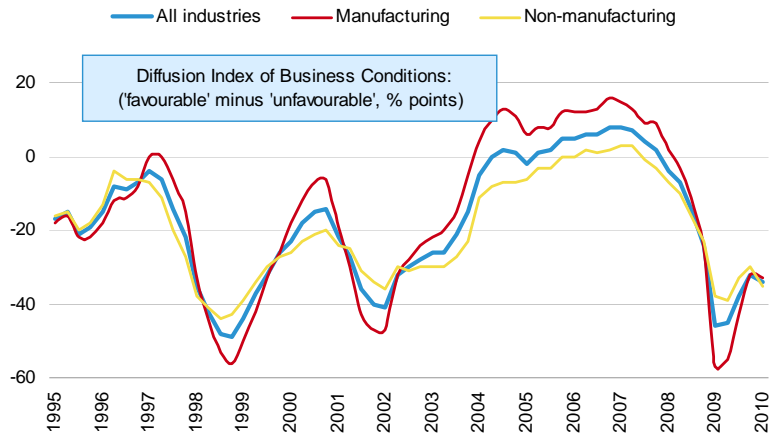
**Exhibit 1: GDP growth outlook for Japan**



Source: Deutsche Bank, January 2010 (F = forecast by Deutsche Bank economists; TMT = technology, media, and telecommunications)

The Tankan Survey conducted by the Bank of Japan confirmed the trend of gradual improvement in the economy in second and third quarters 2009, but the recovery trend suddenly ceased at fourth quarter 2009. The diffusion index (DI) of business conditions for all industries rose 6 points from negative 38 in the third quarter of 2009 to negative 32 in the fourth quarter, but the outlook for the first quarter in 2010 is negative 34, two points below the current level. The anticipated decline is attributable to currency appreciation and ongoing stagnant demand. Small to mid sized companies are being severely affected while larger companies still retain the momentum of recovery.

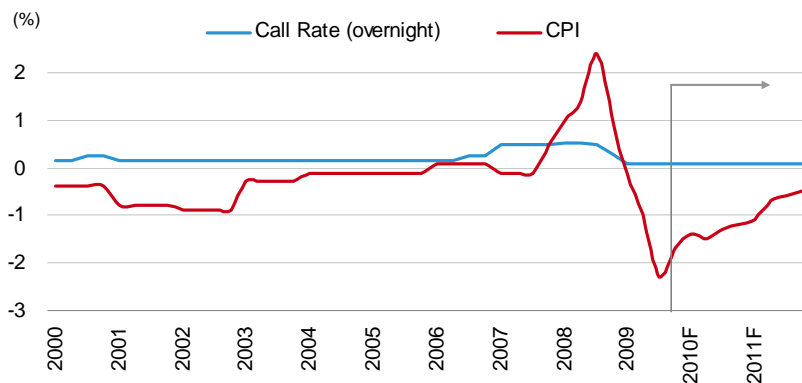
**Exhibit 2: Tankan Survey: Diffusion index of business conditions**



Source: The Bank of Japan, December 2009

Japan's CPI fell rapidly on a year over year basis. Consumer prices fell by 2.3% during third quarter 2009, Japan's worst deflation rate on record, followed by negative 1.7% (estimate) for the fourth quarter. While much of this deflationary trend was a negative payback after the surge in international commodity prices in 2008, stagnant domestic demand and declining household incomes are also playing key roles in pushing down prices further. Deutsche Bank economists do not expect any further interest rate cuts in 2010.

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



Source: Deutsche Bank, January 2010 (F = forecast by Deutsche Bank economists)

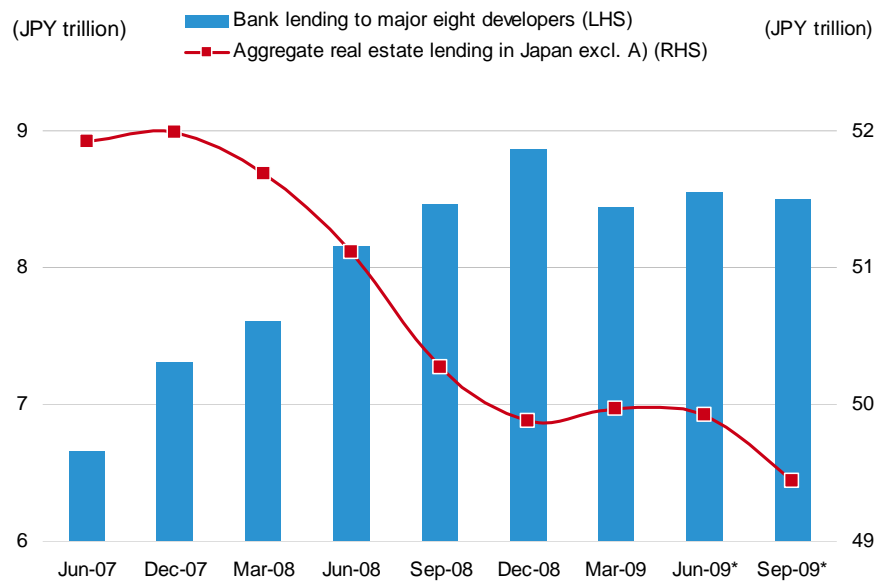
**Capital Market and Pricing**

The credit market is still tight in Japan. Japan's eight major developers<sup>1</sup> decreased their bank borrowings marginally by JPY0.1 trillion (tn) in third quarter 2009 while the aggregate bank lending to all the other developers and managers seems to have declined by JPY0.5 tn in the same period according to RREEF Research estimates. The CMBS market has not been active and new money borrowings (non-recourse loans) are still limited to

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

very selective transactions predominantly in central Tokyo. On the other hand, corporate lending by banks indicates signs of modest loosening. The number of corporate bankruptcies has levelled off and there were no reported bankruptcies among listed real estate companies or REITs in Japan in the second half of 2009, compared to 12 bankruptcies reported in the first half of 2009. However, the number of non-recourse loan defaults increased gradually during 2009. Most banks still tend to extend the terms of existing loans rather than trigger defaults at maturity even if equity value is negative. Extensions, however, are not always the case, especially for second tier assets and/or assets in second tier cities.

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

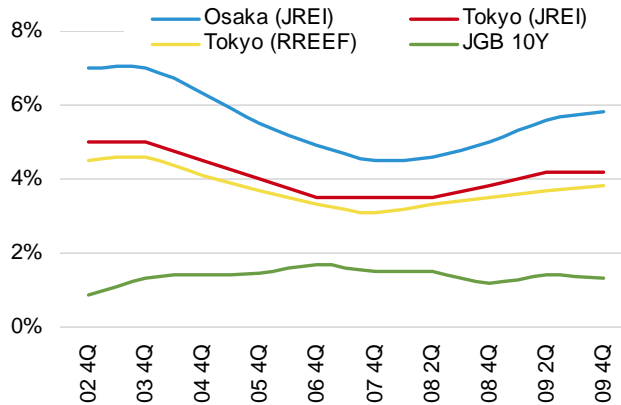


Note: \* RREEF Research's estimate as of December 2009  
 Source: RREEF Research, The Bank of Japan, Annual Reports, December 2009

According to the Japan Real Estate Institute (JREI), cap rates for prime offices in CBD Tokyo<sup>2</sup> rose by 40 basis points (bp) from October 2008 to 4.2% in the first half of 2009 and stabilised at that level in the second half of 2009. In Osaka, cap rates rose by 70bp to 5.7% within a year. We expect firm stabilisation of cap rates for prime assets in Tokyo in 2010 but further marginal softening is expected in regional cities and also for lower grade assets in Tokyo because of lack of demand and tight credit conditions for these assets.

<sup>2</sup> The CBD is defined as the Marunouchi and Otemachi areas near Tokyo Station in Chiyoda-ku.

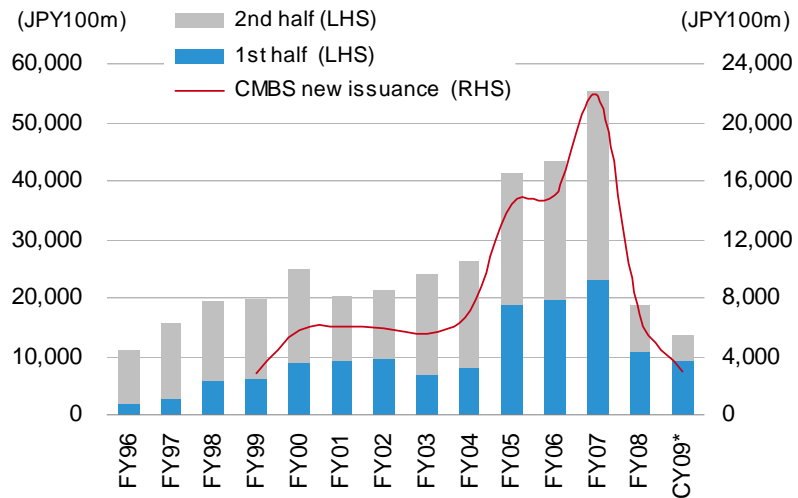
**Exhibit 5: Cap rates and government bond rate**



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

Amid the stagnant sentiment prevailing in global real estate investment, the Japanese market is hardly an exception. The volume of identified commercial real estate transactions in the country in CY2009 was about JPY 1.4 trillion, only a quarter of the overall volume reported in FY2007<sup>3</sup> and a 27% decline from FY2008, which is just in line with the declining trend in the CMBS new issuance market.

**Exhibit 6: Real estate transaction volume and CMBS new issuance in Japan**

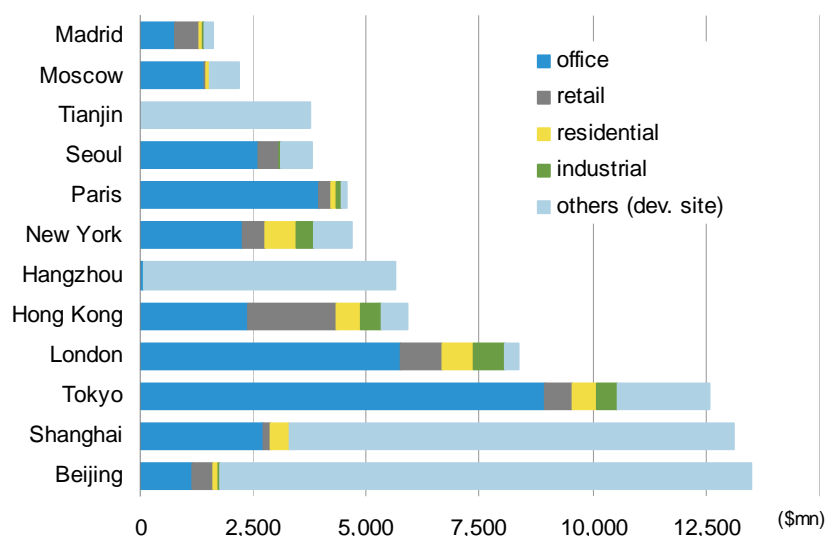


Note: \*CY09 is preliminary estimate by RREEF Research. Financial year starts in April and ends in March in Japan.  
Source: Real Capital Analytics, Urban Research Institute, Deutsche Securities Inc, RREEF Research, January 2010

Despite this weak market, Tokyo maintained top global ranking in terms of the volume of office transactions closed during the first three quarters of 2009. Together with Beijing and Shanghai, Tokyo was among the global top three in overall real estate transactions for all property types during the period.

<sup>3</sup> Data only available on financial year basis. FY starts in April and ends in March in Japan.

**Exhibit 7: Real estate transaction volumes by city in first three quarters of 2009**



Source: Real Capital Analytics, RREEF Research, December 2009

In fourth quarter 2009, some J-REITs, funds, and foreign investors reappeared as buyers in the investment market (which until recently had been limited to domestic developers and domestic corporations). This marked the most significant change in the capital market in the fourth quarter. Japan's largest transaction in the fourth quarter was a partial sale of Pacific Century Place Marunouchi; about 48% of the building was sold to Secured Capital for JPY147 billion in December 2009 and it was the world's largest single office deal reported in the year. In the same month a German-based open ended fund acquired retail buildings in a large shopping mall in Chiba Prefecture for JPY12 billion. It was the only sizable real estate acquisition by German open ended funds reported in Japan in 2009.

**Exhibit 8: Major real estate transactions in Japan in the fourth quarter in 2009**

JPY 100m (= \$1.1m)

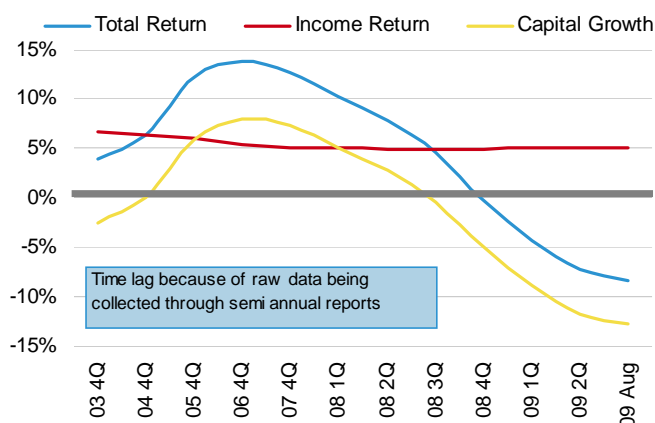
Date	Type	Asset	Price (JPY 100m)	Price (JPY m /sqm)	Prefecture	Acquired by
Dec-09	office	Pacific Century Place (48%)	1,470	3.6	Tokyo	Secured Capital
Nov-09	office	Shiodome Building (30%)	546	1.6	Tokyo	Japan Real Estate (REIT)
Dec-09	office	Risona Maruha Building (27%)	420	2.1	Tokyo	Mitsubishi Estate
Dec-09	office	TOA Headquarters Bulding	231	1.6	Tokyo	Nippon Television Network
Dec-09	office	Sumitomo Shoji Nishikicho Bldg	127	1.6	Tokyo	TOP REIT
Dec-09	retail	Aeon Mall Chiba New Town	120	0.1	Chiba	SEB Asset Management

Note: This table is prepared solely for information purposes and not intended to recommend or endorse any specific company's shares or other products.

Source: Real Capital Analytics, Nikkei Real Estate Market, RREEF Research, January 2010

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 12.8% in August 2009, the rate of total return was squeezed to negative 8.3% (preliminary), and there is still no sign yet 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 term.

**Exhibit 9: Return of unlevered direct investment (all types of property)**

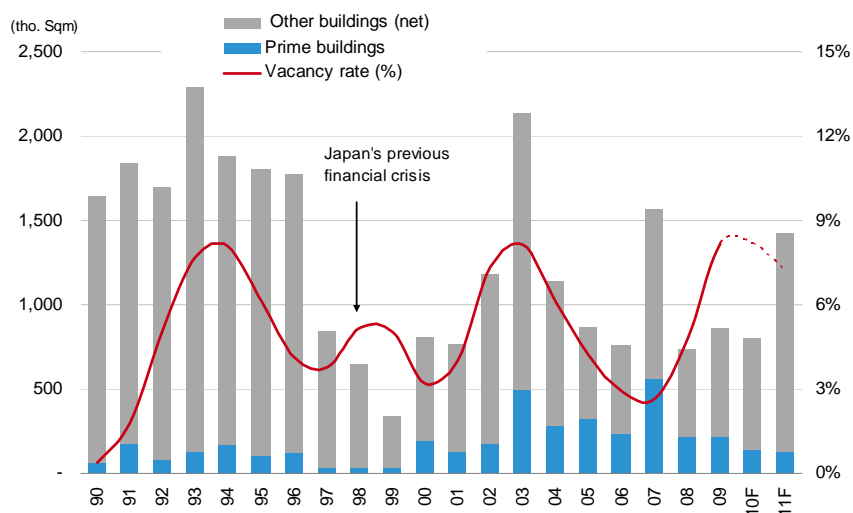


Source: RREEF Research based on IPD Japan Monthly Indicator, December 2009

### Market Fundamentals: Office

Because of the rapid deterioration of the economy, the office vacancy rate in Central Tokyo<sup>4</sup> increased rapidly during the period. At the end of 2009 the office vacancy rate in Central Tokyo rose to 8.1% from 4.7% in 2008 (and from 2.7% in 2007). This was in line with our expectation, and although it was the Tokyo vacancy rate's highest level in the last six years, the sharp speed of increase seemed to be slowing down in the second half of 2009. We expect the office vacancy rate to increase a little further and peak sometime in mid 2010 in this cycle, to be followed then by a slow and gradual recovery.

**Exhibit 10: Office vacancy rate in Central Tokyo (5 wards)**



Source: RREEF Research, Miki Shoji, January 2010 (F = forecast by RREEF Research)

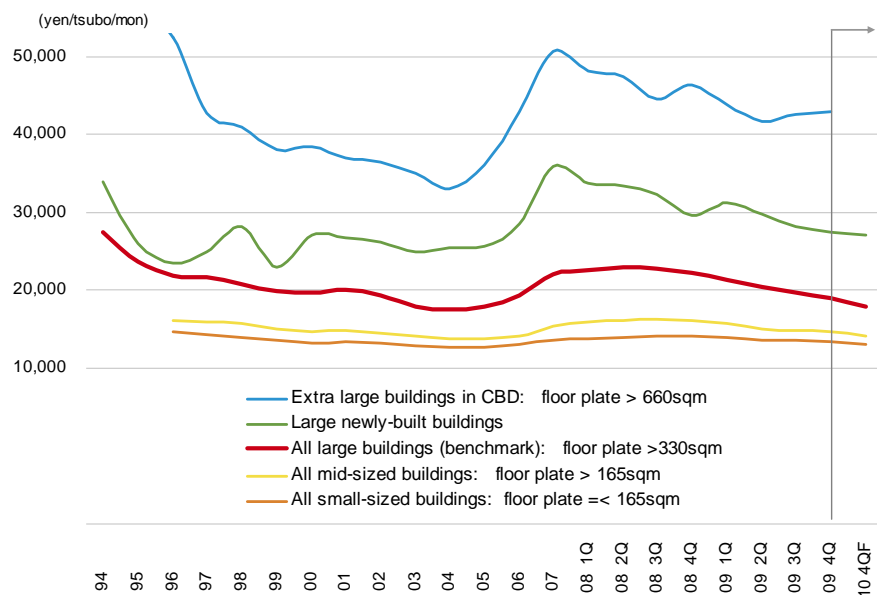
Following a rapid increase in asking rents in 2007, the uncertainty over the economic outlook has since caused asking rents in Central Tokyo to fall. Average asking rents for large-scale newly built offices started to decline in the first quarter of 2008 and by the end of 2009 had dropped by as much as

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

26%. Average asking rents for all large buildings (i.e. the benchmark) in Central Tokyo started to decline in the third quarter of 2008 and have since dropped 17%. Rents for smaller buildings also started to decline in the fourth quarter of 2008 albeit at milder paces. On the other hand, average asking rents for extra large buildings in the CBD started to level off in the third quarter of 2009, with marginal increases posted in the last two quarters of the year.

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, but prime assets could recover earlier than the benchmark.

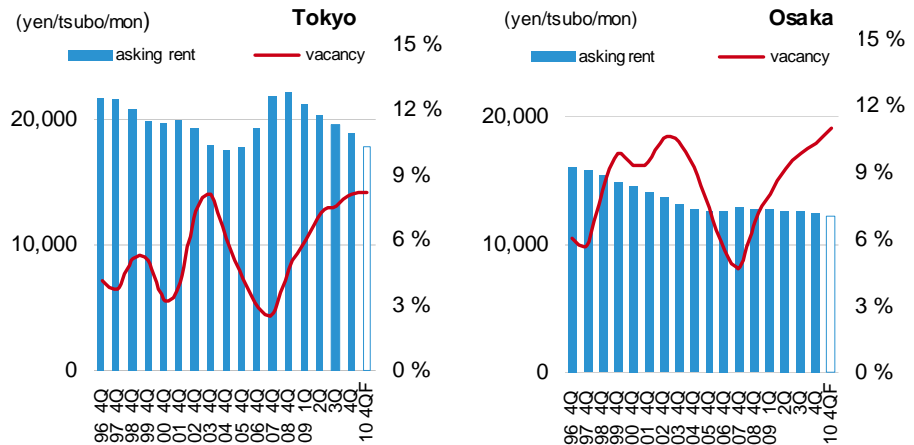
**Exhibit 11: Office asking rents in Central Tokyo by building size**



Source: RREEF Research, Miki Shoji, Sanko Estate, January 2010

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 10.3% in December 2009 from 4.7% in December 2007 while the average asking rent fell only 3.5% during the period, compared to a 17% drop for the benchmark office rents in Tokyo. Given the ongoing downward momentum in the regional 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 medium term.

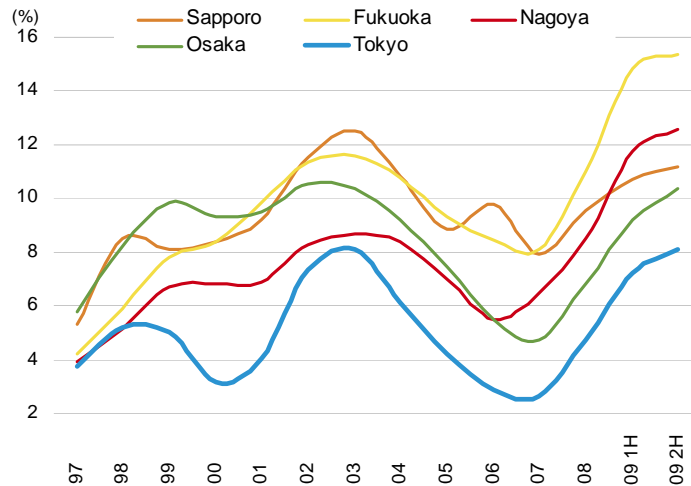
**Exhibit 12: Office rents and vacancies in Tokyo and Osaka**



Source: RREEF Research, Miki Shoji (F = forecast by RREEF Research), January 2010

The vacancy rates in other regional cities are rising even higher, with rates all exceeding 10%. In December 2009 the vacancy rate rose to 15.4% in Fukuoka, 11.2% in Sapporo, and 12.6% in Nagoya. 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 13: Office vacancy rates in major cities in Japan (all grades)**



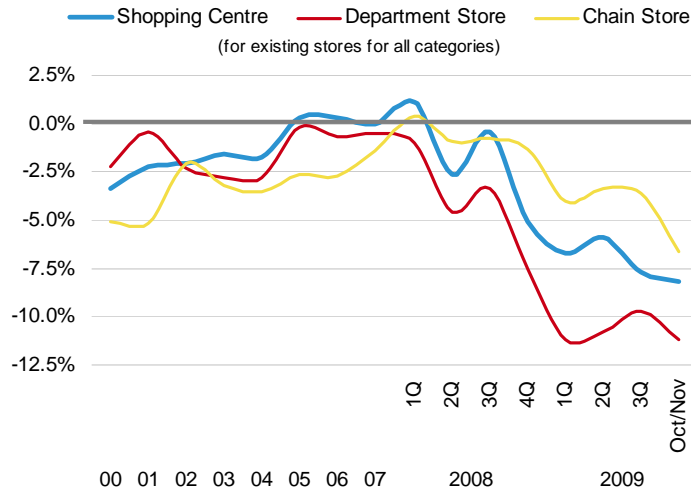
Source: RREEF Research, Miki Shoji, January 2010

### 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 Oct/Nov 2009 continued to disappoint, with same-store sales falling 11.2% from the same period last year. Sales at shopping centres (existing

store basis) also declined 8.2% in October and November from the same period a year ago. Chain stores (existing store basis) seemed to perform slightly better with a decline of 6.6% in the period but this was only because a number of unprofitable stores were closed down, which boosted the sales of the remaining stores.

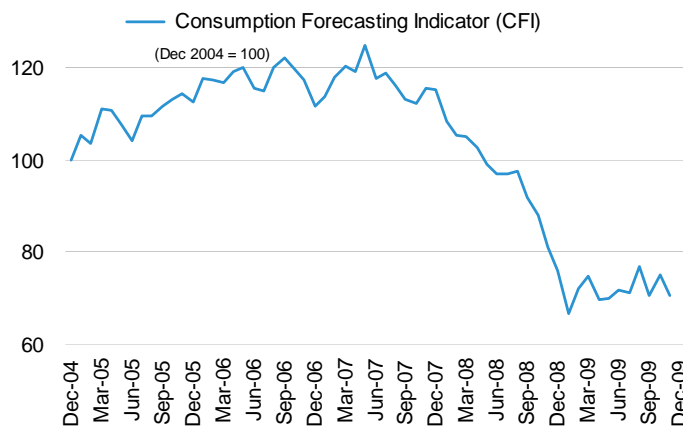
**Exhibit 14: Retail sales in Japan (year on year % growth)**



Source: RREEF Research, JCSC, JDSA, JCSA, January 2010

Nikkei RIM's consumption forecasting indicator (CFI)<sup>5</sup>, a survey that predicts future consumption trends six months in advance, also shows stagnant demand. In November 2009 CFI was 70.6, and a significant increase from the January 2009 trough of 66.7 has yet to be seen. Given the ongoing harsh employment situation we expect it will take a while until consumer confidence recovers.

**Exhibit 15: Consumption forecasting indicator**



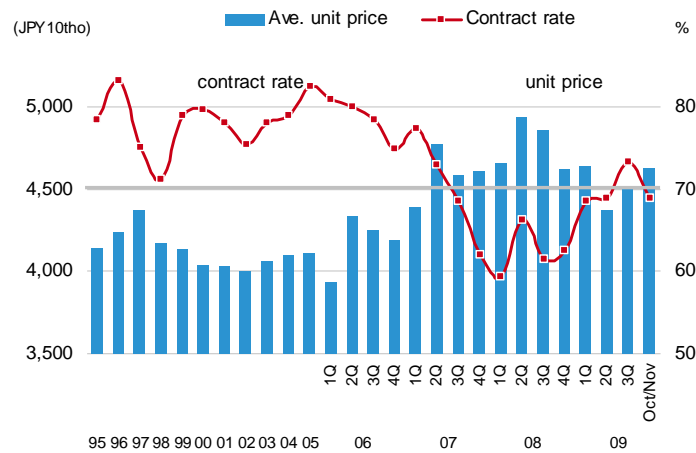
Source: Nikkei RIM, January 2010

<sup>5</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.

## Market Fundamentals: Residential

The Japanese built-for-sale condominium (condo) market hit the bottom in 2008 when the condo contract rate was about 60%. Because of this weak demand and extra inventory carried over from that period, housing developers lowered the average newly developed built-for-sale condo price below JPY45 million (per unit) in mid 2009, which helped increase the contract rate to above 70% in the third quarter. However, the contract rate went down below 70% again in October and November 2009, from 73% in the third quarter 2009. Because of the growing uncertainty in the economic recovery and the declining trend in household income, we expect relatively low and volatile condo sales during 2010.

**Exhibit 16: Condominium unit price and contract rate in Greater Tokyo**

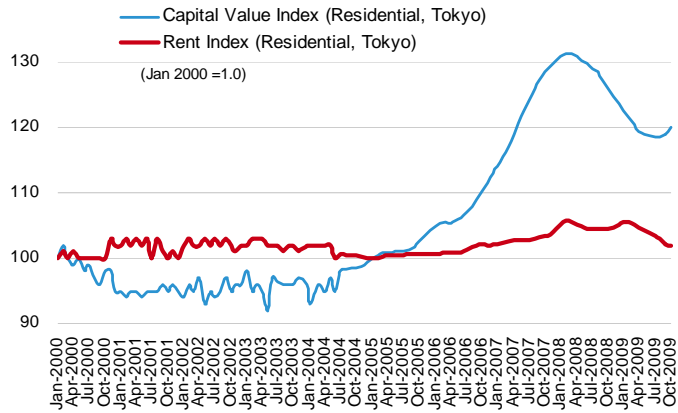


Source: REEI, January 2010

The capital values of existing condos (i.e., the re-sale prices) began to soften in April 2008. This occurred several quarters earlier than the price decline experienced for newly developed condos. The capital values for existing condos fell by 10.8% from the peak price in March 2008 to the bottom recorded in August 2009. However, capital values started to show signs of recovery in September and October 2009 with gradual price recoveries reported in those two consecutive months.

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. Because of this traditional Japanese leasing contract, rents have a strong tendency to remain stable in economic booms as well as in recessions. In this cycle, however, residential rents started to weaken in 2009 and have declined by 3.7% to date. Granting free rent periods for a month or two privately for new tenants is becoming popular, although it is not reflected in the statistics.

**Exhibit 17: Residential capital value and rent index in Tokyo**



Source: IPD RECRUIT Residential Index, RREEF Research, January 2010

The amount of take-up in the residential leasing market in Greater Tokyo started to bounce back in the second quarter 2009, but it started to decline again in the third quarter with contractions of about 8%-9% in third and fourth quarters, respectively, from the same period a year ago. This reflects the ongoing slow recovery of the unemployment rate and indicates further gradual softening in the residential leasing market in 2010.

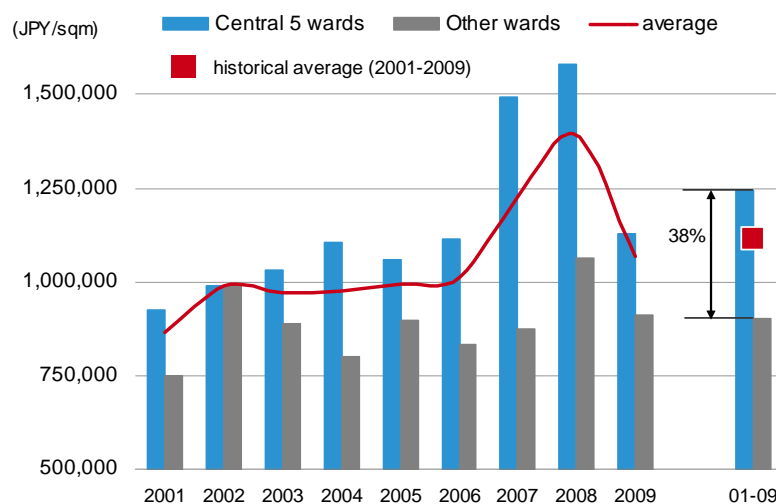
## Research Topic: Introducing unit pricing analysis in Japan

In many western countries, price per square foot (or per square metre) is a popular tool to measure acquisition prices of real estate assets, but traditionally in Japan price per square metre (or per tsubo<sup>6</sup>) is used only for measuring land prices of development sites or unit prices of condominiums for sale. It has been rarely used to measure commercial building prices. Therefore for many investors, cap rates are the only measure relied upon when acquiring assets.

This can be problematic since cap rates are not always disclosed in Japan. Among all office transactions in Japan covered by Real Capital Analytics (RCA) between 2001 and 2009, about 96% of deals show the calculated price per square metre (sqm) but only about 40% of deals show estimated cap rates. Another problem is that because actual rents are not disclosed in Japan, cap rates fluctuate depending on rental assumptions. When the market rent is moving rapidly, the assumption is especially difficult, so the more objective metric of price per sqm could be highly useful. The variables to compute price per sqm incorporate combined prices of both land and building if they are reported separately. This chapter will show the benefits of the price per sqm metric and how it can be used effectively for pricing real estate transactions in Japan.

Exhibit 18 shows the historical price per sqm for office transactions in Tokyo (23 wards<sup>7</sup>). The average transacted price per sqm rose from JPY1.0m in 2006 to JPY1.4m in 2008 but it declined again to JPY 1.1m in 2009, or slightly below the historical average. For smaller buildings the unit price fell even more dramatically in 2009 to a historically low level. (see Exhibit 21). Exhibit 18 also indicates that the average transacted price per sqm for offices in Tokyo's central five wards is 38% higher than that in other wards in Tokyo, and this gap tends to widen when the market booms.

**Exhibit 18: Price per sqm for office transactions in Tokyo in 2001-09**



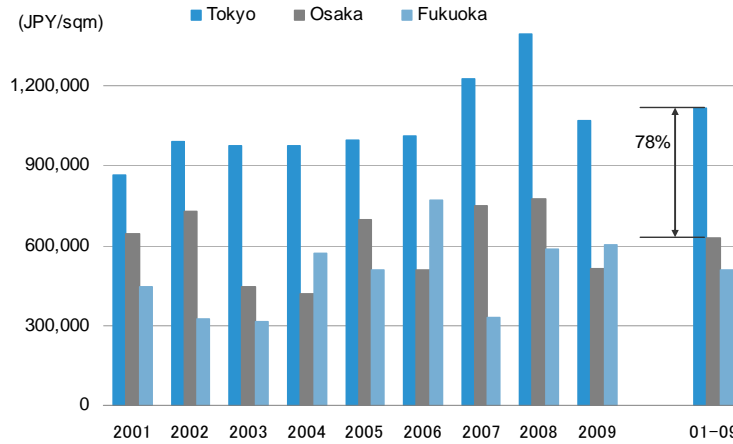
Note: All reported transactions above \$10m in price and above 500 sqm in size.  
Source: Real Capital Analytics, RREEF Research, January 2010

<sup>6</sup> A tsubo represents the area of a traditional tatami mat in Japan. It is the equivalent of about 3.3 square metres (35.6 square feet).

<sup>7</sup> The 23 wards that make up the eastern half of Tokyo prefecture maintain special governing status and are collectively considered the traditional city-level equivalent of Tokyo. The "city" of Tokyo itself technically ceased to exist in the 1940s when Tokyo's municipal government merged with the provincial-level Tokyo prefecture.

When compared with other cities in Japan, Tokyo office property is traded at an average 78% premium over Osaka where the historical average price per sqm is JPY 0.6m. Tokyo's premium over other regional cities, such as Fukuoka, is even larger.

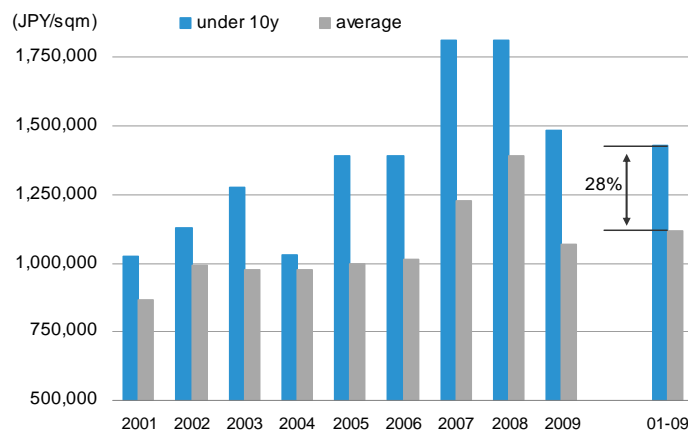
**Exhibit 19: Price per sqm for offices in major cities in Japan**



Note: All reported transactions above \$10m in price and above 500 sqm in size.  
Source: Real Capital Analytics, RREEF Research, January 2010

Transacted price per sqm can also be analysed by other variables such as building age. Exhibit 20 shows historical price per sqm for buildings within 10 years of completion versus the average for each year. This indicates an average 28% price premium for newer buildings over the market average. The existence of the premium is not surprising since newer buildings include modern amenities, mechanical systems, open-plate floor plans, and aesthetic appeal which add to their value. How to price that premium is the bigger issue. The usefulness of this price per sqm technique is in the calculation of a market benchmark for the age premium.

**Exhibit 20: Price per sqm for offices in Tokyo by building age**

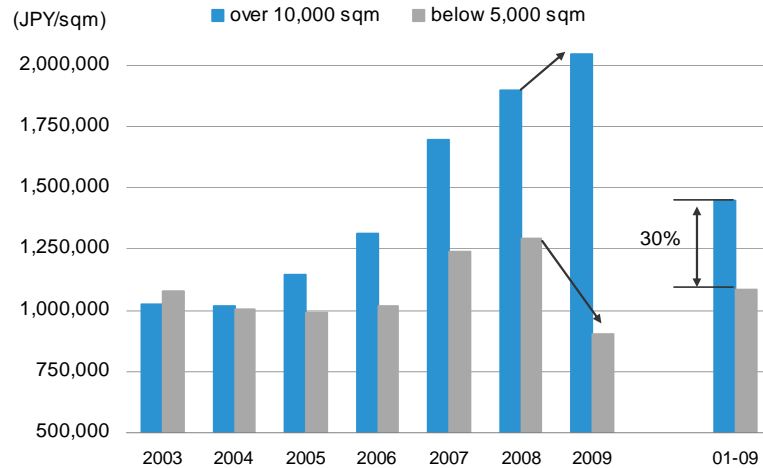


Note: All reported transactions above \$10m in price and above 500 sqm in size.  
Source: Real Capital Analytics, RREEF Research, January 2010

This same technique can also be applied to building size. The following chart shows the transacted price per sqm for large buildings with a gross floor area (GFA) exceeding 10,000 sqm versus those with GFAs smaller than 5,000 sqm. Again, this technique shows there is an average 30% price premium for larger buildings. The gap has widened especially in 2009 when smaller office

properties were traded with discounts on already historically low price levels. Meanwhile, the price per sqm for larger buildings surprisingly increased during the year because of a couple of prime asset transactions that led the market.

**Exhibit 21: Price per sqm for offices in Tokyo by building size (GFA)**

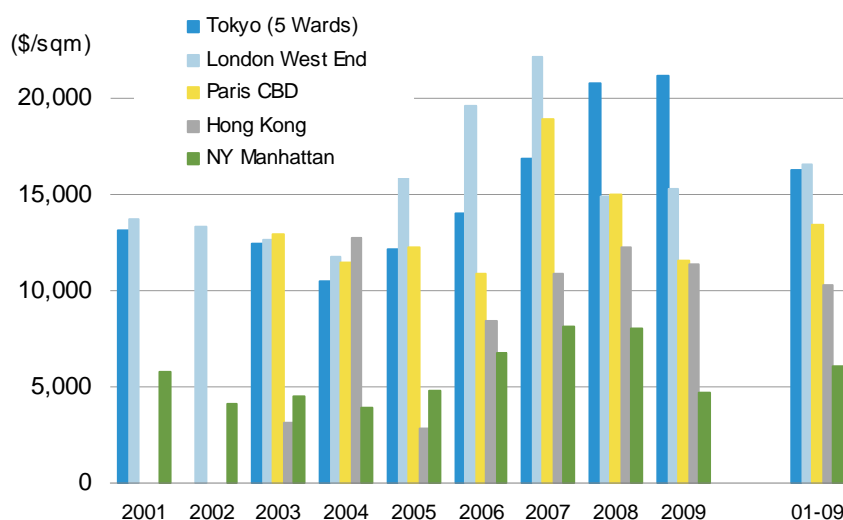


Note: All reported transactions above \$10m in price and above 500 sqm in size.  
Source: Real Capital Analytics, RREEF Research, January 2010

This price per sqm can be easily used to compare property markets across global cities. Exhibit 22 shows the comparative price per sqm (\$/sqm) for CBD-equivalent office transactions in major global cities. These transactions are parallel across all markets by price (above \$100m) and by size (above 5,382 sqm, or 50,000 sqft). Historically offices in London's West End have traded at the most expensive unit prices, followed by Tokyo's Central 5 Wards, Paris CBD, Hong Kong, and New York's Manhattan borough. However, Tokyo displaced London's West End in unit price in 2008 and 2009. There are at least three factors that could have likely caused this. First, the real estate price correction was slower to reach Tokyo than other cities and, particularly, the UK market in this downturn cycle. Second, the Japanese yen increased its value against the US dollar during the period. And third, the global credit crisis sharply curtailed the number and volume of transactions in many cities in late 2008 and throughout much of 2009.

It also should be noted that in some cities, prime trophy properties are closely held by powerful local owners and have rarely been traded in the market. The values of these untraded assets are not captured by the transaction data in Exhibit 22. Hong Kong is a good example of this type of market culture. Many of Hong Kong's prime properties have been owned since construction by the major domestic developers who built them and these properties have never been traded.

**Exhibit 22: Price per sqm for offices in major global cities**

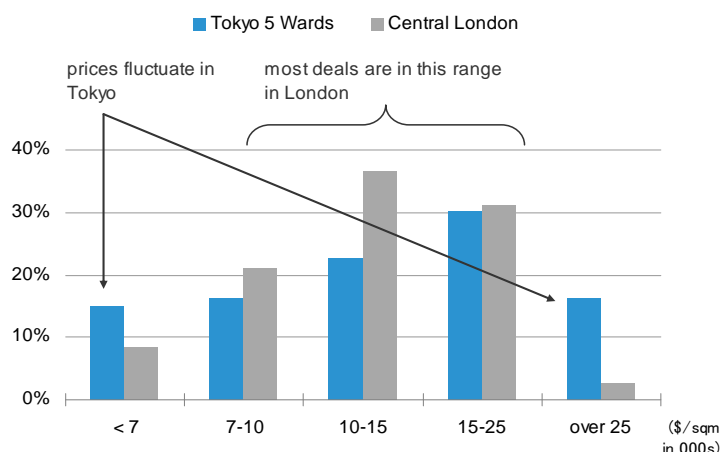


Note: All reported transactions above \$100m in price and above 5,382 sqm in size.  
Source: Real Capital Analytics, RREEF Research, January 2010

On a per sqm basis, office prices in Tokyo fall across a wider spectrum than those in London. Close to 90% of all office transactions in Central London since 2001 have fallen in the range of \$7,000 to \$25,000 per sqm, but in Tokyo's five central wards, fewer than 70% of deals fell within this price band. Nearly one-third of Tokyo's office transactions were priced outside this trading range, or about three times the 11% share of outlier transactions that occurred in Central London over the same time period.

This is surprising since, generally speaking, real estate prices in Tokyo have been less volatile than London throughout the 2000s. Following Japan's property bubble in the 1990s, prices have stabilised considerably. One possible explanation is that quality and specifications of offices are more homogeneous in Central London compared with Tokyo. In Tokyo there are significant variations according to location, building age, size, and developer. It might also imply the possibility of mispriced transactions in Tokyo. Because investors typically rely solely on cap rates to evaluate building prices without objectively verifying transactions with unit price comparisons ("comps"), it raises questions as to whether mispriced transactions may have occurred.

**Exhibit 23: Distribution of transacted office price in Tokyo and London, 2001-2009**



Note: All reported transactions above \$100m in price and above 5,382 sqm in size.  
Source: Real Capital Analytics, RREEF Research, January 2010

This short analysis demonstrates the richness of information on price per sqm across the Tokyo market, and some of the insights this information can provide. Arguments in favour of unit price comparisons in the valuation process include its ease of use, its ready availability, its broad international acceptance, and its objectivity. Unlike cap rates, price per sqm analysis does not involve assumptions, making it more reliable and objective than cap rates especially when the rents are in flux.

At the same time, as always with such analysis, it raises a series of important additional questions. A key issue is, for instance, the appropriate price per sqm at different points in time and compared with other markets. This issue is, in turn, dependent on a complex set of factors including the relationship between price per sqm and replacement costs (rebuilding and land costs), and the prospects for rental growth. These issues are beyond the scope of this paper but it is clear that the depth of information on price per sqm can help in providing profound insights into the behaviour of the Japanese real estate market.

Important disclosure  
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