

March 2009

Japan Quarterly 1Q 2009

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Research Topic: Tokyo Office Market in its Global Context

1. Summary

In February 2002, Japan began a nearly six-year-long economic expansion that lasted through October 2007, but the economic climate has since deteriorated sharply. In February 2009, Deutsche Bank economists lowered the outlook for GDP growth to an unprecedented level of negative 7.6% for 2009. The global credit crunch has battered Japanese real estate investment markets and triggered a series of bankruptcies. The fundamentals of the leasing market which remained relatively healthy until the first half of 2008 are also deteriorating rapidly in light of the economic downturn.

This quarterly review of Japan's property markets begins with the 'Market Outlook 1Q 2009'. This chapter explains the latest fundamentals of each property sector with particular focus on the shrinking 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' chapter 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 focuses on the 'Tokyo office market in its global context'. It provides many different ways of comparing the market with other key global cities and tries to capture the unique characteristics of Tokyo in the global context. Of course Tokyo is not immune to the rapid market deterioration currently experienced in other global cities, but this chapter provides some of the reasons that explain why in a long term perspective investors prefer Tokyo as an investment destination.

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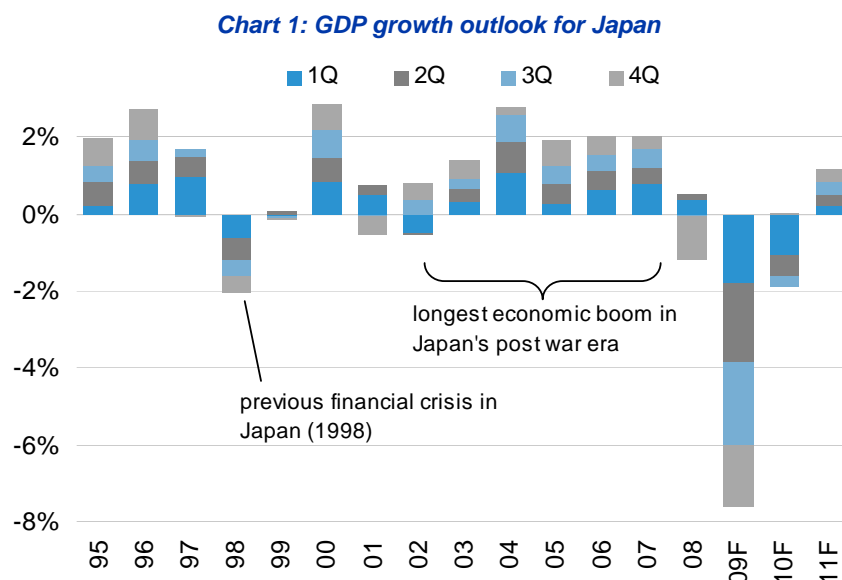
To readers:

The Japanese real estate market continues to evolve, both structurally and cyclically. In this context, this series of quarterly papers attempts to provide useful insights for tracking the ongoing development of the market. This quarterly publication is designed to be interesting and helpful to a range of professional participants in the real estate market. We welcome your comments and suggestions for additional topics that should be addressed in future editions of 'Japan Quarterly'

2. Market Outlook (1Q 2009)

Macro Economy

The previous economic boom that started in February 2002 and officially ended in October 2007 was the longest one in Japan's postwar history. The economy has been in contraction since then and the depth of the recession is reaching an unprecedented level. The Japanese yen appreciated sharply against all of the major currencies between late 2008 and early 2009, and this caused devastating damage to the Japanese export-led economy. Japan's GDP declined at an annualised rate of 12.7% in 4Q 2008 (compared to a 3.3% decline on a QoQ basis, or 1.2% on a YoY basis) which was the worst drop in 35 years. Deutsche Bank economists responded by lowering Japan's GDP growth forecast once again to negative 7.6% for 2009, a record low forecast, followed by a further decline of 1.9% in 2010. Predictions of a return to moderate growth are now pushed back to the beginning of 2011.

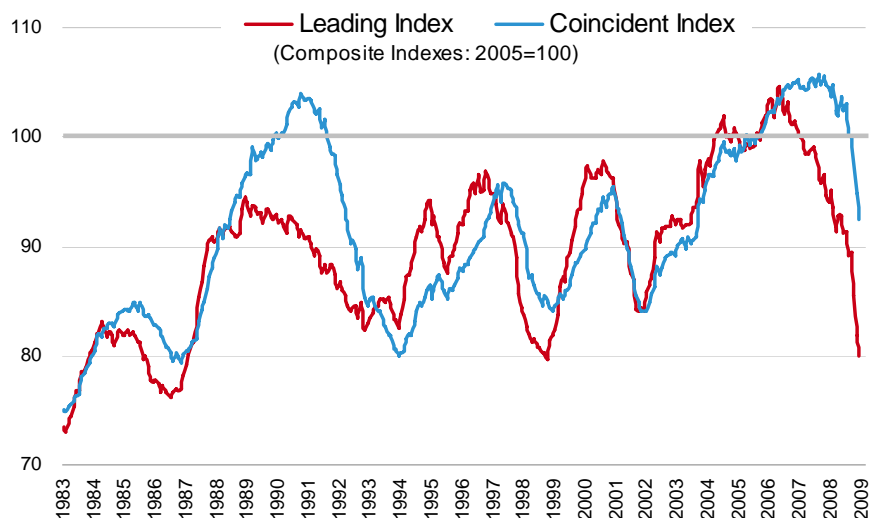


Source: Deutsche Bank, February 2009 (F = forecast by Deutsche Bank economists)

Composite indexes of leading and coincident indicators are published monthly by Japan's Ministry of Internal Affairs and Communications, and are useful for measuring Japanese economic cycles. The leading index, which predicts the short-term future economic trend, made a sharp drop from 81.8 to 79.8 in December 2008, its worst level in two decades. The three-month moving average of the leading index has declined for 18 consecutive months. The coincident index also fell from 94.9 to 92.3 in the same period. Production-related indicators have been especially weak due to extreme pressure on manufacturers resulting from a strong yen and softening demand in overseas markets.

Monthly export figures confirm this trend. The value of Japan's monthly exports declined by 35.0% in December 2008 and by 45.7% in January 2009, respectively, from the same period in the previous year. These unprecedented declines have now reached levels not seen since the first oil crisis in the 1970s.

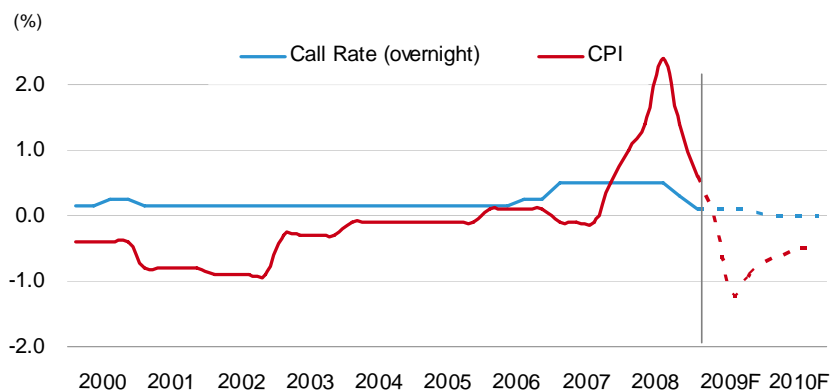
Chart 2: Composite indexes: Leading index and coincident index



Source: Ministry of Internal Affairs and Communications, February 2009

The steep appreciation of the Japanese yen caused a corresponding slump in the economy. The Bank of Japan responded by lowering its benchmark unsecured overnight call rate by a further 10 basis points (bp) to 0.1% in December 2008, following an earlier 20 bp cut in November. Deutsche Bank economists expect a further interest rate cut to zero in 2009.

Chart 3: Forecast of short-term interest rate and CPI



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

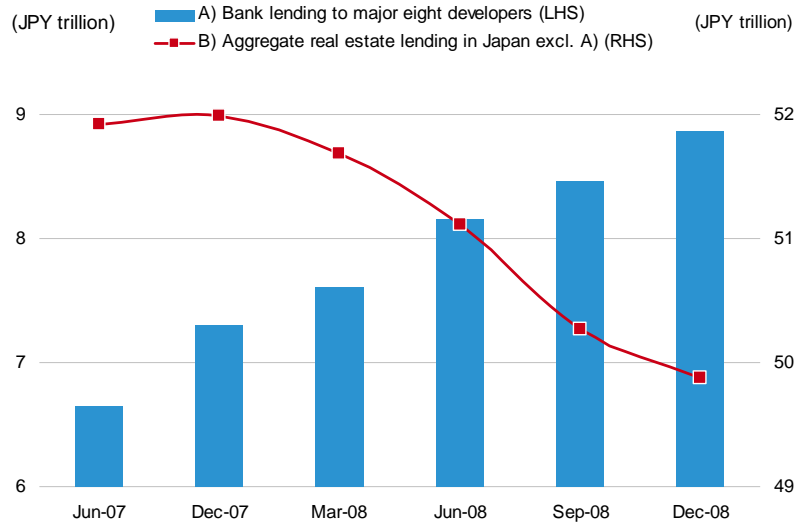
Capital Market and Pricing

Japanese real estate investors have faced serious challenges from the financial markets since the beginning of 2008. Aggregate bank lending to Japan's eight major developers¹ increased by more than JPY2 trillion between June 2007 and December 2008, while aggregate lending to all the other developers and managers declined by JPY2 trillion during the same period. Since the average duration of real estate lending

¹ 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.

tends to be short in Japan (about 3-5 years), tighter credit causes re-finance risk to increase rapidly which can then lead to a series of bankruptcies. Since 2008 there have been 20 bankruptcies among listed real estate companies in Japan, including housing developers, real estate managers, and a J-REIT. The aggregate debt held by the bankrupt companies amounted to JPY 2.4 trillion as of February 2009.

Chart 4: Real estate lending by Japanese banks

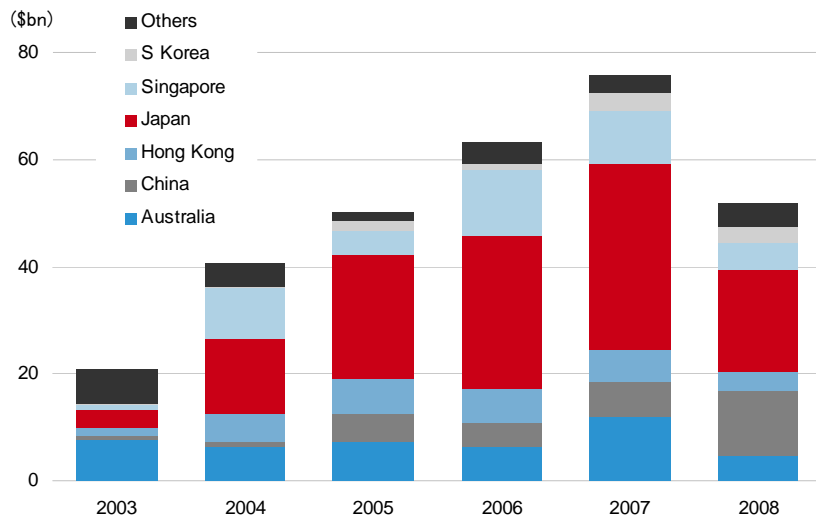


Note: Housing mortgages are not included.

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

Japan has been the largest real estate investment market in the Asia Pacific region since 2004, but capital inflows into Japan are slowing down. The volume of real estate transactions in Japan in 2008 was about US\$19 billion, a 46% decline from 2007. The volume has declined sharply since Q2 2008, and given the ongoing difficulty of real estate financing, a further decline is anticipated in 2009.

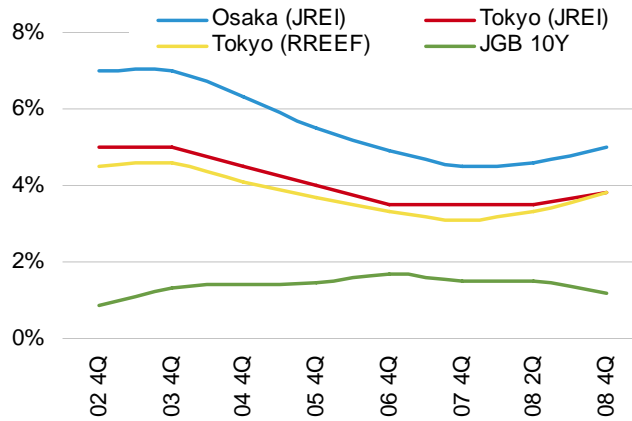
Chart 5: Real estate transaction volume in major APAC countries



Source: RREEF Research, JLL, February 2009

According to JREI, cap rates for prime offices in Central Tokyo² rose by 30 bp to 3.8% in October 2008 and by 50 bp to 4.3% in Osaka. The credit crisis is affecting cap rates of not only second-tier assets but also of prime assets, albeit to a lesser degree. We expect cap rates to continue to drift up gradually in 2009. The weakness of the economy should cause bond yields to remain below 1.5% in 2009.

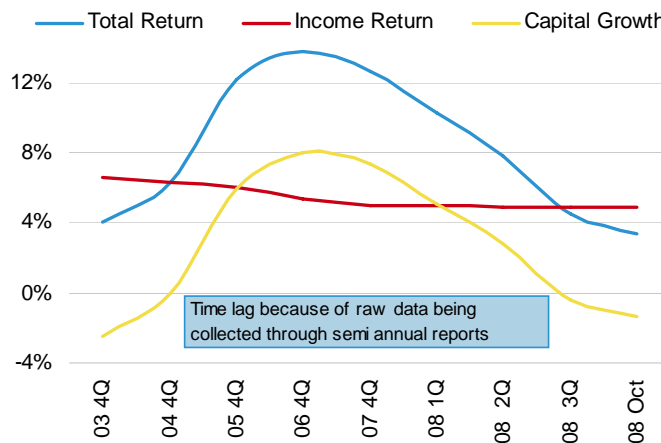
Chart 6: Cap rates and government bond rate



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

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 been gradually declining in accordance with a steep decline in capital value growth. With capital growth falling to -1.4% in October 2008, the rate of total return was squeezed to just 3.4% (year-on-year basis, preliminary), and there is no sign of leveling off. Given the continuous deterioration in capital values and the weakness in the retail market, returns are likely to further decline sharply in the short to medium term.

Chart 7: Return of unlevered direct investment (all property)

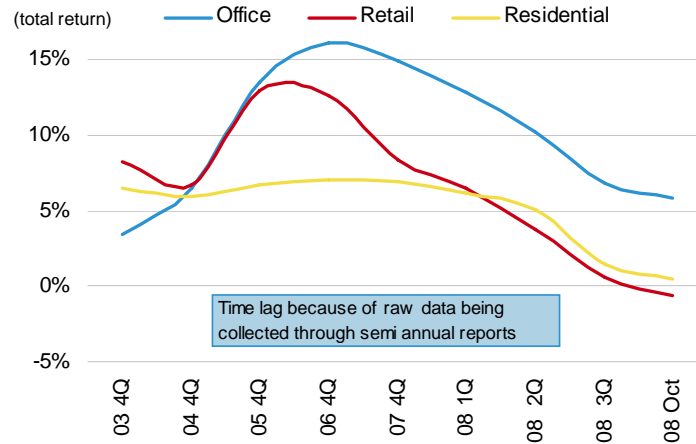


Source: RREEF Research based on IPD Japan Monthly Indicator, February 2009

² Central Tokyo is defined here as the five wards (or "ku" in Japanese) of Chiyoda, Chuo, Minato, Shinjuku, and Shibuya.

All of the three major property sectors are seeing continuous declines in total returns but office is performing relatively better than the other sectors. Retail property's total return fell negative for the first time in October 2008, the most recent figure available.

Chart 8: Total return of unlevered direct investment (by sector)



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

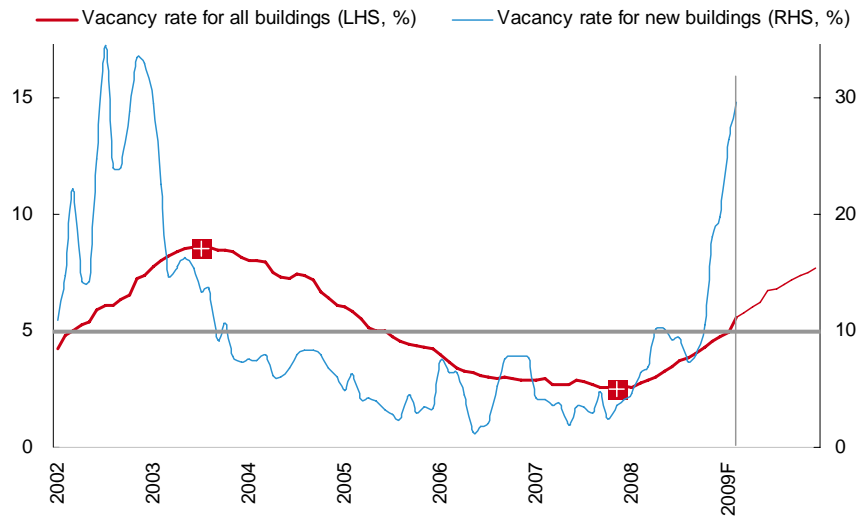
Market Fundamentals: Office

The office vacancy rate in Central Tokyo at the end of January 2009 was 4.9%, a significant increase from 2.7% at the end of 2007. Because of the growing uncertainty over the economy, tenants have become very reluctant to move or to expand work spaces since the second half of 2008. Newly developed offices comprise the sector of the market that is most severely affected, and the vacancy rate for new buildings³ in Central Tokyo skyrocketed to 26.5% in January 2009.

Historically the overall vacancy rate for all buildings has followed the trend of the new building vacancy rate with a time lag of about six to twelve months. Therefore, the new building vacancy rate works as a leading indicator for the overall vacancy rate. Given the current depth of the economic slump and the sharply rising vacancy rate for newly developed offices, the overall office leasing market in Tokyo is expected to soften considerably for months to come. We expect that the average vacancy rate could rise to the level of the previous peak in 2003, depending on the extent of the deterioration of the macroeconomy.

³ The vacancy rate for new buildings includes buildings completed within the past 12 months.

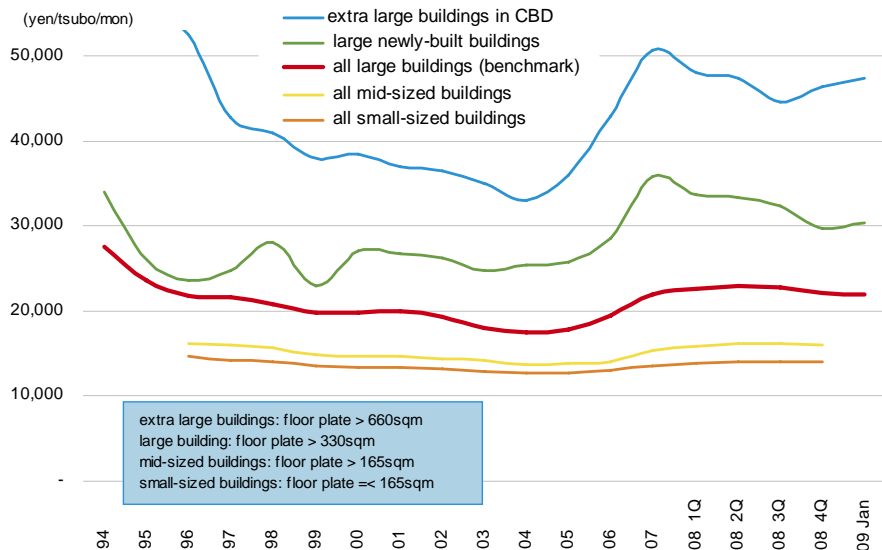
Chart 9: Office supply and vacancy rate in Central Tokyo (5 wards)



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

Following a rapid increase in asking rents in 2007, the growing uncertainty over the economic outlook has since caused asking rents for quality space in Central Tokyo to fall. Average asking rents for extra large buildings in the CBD⁴ as well as large-scale newly built offices started to decline in 1Q 2008. Although both seem to show tentative resilience in the current market downturn, we expect further rental declines in 2009 for these buildings because of weaker demand. Average asking rents for all large buildings (i.e., the benchmark) in Central Tokyo started to decline in 3Q 2008 and have dropped 3.1% since then. Rents for smaller buildings started to decline only in 4Q 2008. The current surge in vacancy rates will dampen the prospects of any positive rental recovery until 2010 or possibly 2011 for all classes of buildings.

Chart 10: Office asking rents in Central Tokyo by building grade

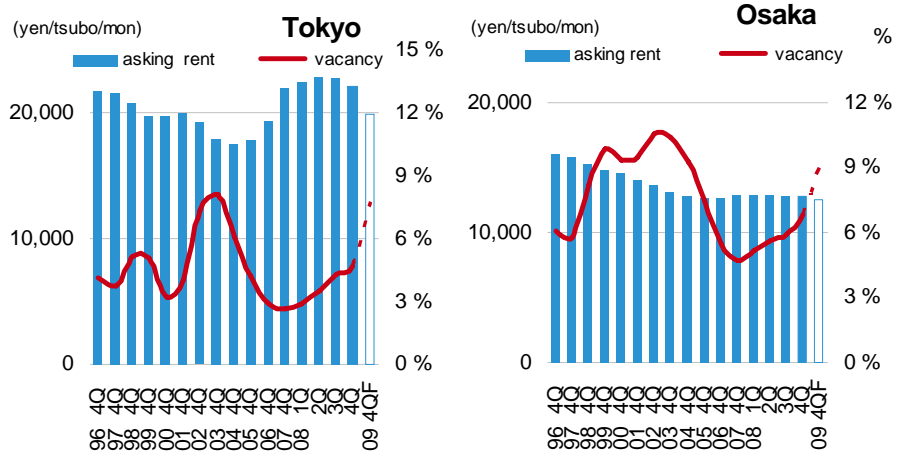


Source: RREEF Research, Miki Shoji, Sanko Estate, February 2009

⁴ CBD: Marunouchi and Otemachi area near Tokyo Station in Chiyoda-ku.

Unlike the Tokyo market, office rents have not risen substantially in regional cities in the past several years. The vacancy rate in Osaka rose to 7.0% in January 2009 from 4.7% in December 2007 while the average asking rent fell about 1% 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 mid term.

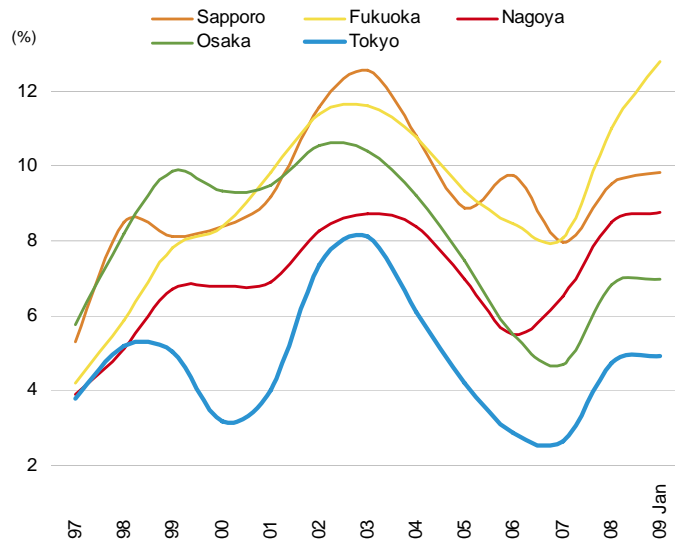
Chart 11: Office rents and vacancies in Tokyo and Osaka



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

The vacancy rates in other regional cities are rising even higher. In January 2009 the vacancy rate rose to 12.8% in Fukuoka, 9.8% in Sapporo, and 8.8% in Nagoya, compared to 4.9% 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.

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

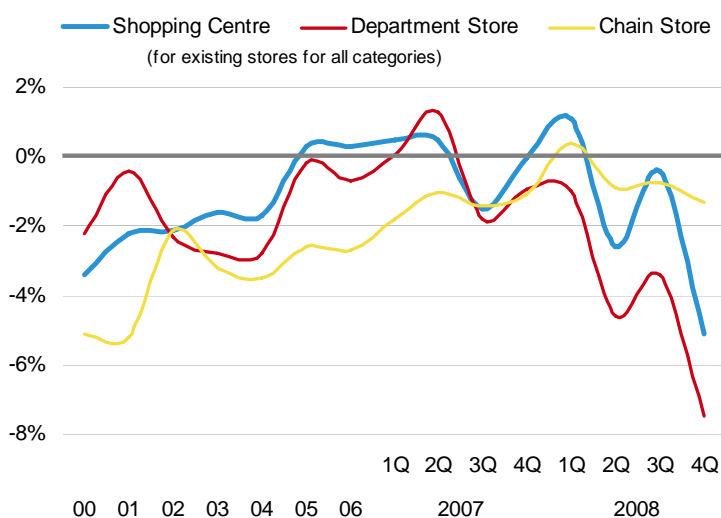


Source: RREEF Research, Miki Shoji, February 2009

Market Fundamentals: Retail

Imported food products are becoming more affordable because of the strengthening yen, yet at the same time, the current economic turmoil is further eroding consumer confidence. Department stores (existing store basis) were the worst hit subsector in 4Q 2008, with same-store sales falling 7.5% from the same period last year, the steepest decline in 15 years. Sales in shopping centres (existing store basis) also declined sharply, down 5.1% from last year. Chain stores (existing store basis) seemed to perform best among the three categories with a decline of only 1.3% in the same period but this was only because a number of unprofitable stores were closed down, which boosted the sales of the remaining stores.

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

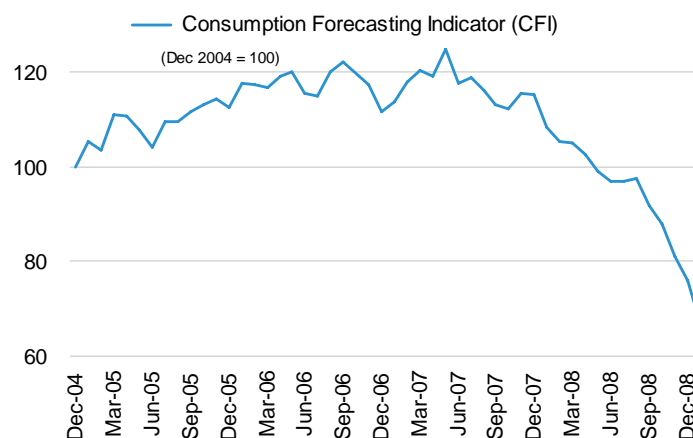


Source: RREEF Research, JCSC, JDSA, JCSA, February 2009

Nikkei RIM's consumption forecasting indicator (CFI)⁵, a survey that predicts future consumption trends six months in advance, shows a strong deterioration in consumer confidence. In January 2009 CFI was 66.7, a more than 20-point drop from October 2008 which, as we reported last time, was already a record low level for CFI since its inception. This CFI performance indicates gloomy retail sales until at least the second half in 2009.

⁵ 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.

Chart 14: Consumption forecasting indicator

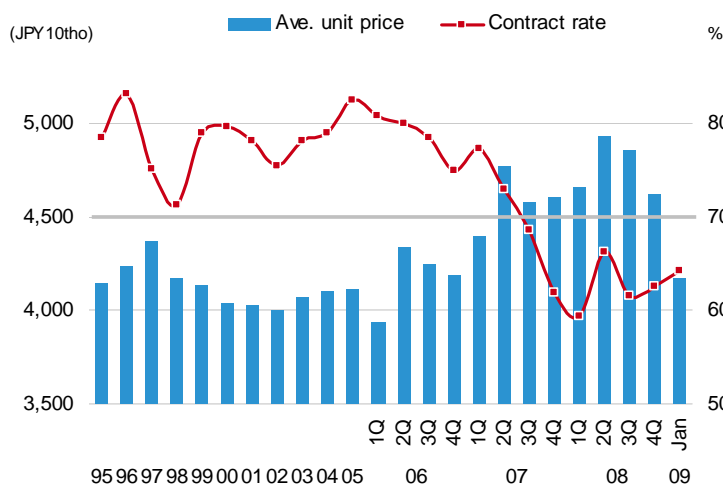


Source: Nikkei RIM, February 2009

Market Fundamentals: Residential

The average newly developed built-for-sale condominium price in Greater Tokyo began to rise sharply in early 2007, pushing prices above the JPY45 million threshold for seven quarters running and signaling constrained housing affordability in Tokyo. As a result, the condominium contract rate⁶ has held below 70% for more than six consecutive quarters. Housing developers started to lower their sales prices in the beginning of 2009 and there seem to be further unofficial discounts offered to home buyers through bilateral negotiations, but the recovery in the contract rate has not materialised. Housing developers are expecting demand recovery by enhanced residential mortgage tax breaks implemented this year, but because of the discounts offered to buyers, the developers face significant write-down risks for the values of their existing land inventories or other assets that are held on the balance sheets.

Chart 15: Condominium unit price and contract rate in Greater Tokyo



Source: REEI, February 2009

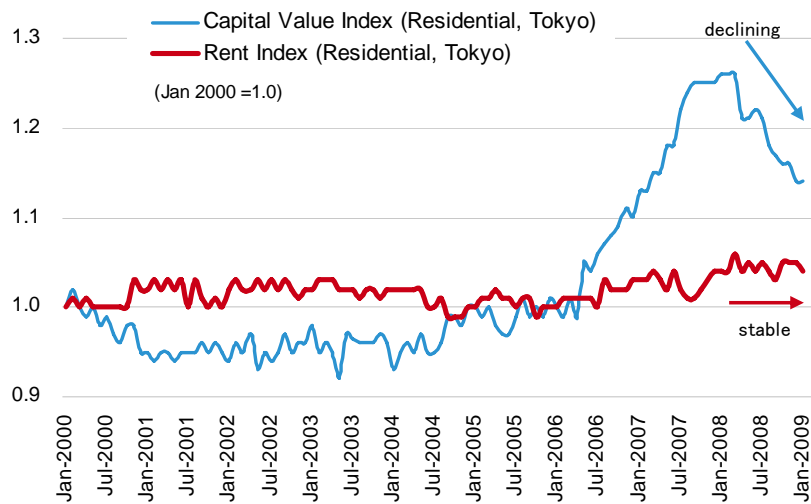
The capital values of existing condominiums (i.e., the re-sale price) began to soften in April 2008, several quarters earlier than the price decline experienced for newly

⁶ The contract rate is the ratio of units currently under contract to the inventory of units for sale.

developed condos. The capital values for existing condos fell by 9.5% between March 2008 and January 2009. On the contrary, residential rents remained 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.

Although rents have remained relatively stable, the amount of take-up in the residential leasing market in Greater Tokyo has been declining for 12 consecutive months till January 2009. The vacancy rate is increasing for the top-end apartments which were mainly designed and developed for foreign expatriates, and this parallels the growing trend to downsize Tokyo operations by foreign companies. Also, granting free-rent periods for a month or two for new tenants is becoming popular. These trends are expected to gradually impact the cashflows generated by residential assets.

Chart 16: Residential capital value and rent index in Tokyo



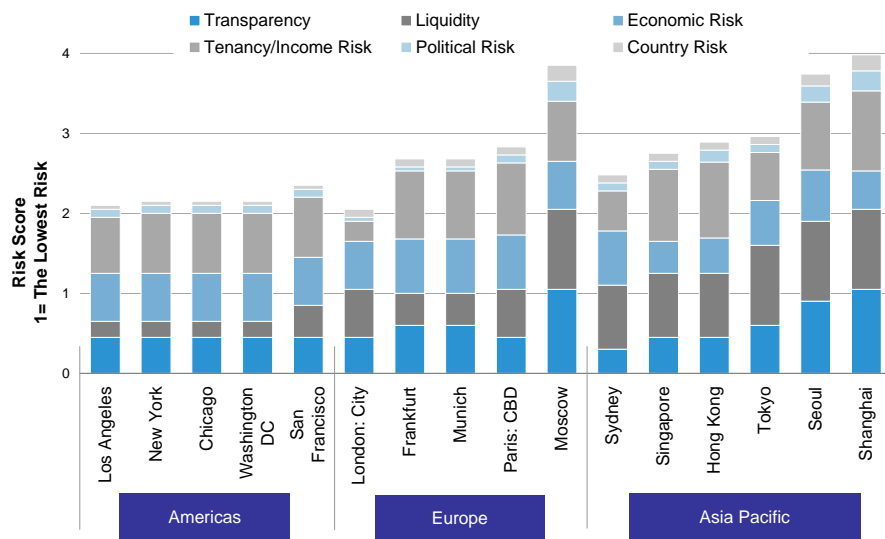
Source: Recruit-IPD, RREEF Research, February 2009

3. Research Topic: Tokyo Office Market in its Global Context

The worldwide credit crunch has impacted the real estate markets of key global cities, and Tokyo is not an exception. Just like its peers such as London, New York, Singapore or Hong Kong, the real estate investment market has deteriorated rapidly in Tokyo. As described in the previous chapter, Japan's macroeconomy is in a deep slump which casts a shadow over the fundamentals of the leasing market in Tokyo.

The history of the real estate investment is relatively short in Japan and the market is not regarded as mature as western or some Asian cities. Tokyo's market transparency is lower⁷ than Australian cities, Hong Kong or Singapore while liquidity risk in Tokyo is substantially higher than American cities, according to our in-house research. These factors reduce the attractiveness of the market as an investment destination.

Chart 17: Real estate investment risk among major cities



Source: RREEF Research.

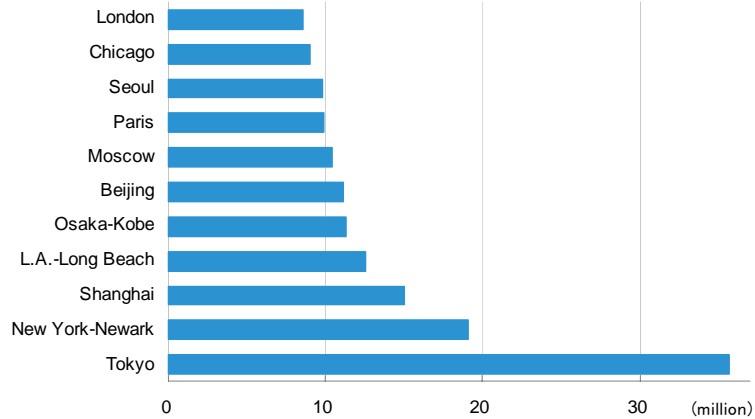
Despite these weaknesses, the Tokyo's office market has a series of unique characteristics, and strengths, compared with other global cities. This chapter compares and contrasts Tokyo with its competing peer cities and highlights its unique strengths in its global context.

First of all, the population of Tokyo, including surrounding cities, is by far the largest in the world according to 'World Urbanization Prospects 2007' compiled by the United Nations⁸. The agglomeration of Tokyo as defined by the UN had more than 35 million inhabitants in 2007. Accordingly, the region's GDP, retail sales, number of office workers, and volume of office stock all rank as the largest in the world.

⁷ See Japan Quarterly 2Q 2008. "Making sense of the rental market", published by RREEF Research.

⁸ Similar analyses by Demographia and the World Gazetteer have reached the same conclusion, defining the Tokyo agglomeration as the largest in the world. The United Nations defines urban agglomeration as a contour of a contiguous territory inhabited at urban density levels without regard to administrative boundaries or commuter flows.

Chart 18: Population of largest urban agglomerations, 2007



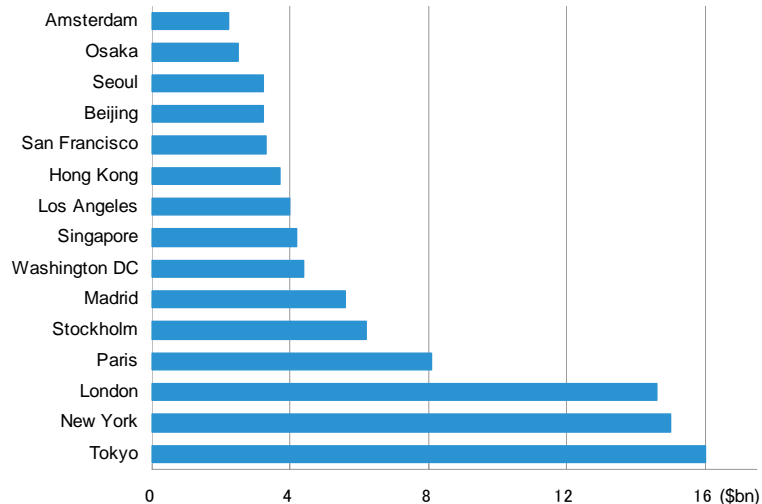
Note: Cities in Africa, Central and South America and South Asia are not shown in the chart.

Source: World Urbanization Prospects by United Nations 2007

As seen in Chart 17 Japan's real estate markets are less liquid than those of the highly-mature western markets. Still, in 2008 Tokyo ranked first globally in terms of the volume of office transactions closed during the year, ahead of both New York and London. To some extent this is because the credit crisis hit the UK and the US markets first while the Japanese market remained active, certainly during the early part of the year. A couple of large buildings, such as the headquarters of Shinsei Bank and Risona Bank, were sold during Q1 2008.

The credit market in Tokyo was squeezed sharply after spring 2008 and the volume of transactions has been declining since then. Investors also show preference for markets that have been correcting faster (such as London), so it is not likely that Tokyo will maintain the top spot as an investment destination going forward, but it is expected to remain as a leading market in the Asia Pacific region in the long term.

Chart 19: Volume of office building transactions in 2008

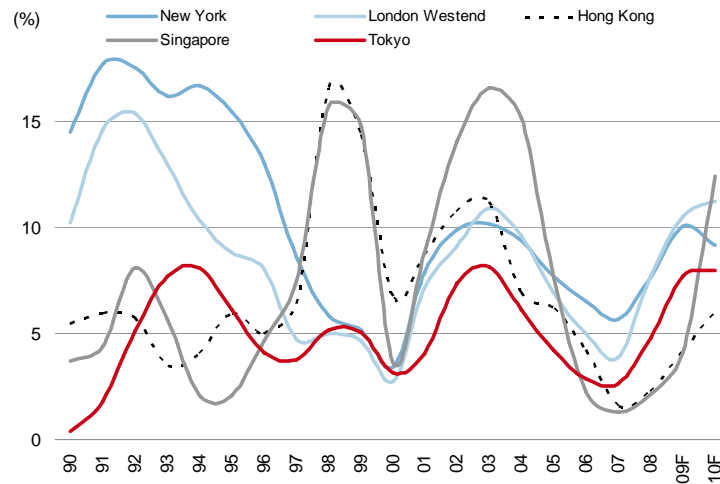


Note: Volume of investment in American cities includes the entire metropolitan area.

Source: RCA 2009

Tokyo has a large office stock with a diversified tenant base that draws from all kinds of industries. As such the market is reasonably insulated from industry-specific downturns and the office vacancy rate in the central five wards in Tokyo has been relatively stable compared to other global peers. The historical peak was 8.1% in 1994 and in 2003. When supply surged in 2003, Tokyo's vacancy rate rose to only half the level of peaks observed in other cities (peaks ranged between 15% to 18% in London, New York, Hong Kong and Singapore). Tokyo is not immune to the current world economic slowdown, however, and the vacancy rate is expected to rise sharply in 2009 and 2010, reaching its previous peak or possibly even higher, depending on the economic situation.

Chart 20: Comparison of office vacancy rates

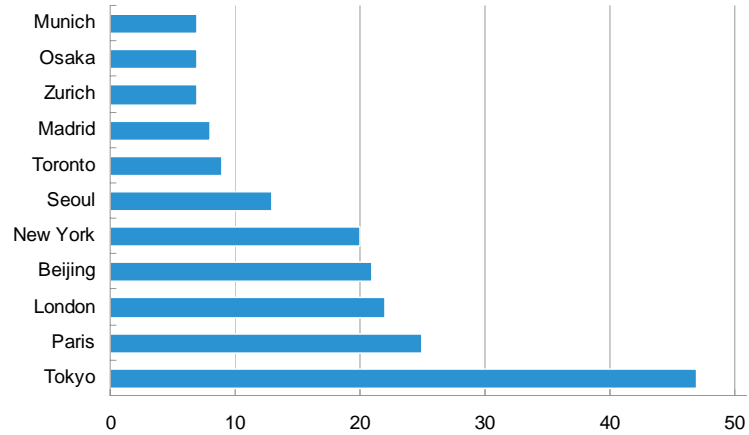


Source: RREEF Research, Miki Shoji, (F = forecast by RREEF Research), February 2009

One distinguishing characteristic of Tokyo's office market is tenant diversification. The number of 'Fortune Global 500'⁹ companies based in Tokyo is about twice the number in Paris, London, Beijing or New York. Unlike New York or London, Tokyo's office market includes many head offices for manufacturers in industries such as electronics and automotive as well as headquarters for firms involved in the financial and service industries. This is partly because Japan is an unusual developed economy that still has strong manufacturing industries while the economies of the majority of developed countries tend to be led primarily by service-based tertiary industries.

⁹ The Fortune Global 500 is a ranking of the top 500 corporations worldwide as measured by revenue. The list is compiled and published annually by Fortune magazine.

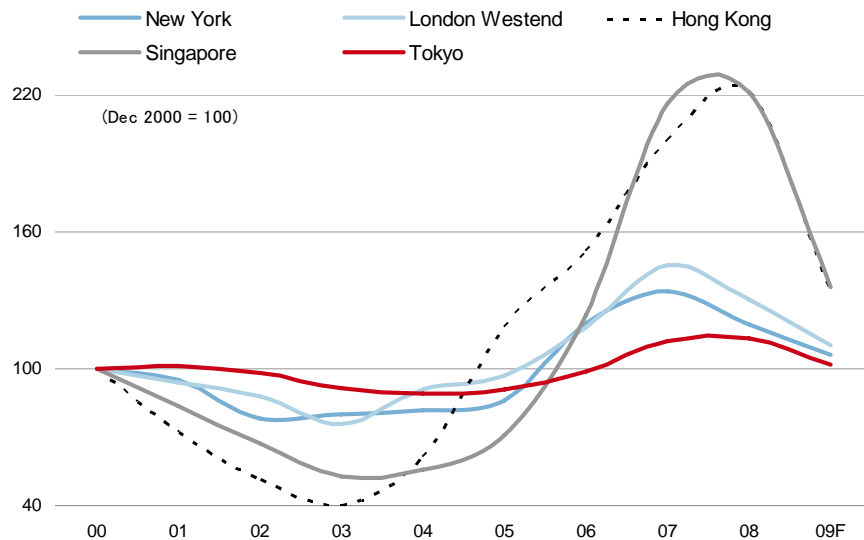
Chart 21: Number of Fortune Global 500 companies in 2008



Source: Fortune Global 500, July 2008

The final chart shows the comparison of office rent trends of each city since 2000. Of course it has to be noted the types of sample buildings¹⁰ in the basket differ city by city and the rent index cannot be compared directly among different cities, but it indicates at least some stability of rent trends in Tokyo in comparison with other cities. Office rents were volatile in Tokyo at and after the 'bubble' era of the 1990s but the experience of that era may have ushered in more stabilising influences today. The diversified tenant base across industries, the size of the market, and the uniqueness of the Japanese leasing contract¹¹ are all thought to support lower volatility.

Chart 22: Comparison of office rents (index)



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

¹⁰ The data for the average asking office rents in Tokyo is collected by monitoring the rents of all large-scale offices in the central city area. This includes 2,600 leased buildings with a floor unit size of 330 sqm or larger located in the central five wards of Tokyo.

¹¹ See Japan Quarterly 2Q 2008. "Making sense of the rental market", published by RREEF Research.

In this chapter we described the uniquenesses of the office market in Tokyo, which is characterised by its large size, some market stability and a set back of relative market immaturity, but it also should be noted once again that Tokyo is not immune to the rapid contraction of the global market. Despite any relative advantages that Tokyo may offer in the long term, real estate fundamentals in the city are nonetheless expected to deteriorate sharply over the next one or two years, especially given the current very difficult economic environment in Japan.

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I-010763-1.0