JAPAN PROPERTY MARKET REPORT 2023

JAPAN PROPERTY CENTRAL K.K.

JAN 2024 // PREPARED BY ZOE WARD

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Overview

2023 AT A GLANCE

Despite the turmoil happening in some overseas commercial real estate sectors, investors in Japanese real estate were increasingly active in 2023.

That may be due in part to a stable property market with low interest rates, making it one of the few places with a positive yield spread over government bonds. The continued low interest rate environment has underpinned the market with domestic investors continuing to acquire and hold assets, and foreign investors desperate to get a foot in.

Japan’s Nikkei Stock Average ended the year at the highest level since 1989 and posted a 28% annual gain, thanks to an economic recovery and strong corporate earnings. The Tokyo metropolitan government is expecting to collect 6.3 trillion Yen in tax revenue for the year, reaching the highest level in history, largely due to corporate taxes resulting from increased exports and the rising price of raw materials.

The total volume of commercial real estate acquisitions made during the first half of 2023 reached 2.3 trillion Yen (approx. US$16 billion), according to the Japan Real Estate Institute, up 9.5% from the second half of 2022. At the previous market peak in the first half of 2007, transaction volume reached a record 3 trillion Yen before dropping to around 1 trillion Yen in the second half of 2008. Since the introduction of monetary easing policy in 2013, transactions have maintained a strong half-yearly pace of over 2 trillion Yen.

Overview, cont.

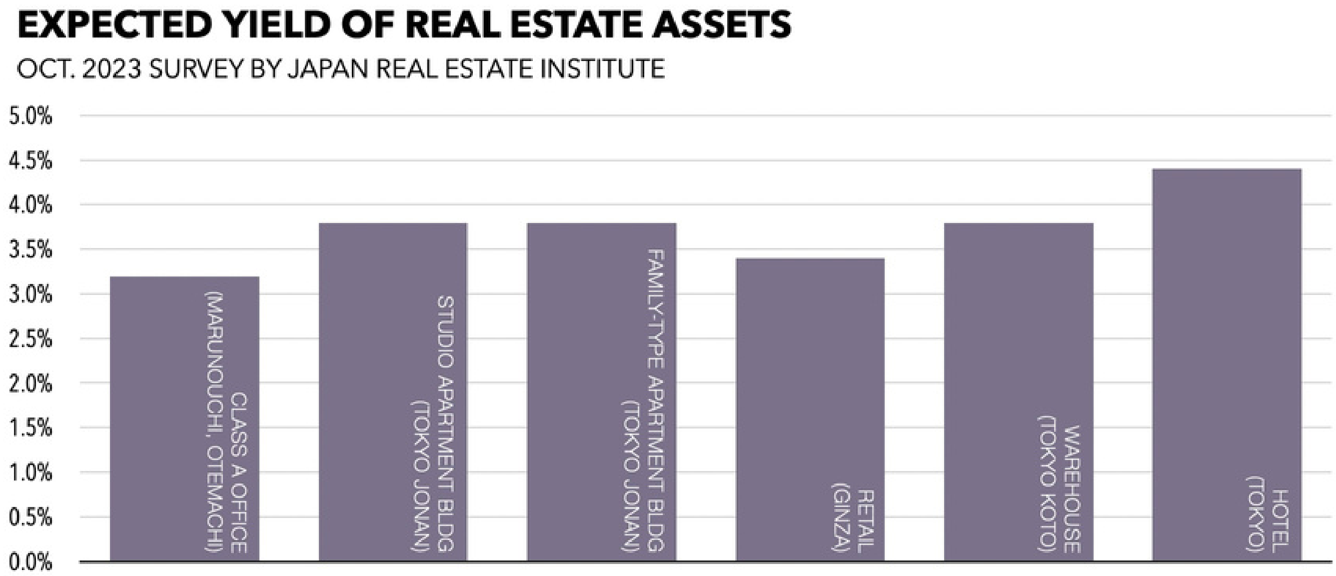
Although it still comprised the biggest share out of all asset types, transaction volume in office buildings saw a slight decline. Meanwhile, activity has been lively in the logistics and hotel sector as investors anticipate growth and a recovery in tourism. Known for buying more than they sell, J-REITSs have been consistently underpinning the market, their activity balancing demand and supply. Since 2022, special purpose companies and asset managers have become more active, and private placement funds have become more prominent in terms of acquisitions.

DOMESTIC INVESTORS FORMED THE MAJORITY OF INSTITUTIONAL INVESTMENT IN JAPANESE REAL ESTATE

Acquisitions by foreign funds in the first half of 2023 reportedly dropped to 480 billion Yen (approx. US$3.3 billion), down from a record 1 trillion Yen seen in the first half of 2022, according to the Japan Real Estate Institute. This represents 20% of institutional investment, with domestic investors accounting for 80% of the total.

According to the NLI Research Institute, total J-REIT acquisitions between January and September of 2023 reached 905.7 billion Yen, up 57% from the same period in 2022. Office buildings accounted for a third of the transaction volume, followed by logistics (27%), hotels (20%), residential (13%) and retail (7%). CBRE's Japan Investment Marketview Report for Q3 2023 had cumulative transaction volume for the first three quarters of the year up 27% from 2022, supported by a large increase in transactions by J-REITS.

Overview, cont.



YIELDS REMAIN AT RECORD LOWS

The latest investor survey by the Japan Real Estate Institute in October showed expected yields had either remained the same or compressed further, depending on the asset class and location, compared to a survey conducted six months earlier. Class A office space in Tokyo's Marunouchi and Otemachi districts remained at a historic low. Investors are showing even more confidence in family-type apartment buildings, where expected yields decreased in eight out of ten locations nationwide. 95% of respondents said they plan to continue investing over the next 12 months.

POPULATION GROWTH IN TOKYO

As the pandemic winds down and remote work hits a ceiling, residents are returning to the capital. The work-from-home trend has placed a growing emphasis on one's living environment. However, with the emergence from the pandemic, there has been a strong influx of people returning to the city center, resulting in a noticeable increase in land and property prices in areas that offer convenient access to central Tokyo.

In August, the population of the Tokyo metropolitan area, which includes the 23 wards, cities in West Tokyo, and islands, reached a record high of 14.09 million. Most of the recent growth has been in the central and eastern parts of the 23 wards as the population continues to concentrate in the city center.

The population of Tokyo's 23 wards reached 9.794 million as of November 1, 2023, a 0.72% increase y-o-y and a record high. The concentration of the country's population in Tokyo is only expected to intensify further in the coming years, with the National Institute of Population and Social Security Research forecasting that Tokyo will be the only prefecture in Japan to see a higher population in both 2035 and 2050 compared to 2020. It is forecast to be 2.5% higher by 2050, although the peak is expected to be reached by 2040.

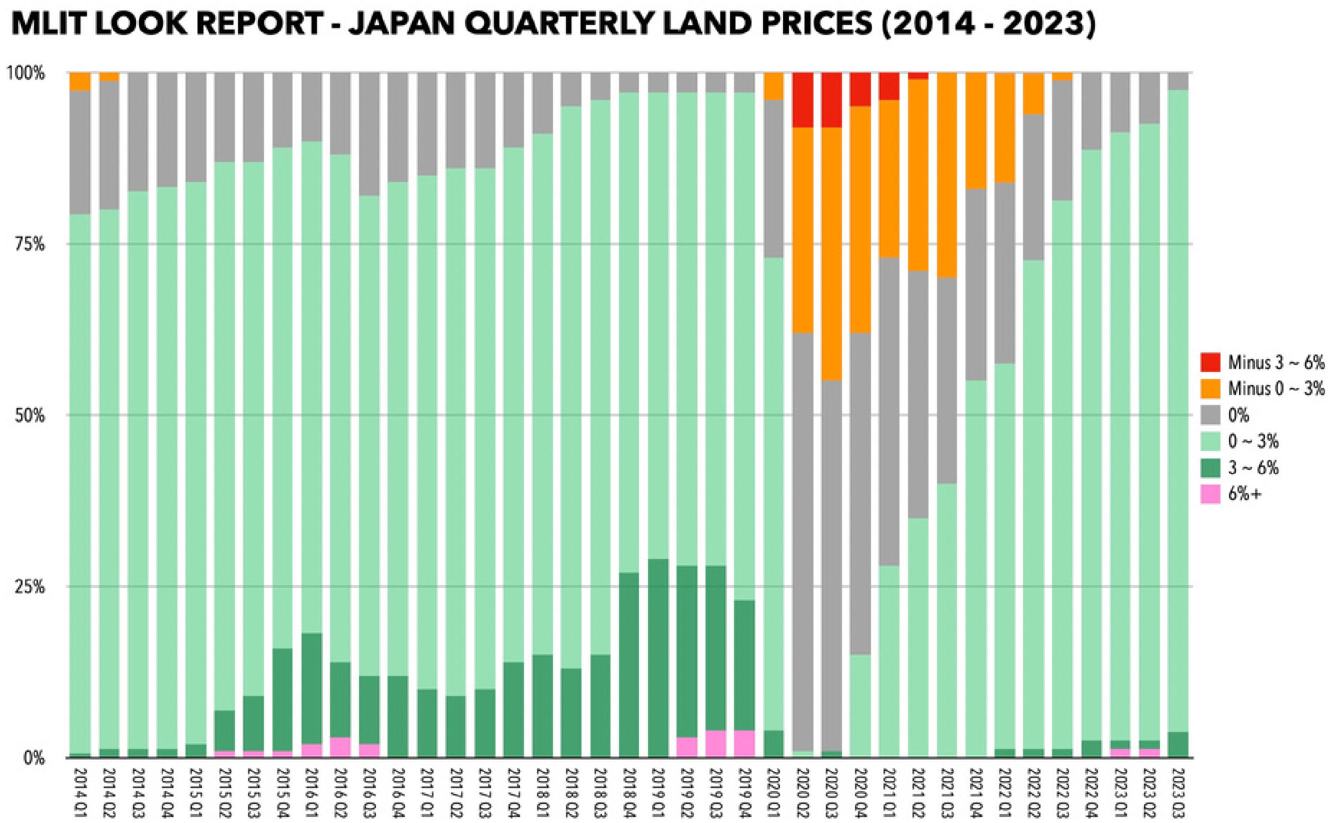
Overview, cont.

LAND PRICES CONTINUE TO GROW

Land values across Japan continued to rise at a fastening pace after suffering some declines during the pandemic. Rising prices are due to improving economic conditions, strong demand for apartments, and signs of a recovery in retail demand. According to the LOOK report published by the Ministry of Land, Infrastructure, Transport and Tourism (MLIT) for the third quarter of 2023, 97.5% of the surveyed locations saw positive growth – the highest share seen on record. No locations saw a drop in prices.

Standard Land Prices, also issued by the MLIT, increased nationwide by 1.0% following a 0.3% increase in 2022. Regional areas saw the first increase in 31 years, driven primarily by growth in cities such as Sapporo, Sendai, Hiroshima, and Fukuoka. In the Tokyo metropolitan area, land prices increased by 3.6%, marking the 11th consecutive year of growth.

'Rosenka' or road-side land prices, used for calculating gift and inheritance taxes, increased nationwide in 2023 by 1.5%. This was the second year in a row to see an increase, and at a faster rate of growth than the 0.5% increase reported in 2022. A representative from the Urban Research Institute Corporation commented that land values in shopping and tourist districts are recovering, and expects them to exceed pre-pandemic prices. For the suburban residential areas which have seen a bump in values as companies offer remote-work or flexible working schedules, the increase in demand may have already reached its limit.



MULTI-FAMILY

Tokyo will be the only prefecture in Japan to see a higher population in both 2035 and 2050 compared to 2020

Would-be buyers, priced out by the ever-increasing sale price of housing, are starting to turn to rentals, causing it to swing to a landlord's market in some cities. A recovery in corporate earnings and pay-rises is also expanding renters' budgets.

> *Changes in rental prices in greater Tokyo are not uniform, with larger apartments now outperforming smaller, single-occupant housing.*

A rental index published by AtHome in June showed much higher rental growth for larger apartments than smaller, single-occupancy ones. Apartments in the 30 ~ 50 m2 and 50 ~ 70 m2 range have seen year-on-year increases for the past 7 and 6 months consecutively. In Osaka City, for example, single-occupancy apartments under 30 m2 saw a year-on-year increase of 3.4%, compared to 6.6% (30 ~ 50 m2), 12.4% (50 ~ 70 m2) and 13.5% (70 m2 and above).

DEVELOPERS AND INVESTORS ARE TAKING NOTE

Nomura Real Estate Development recently announced plans to develop 1,500 rental apartments over the next three years through its Proud Flat brand. This is averaging 75 apartments per building, with some 100+ unit buildings planned for Takadanobaba and Monzennakacho. The company's family-type rental apartments are currently seeing occupancy rates in the 97% range.

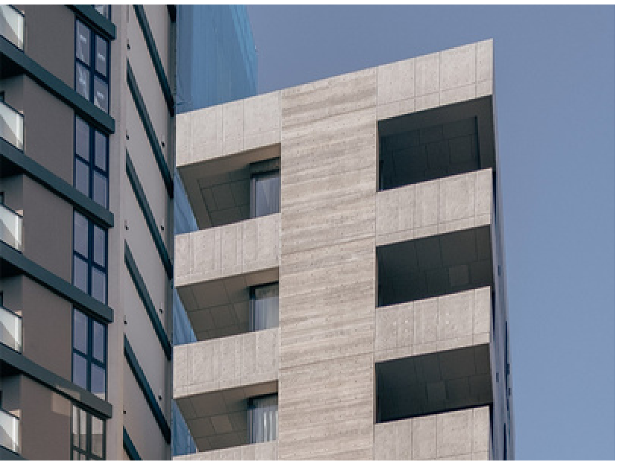
A subsidiary of Haseko Corporation is planning to increase its developments by 50%. Haseko Livenet has already developed 38 buildings with 1,587 rental apartments, with a further 22 buildings and 804 units under development.

Tokyo Tatemono has around 2,000 rental apartments under development. Rental apartment building sales for the firm have doubled since 2018. The developer's typical model is build-and-sell, but with rental prices rising, the company is also considering holding these income-producing assets over the long-term.

Multi-family, cont.

Up to 85% of the apartments in Star Asia Investment Corporation's rental apartment portfolio are over 30 m2 in size - a size considered to offer stable tenant demand. In response to market conditions, the REIT was able to achieve a net increase in the rents charged on apartments over 30 m2 in size by adjusting rents between tenancies. However, for its apartments under this size, it had to reduce rents in order to sustain occupancy rates. Single-occupant housing in the REIT's portfolio saw occupancy rates drop from pre-pandemic levels that were between 95 ~ 100% down to almost 75% by late 2021, before recovering sharply in early 2022. They now sit at 94.8%. For the family-type apartments, occupancy rates remained stable throughout the pandemic and sit at 95.7%.

Japan's stable rental market and favorable exchange rate is also drawing the attention of foreign funds and institutions. According to US-based MSCI, foreign funds spent an average of 450 billion Yen per year between 2020 and 2022 on rental apartment building acquisitions in Japan. This was a 50% increase from the annual average between 2017 and 2019. This surge in demand has also encouraged domestic developers to boost the supply of rental projects.



GETTING CREATIVE

With low cap rates, some investors and landlords are looking at ways to differentiate and add value to their buildings. One landlord of a newly-built apartment building in Meguro is offering tenants daily free breakfast and coffee at the cafe on the ground floor. The apartments are priced 20 ~ 30% higher than comparable ones in the neighborhood. The building was 83% leased within the first 9 months.

Furnished and serviced apartments for shorter-term stays are becoming a sector of interest. Over the past few years, international serviced apartment brands have been tapping into the demand for quality short-term rentals in Tokyo. Historically, this space has been primarily supplied with small, sparsely furnished shoeboxes for single occupants, typically domestic businesspeople sent to Tokyo on work assignments. In September, Hong Kong-based Weave Living announced the acquisition of nine apartment buildings with 352 units in Tokyo that will operate under the serviced and flexible apartment provider's brand. The company plans to grow its holdings in Japan to US$1.5 billion by 2025.

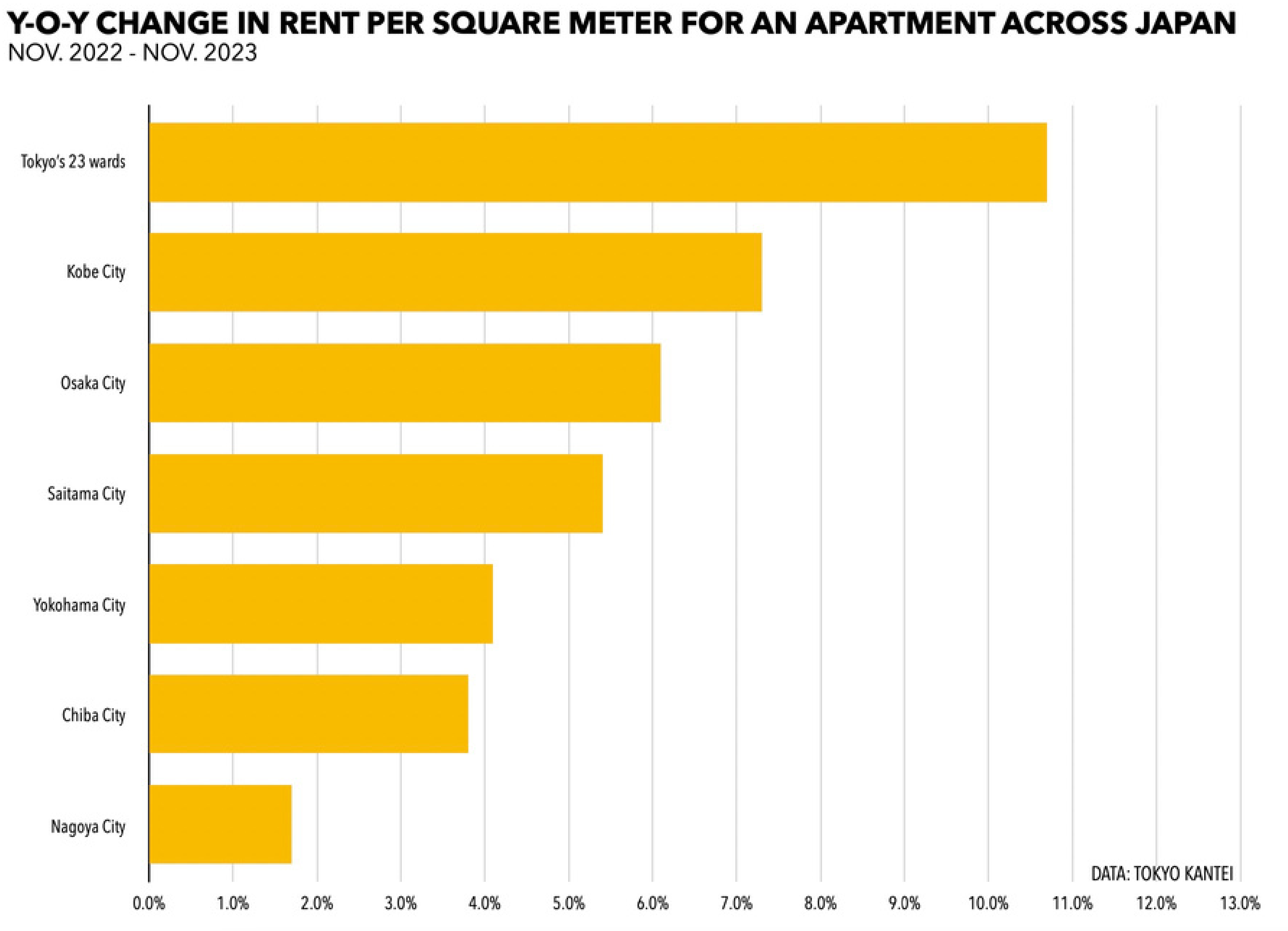
Singapore-based Hmlet entered Japan in October 2019, partnering with major developer Mitsubishi Estate in late 2019 to offer co-living and short-term stay furnished apartment buildings. The company now operates over 30 buildings with 600+ apartments in Tokyo. Mitsubishi Estate has also signed a licensing agreement with US-based Blueground Holdings to operate 10,000 monthly-rental apartments targeting foreign tourists and digital nomads, with rents expected to range from 300,000 to 500,000 Yen a month.

Multi-family, cont.

RISING RENTS

According to Tokyo Kantei, the average monthly rent of a condominium-type apartment in Tokyo's 23 wards was 4,236 Yen/m2 in November, up 0.2% from the previous month and up 10.7% from last year.

Rents increased across all building age ranges, with buildings aged between 6 ~ 10 years and 30+ years setting record highs for the month. November is typically a month that would see a drop in average rents as the busy Autumn moving season has ended. However, this is not the case this year with market conditions favoring landlords.



OFFICE

Tokyo has over 330,000 companies of which 80% have less than 20 employees and only 1% have over 300 staff

Experiences varied within the office market as some buildings struggled to attract tenants while others maintained high occupancy ratios.

> *Looking at the office market as a whole would be a mistake, as the sub-markets continued to bifurcate in 2023. In particular, there were some noticeable differences between the market for large-scale and mid-sized office space.*

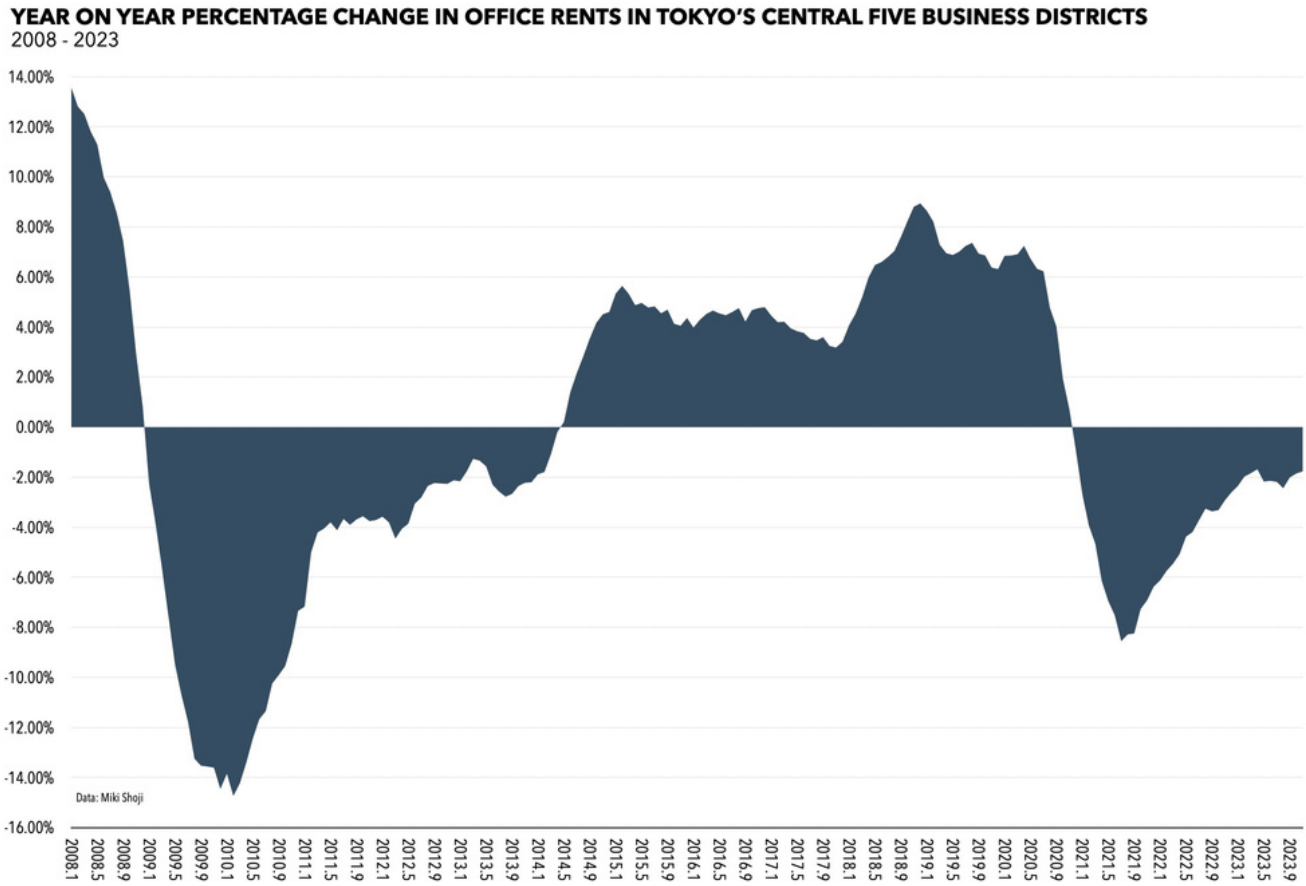
Large-scale Grade A office is dominated by major corporations and tends to be the focus of office market reporting. However, it is the mid-sized office buildings serving small-to-mid-sized enterprises that underpins the Japanese office market, and this sector has been drawing interest from domestic investors and developers. It is no wonder as to why - as Tokyo has over 330,000 companies of which 80% have less than 20 employees and only 1% have over 300 staff.

Mid-sized office buildings (those with a GFA of between 500 to 3,000 tsubo, or 1,652 to 9,915 m2) are positioned in a sweet spot in terms of size and rent, attracting tenants who have outgrown smaller buildings as well as tenants who are looking to downsize from larger and more expensive buildings. According to Kenedix Office Investment Corporation, the typical tenant profile in these buildings is a business with less than 30 employees. In Tokyo, 92.2% of businesses have less than 30 employees.

The Ichigo Office Reit, which has an average office size per tenant of 257 m2 (2,765 sq.ft), was operating at a 96.3% occupancy ratio for its office buildings as of November 2023, an improvement from a recent low of 96.0% in April 2023. In April 2020, the occupancy ratio was as high as 99.6%.

Office, cont.

Overall, the large-scale office market appears to be stabilizing with brokerage firm Miki Shoji reporting that the average vacancy rate for existing office in central Tokyo's five business districts was 5.27% as of November 2023, the lowest level seen in 33 months. The vacancy rate peaked at 6.39% in October 2021. In one example, Tokyo Midtown Yaesu (GFA 283,900 m2), a new skyscraper in front of Tokyo Station with the Bulgari Hotel on the upper floors, was fully leased to tenants as of March 2023.



LOW CAP RATES CONTINUE

According to the Japan Real Estate Institute, the expected yield on Class A office space in Marunouchi and Otemachi was 3.2% as of October 2023, showing no change from a previous survey conducted six months earlier. Back in April 1999, when the Institute began collecting data, they were as high as 6%, before dropping below 5% in 2005. Expected yields have been in the 3% range since 2015. CBRE's Japan Investment Marketview Report for Q3 2023 had cap rates for Otemachi area office at 3.15%.

The Japan Real Estate Reit acquired a 50% quasi-ownership share in the ARGYLE aoyama mixed-use building in Omotesando in early 2023 at a 2.9% cap rate. The 20-story building includes retail, office, and a hotel. In August, Japan Real Estate Investment Corporation acquired a 13-story office building in Osaka at an appraised cap rate of 3.5%. It had a vacancy rate of 7.9% at the time of acquisition.

Office, cont.

CHANGE IN TENANT PREFERENCES

Work styles have changed since the onset of the pandemic, and tenants are now favoring buildings that offer a variety of amenities, such as communal lounges and private booths for online meetings. These features are typically not found in older office buildings. Landlords are also mixing up the floor sizes on offer by splitting up some floors to attract small-to-mid sized corporate tenants.

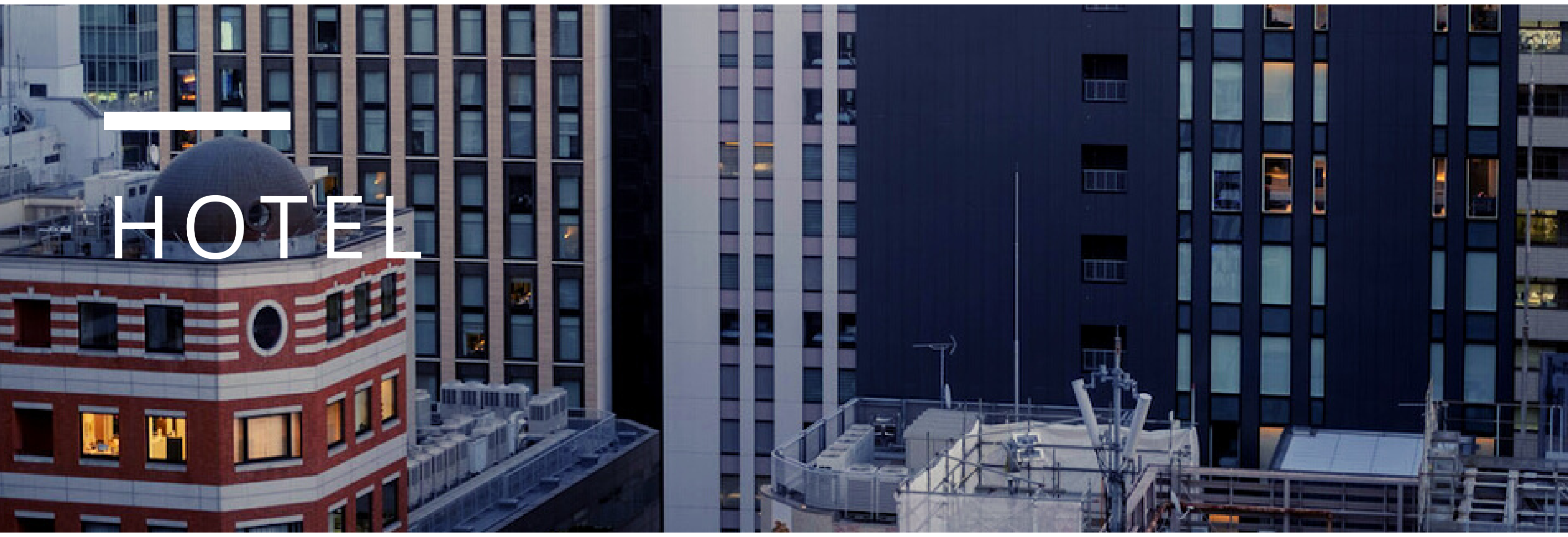
> *With tenants becoming increasingly picky about office building design and atmosphere, developers need to be innovative in order to maintain a competitive edge.*

And while the odds of completely leasing out a new Grade A office building prior to completion may be lower in the current market, developers are taking this into account and allowing more time to fill their buildings with the right mix of tenants.

Some regions are lacking much-needed office space. Chiba City is one of those places. To attract new office construction in the vicinity of Chiba Station, Makuhari New City, and Soga Station, the city began offering financial incentives of up to 2 billion Yen per project to developers. The city is also considering offering floor area ratio allowances as further enticement.

SECOND TIER BECOMING SECOND CHOICE

The phenomenon of secondary vacancies, where older buildings see increasing vacancies as the tenants move into newer ones, is starting to become apparent outside of the central 5 wards, with a growing divide between the high-demand buildings in prime locations, and the older, hard-to-fill buildings in second-tier locations.



HOTEL

The hotel industry entered the year at full speed as the tourism market saw a swift recovery. With the pandemic becoming a distant memory and tourism bouncing back, domestic and foreign investors are aggressively acquiring hotels throughout Japan to capitalize on the rising room rates.

> *A weakened Yen and high-inflation in other countries has made Japan appear relatively cheap for foreign visitors. In fact, Japan ranked between Romania and Vietnam on the Big Mac Index in 2023.*

In October, inbound tourist arrivals exceeded pre-pandemic levels for the first time. A total of 2.51 million foreigners visited Japan, up 0.8% from October 2019. The rate of increase is 28% if tourist numbers from mainland China are excluded.

Nationwide hotel occupancy rates in August were 71.7% for city hotels (+19.6 points from last year, -11.3 points from 2019), and 73.5% for business hotels (+14.9 points from 2022, -6.1 points from 2019). In Tokyo, city hotels had an occupancy rate of 73.8% in July and business hotels had an occupancy rate of 79.5%. In July, total overnight stays in Tokyo for both domestic and foreign travelers reached 8.455 million, up 74.4% from 2022 and up 24.7% from 2019. This was the highest improvement across all 47 prefectures. Osaka Prefecture saw a 62.1% year-on-year increase in overnight stays, and a 1.8% increase from 2019. For just foreign travelers, Tokyo was in top spot with 4.116 million stays in July, up 56.2% from 2019. Osaka Prefecture was in second spot with 1.812 million stays, up 3.0% from 2019.

HOTEL ROOM RATES EXCEED PRE-PANDEMIC PRICING

According to Metro Engines, Kyoto City has seen the highest increase in room rates across Japan. The average nightly rate for a pair of guests was 73,143 Yen in 2023, up 88% from 2019. In Tokyo, the nightly rate increased by 77% to 69,281 Yen. Osaka City saw a 31% increase to 35,662 Yen, Fukuoka City saw a 28% increase, and Sapporo City saw a 19% increase. The wealthy summer resort of Karuizawa in Nagano Prefecture saw a 43% increase to 97,169 Yen/night. In contrast, other holiday areas like Hakone (-7%) and Naha (-18%) have yet to see the same jump in pricing.

Hotel, cont.

The Nikkei Shimbun newspaper reported in early September that hotels in central Tokyo are seeing ADRs that are 30% higher than pre-pandemic levels, and the rate of increase has exceeded that of New York. The Palace Hotel Tokyo's ADR has exceeded 100,000 Yen for the first time. Some city hotels in Osaka have seen their ADR increase by as much as 30% since the beginning of the year and over 100% from early 2022. JLL reported that the RevPAR for 5-star hotels in Tokyo for the first half of 2023 to be 12% higher than during the same period in 2019.

The Yen has sunk to historic lows against other major currencies, making Japan seem like a bargain tourist destination for foreign travelers. As a result, hotels have been able to increase pricing while still matching demand. Some believe pricing will continue to rise, as labor shortages change the priority from high occupancy to one of maximizing nightly rates.

According to the Japan Tourism Agency, foreign tourists are currently spending an average of 50% more on accommodation compared to pre-pandemic levels. Visitors from the UK are spending 93% more on hotels than they did pre-pandemic, averaging 153,423 per person per trip. Hotel spending by mainland Chinese tourists has increased by 84% to 85,322 Yen.

INVESTMENT TO RAMP UP

Domestic developers are starting to expand their portfolios as the tourist industry recovers. Nippon Steel Kowa Real Estate (NSKRE) plans to invest between 40 ~ 50 billion Yen in hotels over the next five years. The first project is a 145-room extended-stay hotel called '& Here' opening in Tokyo's Ueno neighborhood in March 2024. Rooms for up to four guests will be priced between 30,000 ~ 50,000 Yen per night, and suites for up to six guests will be priced between 100,000 ~ 120,000 Yen per night. Room sizes will range from 21 ~ 73 m2 (226 ~ 785 sq.ft). The hotel is already accepting reservations, with up to 80% of the guest bookings made by foreign tourists. Additional hotels are planned for Shinjuku, and Namba in Osaka. The company is forecasting that up to 70% of hotel guests will be foreign travelers. By implementing electronic check-ins and outsourcing cleaning, the hotel can be operated with just 15 staff.

Over the next 3 years, NTT Urban Development Corporation is increasing its supply of hotel rooms to 50% more than its pre-pandemic level. Hotels with a total of 526 rooms are planned in Kyoto, Osaka and Hokkaido, and may include international luxury operators like Capella and Hyatt.

Hotel, cont.

Going forward, Mitsui Fudosan is planning to develop up to 1,000 rooms domestically and internationally, a 10% increase from current levels. The company's hotel operating ratios dropped to the 40% range in 2020 but have already exceeded 80% during the second quarter of 2023.

With inbound tourism expected to grow further, real estate giant HULIC is putting more effort into its hotel developments. The company is opening a luxury hot spring-style hotel called Fufu Tokyo Ginza on a corner site above Ginza Itchome Station in 2025. The hotel will occupy the top 6 floors of the 12 story commercial building currently under construction. This will be the 13th 'Fufu' branded hotel to be developed. All rooms will have their own terrace and natural hot spring water. The company is no stranger to Ginza, currently owning around 34 buildings in the country's most expensive address.

Jones Lang Lasalle reported that hotel investment in Japan for the first half of 2023 reached 203.4 billion Yen, 1.7 times the volume for the same period in 2022. While this figure was only at about 70% of the level seen in the first half of 2019, investment by foreign funds increased by 3.6 times to 128.5 billion as they took advantage of the record low interest rate and cheap Yen.

Hotel, cont.

HOTEL PRICING PER KEY

9.3 million Yen
Three business hotels in Akashi, Naha, and Matsuyama
Acquired by Nippon Accommodations Fund REIT

20.2 million Yen
Five hotels across Japan
Acquired by Ichigo Hotel REIT from its affiliate/s for 15.08 billion Yen

33.3 million Yen
Three hotels in Kyoto, Sapporo, and Fukuoka
Acquired by Japan Hotel REIT for 18.93 billion Yen

36.3 million Yen
Hotel Wing International Premium Kyoto-Sanjo
Acquired by Nomura Real Estate Master Fund for 3.2 billion Yen

44 million Yen
The Gate Hotel Kaminarimon by Hulic (Tokyo)
Hulic REIT acquired from its sponsor for 5.9 billion Yen with a 3.7% cap rate

48.1 million Yen
Righa Royal Hotel (Osaka)
Acquired by BentallGreenOak for an estimated price of around 50 billion Yen

55.7 million Yen
Six hotel/resort portfolio across Japan
Acquired by Invincible Investment Corporation for 57.23 billion Yen

65.5 million Yen
Mimaru Suites Tokyo Asakusa
Acquired by Nomura Real Estate Master Fund

69 million Yen
Mimaru Tokyo Hatchobori
Acquired by Daiwa House REIT Investment Corporation

77.9 million Yen
Mimaru Tokyo Akasaka
Acquired by Daiwa House REIT Investment Corporation

RETAIL

Foot traffic, tourism, and consumer spending are big drivers for retail real estate, and with the pandemic subsiding and inbound tourism returning with vigor, prime retail is seeing high tenant demand and fewer vacancies.

For the first half of the fiscal year, the Isetan Shinjuku Department Store reported a 15.5% increase in gross revenue, reaching 170.3 billion Yen. This is the highest first half-yearly sales revenue in the store's history. Gross sales for the year ending March 2024 are forecast to reach 372.7 billion Yen, exceeding the 300 billion Yen mark for the first time in 31 years.

The return in foreign tourists, buoyed by the historically cheap Yen, has helped Isetan Mitsukoshi, with inbound spending at the company's five stores in greater Tokyo 40% higher in the first half of 2023 compared to the same period in 2018. The Ginza store, where many foreign tourists visit, is expecting to post total gross sales of 102.7 billion Yen for the year ending March 2024, a 33% increase from the previous year.

Ginza has the lowest cap rates in Japan. CBRE's Japan Investment Marketview Report for Q3 2023 had cap rates for Ginza high-street at 3.25%. Luxury brands have been actively taking up new space in the prime retail district, resulting in limited vacancies in areas with high visibility and foot traffic.

In Shibuya, a transformation is underway as luxury brands start to increase their presence. The Miyashita Park shopping mall to the north of Shibuya Station opened in 2020 and now includes Prada, Balenciaga, Gucci, and Louis Vuitton as tenants. In January 2023, the Tokyu Honten Department Store closed its doors after 55 years to make way for a high-rise redevelopment that will include luxury retail, apartments, and one of The House Collective Hotels. This project is being carried out by Tokyu Corporation and L Catterton Real Estate.

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JAPAN PROPERTY CENTRAL K.K.
GOVERNOR OF TOKYO LICENSE NO. (2) 96648
H^{1}O AOYAMA 401, 3-1-30 JINGUMAE
SHIBUYA-KU, TOKYO, JAPAN 150-0001

TEL 03-6343-0801

HTTPS://JAPANPROPERTYCENTRAL.COM
INFO@JAPANPROPERTYCENTRAL.COM