A TALE OF THREE CITIES

Supply is not a threat; obsolescence of office stock supports development in Tokyo, Osaka and Nagoya
**Summary & Recommendations**

We forecast steady outperformance for Japan’s office market with more upside emerging for regional cities.

More developments are making economic sense for developers and investors given:

- The rising cost of compliance with current earthquake building standards often means that it is cheaper to demolish and rebuild obsolete office buildings than to refurbish them.
- A very tight supply outlook should boost strong rental growth, especially in Osaka.
- Landlords can enhance low NOI yields in many underutilised buildings through refurbishment.

Our top investment pick is Osaka, although Tokyo has better fundamentals to support rental growth beyond the cyclical horizon. A lower-than-expected vacancy rate in markets should keep net investment yields above an attractive 3.5% even with more money chasing steady yields in real estate.

Conversely, we expect tenants to suffer from historically tight markets at least until 2020; we advise them to take earlier actions and extensive planning given a larger-than-expected reduction to net incoming supply over the next five years.

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<td>Average age of all-grade office building stock in Tokyo’s five central wards</td>
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| **45 years**                | **10,000 m²** | **< 1.0%** | **-1.3%** |
| Average age before demolition of nation-wide all-grade office building stock | average size of demolished office buildings nationwide | of annualised incoming supply to existing stock for the next three years (except Tokyo) | is the lowest NOI yield on acquisition cost for the past three years among Grade A office assets in Osaka* |

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In this report, we focus on major regional cities such as Osaka and Nagoya relative to Tokyo. While the window of opportunity is narrow in regional cities where the net supply is tracking near zero and the average annual real estate transaction turnover tracks on average below 10% of that in Tokyo, the limited number of market participants also means that a greater proportion of assets may have been mispriced in these regional cities. Furthermore, different price implications by submarket and by age of building in each city have, to date, not been fully addressed. Supported by strong corporate balance sheets giving flexibility to invest, Japan’s property market remains strong, suggesting more upside in asset prices.

We expect historically tight market conditions to continue for occupiers, developers and investors despite some uptick in Tokyo’s net supply toward 2020. Although economic prospects for all regional cities, including Osaka and Nagoya, are not as robust as those in Tokyo, investors seeking steady income-producing assets ought to find more attractive opportunities in local cities where more underutilised assets exist, notably Osaka.

**Mari Kumagai**  
Senior Director  
Research | Japan

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*Based on the 61 available listed J-REIT disclosures by building for the first half ended September 2018.
Tokyo
Tokyo continues to attract investors with more infrastructure development ahead of the 2020 Tokyo Olympics. With continued redevelopment, we expect that Tokyo’s job and economic growth will continue to surpass the national average, increasing the wealth gap compared to other cities. Tokyo also benefits from its growing status as the centre of leading technology ventures, attracting nearly one-third of technology companies nationwide. Vacancy remains low despite some expected uptick in net supply. That said, we see the proportion of overall Japanese property investment in the Tokyo office market as excessive. Consequently, Tokyo offers lower yields than other Japanese cities, with prime office net yields ranging up to mid-4%.

Osaka
The capital of the Greater Kansai urban area has been transforming into a more service-oriented economy with more national policy initiatives being implemented in recent years. Over the past 25 years, increasing corporate headquarters relocations to Tokyo, and an unfavourable demographic profile, have led to lower economic growth and weaker price recovery for Osaka than for other cities. The same dynamics have compressed office market demand and size, keeping net supply negative since 2014. However, with some of Tokyo’s prime yields falling below 4.0%, Osaka has started to catch up with higher investment activity. We expect reasonable rental growth to return to the city, with prime office net yields ranging up to 6.0%.

Nagoya
As Japan’s third largest city, Nagoya’s growth and job market are anchored to “monozukuri” or efficient advanced manufacturing industries. We expect the recent trend of above-average growth will continue, although the city will likely be eventually exposed to a shift to automation in manufacturing. The city’s pro-business stature, as evidenced by its hosting Toyota Motors headquarters, is evident in efficient and centralised city planning; recent redevelopment in the station front area has boosted average office rents by 2.3% p.a. over the past three years. Nagoya has been relatively immune to market downturns, but the same is true of market upturns. This helps explain why current prime office net yields range up to about 6.5%.
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LATE CYCLICAL COMEBACK

Rent growth has been limited to top locations within a city

Comparing historical office rent growth in each city nationwide, rent growth is limited to central urban areas. Most regional cities, including Osaka, have yet to recover the historical average rent level since 2000. Since 2010, relatively weak trends have persisted until recently with top rents in premier locations such as Tokyo’s Marunouchi having already passed their peak in growth as tenants are moving toward more affordable surrounding districts.

Looking through market cycles since 1984, larger cities have tended to see larger cyclical swings. For the period since 2010, office rent has risen by 10.9% and 9.5% in total for Tokyo and Osaka respectively based on the data from Japan Real Estate Institute and Mikishoji (see the bottom right chart). Weak rental growth in other cities reflects lower investment in upgrading the office facilities relative to Tokyo, Osaka and Fukuoka.

Understanding tenants’ rotation surrounding top districts

Work efficiency will improve with improved access to station-front facilities or top locations in each city. However, as the gap in rents between top districts and the remaining areas already exceeds a factor of three for Tokyo’s Marunouchi, with a slightly smaller gap for Osaka’s Umeda and Nagoya’s Meieki districts, tenants are becoming more location specific in each city, contributing to notably different rental trends by submarket.

> Key occupiers’ real estate strategies are diverging:
  - Attracting top talent in top districts remains a key priority for the largest corporations
  - For most other companies, cost containment remains a priority, and most tenants are unwilling to pay above a price ceiling of JPY30,000 (USD273) per tsubo (3.31 sq metres)

Our quarterly rent survey has revealed that the most popular leasing option remains newly refurbished buildings in the areas surrounding top districts; this is because these areas can offer lower rent, and larger space than top districts, but with updated office facilities and similar mobility in business activities.
NET REDUCTION TO INCOMING SUPPLY

Unlike most other cities in Asia, major cities in Japan are likely to see a surging wave of obsolete buildings in coming years. This is mainly because more than five decades have passed since the economic boom of the mid-1960s. More than 17% of buildings in Tokyo were built before the 1960s, with the same ratio tracking 10% higher for older cities such as Osaka and Nagoya.

Regulatory tightening could prompt further redevelopment

Furthermore, a series of regulations in building standards since the 1980s means demolishing and redeveloping older office stock is cheaper than other options. The quantity of buildings that remains non-compliant with Japan’s anti-seismic standards is rising higher in regional cities; Fukuoka (39%) tops the list of non-compliant buildings, followed by Osaka (31%) and Nagoya (28%) based on the data from Japan Real Estate Institute.

Tokyo’s virtuous investment cycle has supported faster redevelopments

Regardless of the scale of obsolescence of office buildings, the size of available institutional investments ultimately defines the scale of possible redevelopment. With this in mind, Tokyo has attracted a disproportionately large share of 78.1% of real estate investment. This figure may be compared to Tokyo’s share of national office building stock of 54.6% and Tokyo’s all-grade office stock totalling 69.2 million sq metres. This compares with 16 million sq metres in Osaka and 6.4 million sq metres in Nagoya. Likewise, the turnover of redevelopment in Tokyo is quicker, contributing to faster rental increases than in all other cities.

Revisiting the allocation of investments in favor of Tokyo

We attribute larger money inflows to Tokyo’s investment outperformance in recent years. With office assets set to deliver net investment yields of above 4.0%, we think Tokyo’s returns remain attractive enough for landlords and investors. However, within the same asset class, the current risk premium for regional cities appears too high with the net yield gap between Tokyo and the remaining cities including Osaka approaching 2.0 percentage points.
MORE MONEY FROM MARKETS

More refurbishing before re-leasing has justified rental growth

Redevelopment has many challenges. Buildings remain tightly held and there are fewer sellers as selling prices continue to rise.

However, investors are turning cautiously optimistic with more money being shifted in favour of demolition and redevelopments of existing properties since 2017. A more creative investment scheme requiring office refurbishments is also becoming more common as less investors are willing to exit from current holdings with few investment alternatives available.

These emerging trends, in favour of development, have already doubled the asset management projects from 19.2%, the past twenty-year average of all development project permits in Tokyo as shown in the right chart.

Understanding major urban developments from 1960s

Unsurprisingly, Tokyo's office stock vintage reflects the same historical trends of the country's rapid rise in GDP growth; the building stock almost quadrupled to 20 million sq metres between the 1960s and the 1980s. Tokyo’s office buildings are getting older faster with the average age reaching 26.7 years. This compares to the average age of demolished buildings of 43.0 years.

Tokyo’s central three wards are aging faster than other districts

Looking ahead, a large stock of buildings is becoming obsolete as the building stock of the 1960s (12% of existing stock) and 1970s (13% of existing stock) will enter into obsolescence over the next eleven years. Given that new buildings, with advanced building techniques meeting the latest regulatory standards, can be three times the size of their predecessors, most developers are likely to see lower hurdles to recover rising construction cost mostly attributable to labour shortage.

As of Q4 2018, various quarterly readings still support incoming trends. The nationwide survey of new construction investments - from the Ministry of Infrastructure, Land and Transportation or MILT - also indicates a 158% yoy jump in the real estate industry. This compares to a 25.6% decline in manufacturing and a 27.5%, increase in all industries.

Source: Colliers International, Tokyo Metropolitan Government
Note: data scope is limited to land development requiring more than 2,000 M², above years are based on the fiscal year ending March 31 in the following year.
Tokyo’s five CBDs: office stock by vintage

Average age of building demolition (nationwide, 2015-2017)

Average building size by phase of development cycle (1,000 sq m)

Average years until the buildings are demolished by city

Demolished: 10,000 m2

Source: Colliers International, The Metropolitan Government of Tokyo, Urban Planning Bureau (UPL), J-REI
Supply is not a threat in Tokyo, Osaka and Nagoya. We expect most landlords will retain a strong position over the next three to four years given the new supply is back-loaded. Even in Tokyo, larger supply from late 2019 is unlikely to hit anywhere close to the levels seen during previous peaks as the same land is recycled for new developments. By district, larger supply in Chiyoda-ku means a larger stock of obsolescent buildings in this area.

In fact, supply has not increased using the data from the latest tax filing documents, the most comprehensive office stock measures available. Tokyo’s total office stock has not effectively increased, tracking below the corresponding market indicators. Net change to Tokyo CBD office stock has declined to a CAGR of +0.5% since 2010. This compares with a CAGR of +2.5% since 1984 and a CAGR of +1.0% since 2000.

It is little known that demolition is rising faster in most regional cities. For the past three years until 2017, the demolition to gross supply ratio has averaged 167% in Sapporo and 96% in Osaka, tracking above 58% in Tokyo, 44% in Yokohama, and 33% in Chiba. Altogether, while the new supply remains airtight tracking below the net absorption in most cities, office stock equivalent to nearly one-half of the country’s gross new supply was demolished over the three years until 2017. Looking ahead, we expect this ratio to inch up further given the larger incoming stock of obsolescent buildings in coming decades.

In our view, vacancy in each city should stay in check, tracking well below the ten-year historical average in each city. A backlog of office moves from extended tight supply over the past four years should also support the future net absorption, and accommodate an expected uptick in gross supply towards 2021.
INVESTMENT OUTLOOK

Japan’s market signals for investments are strong with the NAV multiple of 1.0x tracking below the ten year average of 1.1x based on the data from Japan stock exchange. Lower LTV ratios and higher unrealised gains, already equivalent to 18% of its cost on balance sheet, also provide enough buffer for market volatility. For dollar-based investors, we also expect tailwinds from dollar weakening with the flight to safer assets.

Over the next eighteen months, we expect:

Average cap rates in Tokyo should decline towards 3.5%

Our base case assumes the cap rates under direct methods should drift tighter toward 3.5%. Approximate economic cap rates, after adjusting for expense items, could break below 3.0% for more buildings in Tokyo.

Average NOI yields should stay around 4.6%

Our base case approximates NOI yields to the yields on total building acquisition costs. Its steady yield performance, with annualised returns of around 4.7%, masks a wide variety of building performance, especially in Osaka.

Average yields spreads should drift lower toward 3.5%

With interest rates in Japan rising even more slowly than previously expected, we continue to believe that Japanese prime grade office property assets offer the most attractive yield spread globally over the corresponding government bonds. Aggregate transaction volume is declining as J-REITs are rotating their asset holdings from Tokyo to Osaka and Fukuoka. Yield spreads are still drifting lower, testing the ten-year low of 2.9 percentage points. This is still more attractive than investing in other asset classes such as bonds.

Yield spread is wide enough to compensate for lower growth than in other mature markets

Japan’s capital return should remain low, with annualised capital returns since the beginning of Abenomics tracking around 2% for Tokyo, Osaka and Nagoya. This figure compares to the mid-2% to mid-3% range for Sydney, London, and New York for the same period based on Real Capital Analytics data. In our view, Japan’s yield spread of 1.5 percentage points is wide enough to compensate for lower growth than in other matured markets.
Office yield spreads over ten-year government bonds (bps)

Source: Colliers International, RCA, Bloomberg

Japan’s office building transactions by investor type (USD billion)

Source: Colliers International

Osaka: buyer composition (percent of transaction volume)

Source: Colliers International, RCA

Osaka: seller composition (percent of transaction volume)

Source: Colliers International, RCA
BETTER TOTAL RETURNS

A plethora of underutilised buildings

For nearly 1,600 office buildings in Tokyo, Osaka and Nagoya, we have plotted the latest office building performance by post-acquisition capital gain/loss and NOI yields, as shown in the chart. While there is a known sampling bias for J-REIT’s holdings, we still feel it adequate to demonstrate the tendency of building performance.

Focus on Osaka’s underutilised buildings

- Capital gain/loss positions reflect the timing of market entry
  - Around 4.8% capital gain on average
  - Most capital loss positions are associated with acquisitions around the past cyclical peak in 2005-2006

- NOI yields differ considerably even for similar building profiles
  - Highest NOI yields reach around 7.9%
  - Lowest NOI yields reach around -1.7%
  - Average NOI yields reach around 4.6%
  - Osaka is the most unpredictable city, with the standard deviation reaching around 25% higher than that for Tokyo

Note. A negative NOI yield means that a building offers zero rent, and that the buyer has to spend significantly on upgrading it.
RANKING THE CITIES

Obsolescence of office stock in Osaka can support more developments

Looking at cities in Japan, it is apparent that each city accommodates stable office demand differently. In a city where the quality of physical office stock is relatively low, such as Osaka, demolition has already matched gross supply (as shown in the chart). This is not surprising given that available land for new development is very limited, and so it is much cheaper to demolish and rebuild obsolete buildings to meet the revised earthquake resistance standards.

According to the data from J-REI, Tokyo is the only city where the incoming supply for the next three years could cover the net absorption, with gross supply tracking around 1.5% of existing office stock. However, given the supply is back-loaded by a few years, we do not expect the current rental growth in regional cities to decelerate until after 2021.

Policy initiatives to add soft tailwinds to Osaka’s employment

Toward the year 2025, Osaka’s business confidence should see some tailwinds from (1) hosting the 2025 Osaka World Expo exhibition, (2) rising potential to host Japan’s first integrated resort facilities, and (3) completing the Umeda-kita (Umeda-north) redevelopment project, together with the new Umeda-kita station.

Based on official impact studies from previous expos, it is fair to assume that the city’s GDP of JPY18.9 trillion (USD172 billion) could increase by up to 12.6% over three years, as shown at right. However, it is also important to note that these stimuli are mostly intended to temporarily lift consumption and that the direct impact on construction and supporting employment is limited to 20% of the economic output increase – equivalent to JPY400 billion (USD3.6 billion). We still view positively the fact that ongoing infrastructure developments are likely to add 89,000 employees to tourism-related industry that tends to congregate in the southern part of Osaka city or Namba, where rents tend to be softer and more cyclical than for facilities near Osaka Station.
GDP and employment will eventually determine the office demand in each city

Between now and 2035, Japan’s three largest cities will see contrasting outlooks for their economies and employment.

**Tokyo** is likely to benefit from higher GDP growth, which should partially offset flat to declining job growth from the impact of automation. Its massive concentration of internet-related industries will continue to attract both domestic and global talent to the benefit of popular submarkets like Shibuya.

**Nagoya** is likely to enter first into uncharted territory with improving productivity from further automation contributing to a better economic outlook. Its contradictory outlook is further complicated by the planned opening of the maglev (“magnetic levitation”) Shinkansen bullet train within the next eight years; the 40 minutes access to Tokyo, 350 kilometres away, also means that more corporate functions will likely be relocated in favour of Tokyo.

Improving business confidence masks larger challenges in Osaka

Osaka is likely to suffer the most without major policy initiatives as 75% of its economy is in the services sector. The city’s job losses are likely to be faster even if its real GDP growth rate manages to stay steady at around 1.0% annually. The prospect of larger job losses in Osaka is also attributable to its unfavourable demographic profile relative to its domestic peers and to the fact that its manufacturing base is focused on old-economy industries such as steel and low-end consumer electronics. This has led to a high mismatch between available labour skills and available job openings, contributing to an unemployment rate almost double the national average of 2.8%.

To overcome its structural challenges, the city has implemented various initiatives to diversify its industry structure, shifting more focus towards tourism and entertainment in recent years.
LATE BLOOM FOR OSAKA

Based on our analysis, historically tight net supply tracking at less than 1% of total office stock will define the Osaka office market over the next three years until 2021. There was only one large building completed in 2017, Nakanoshima Festival Tower West (NFA: 62,700 sq metres). In 2018, one additional building came onstream, Namba Skyo (NFA: 33,000 sq metres), with no supply being planned in 2019. The next new supply planned to be delivered is Orbic Midosuji (NFA: 19,400 sq metres) in 2020, followed by JP Tower Osaka (NFA: 123,300 sq metres) and Umeda Twin Tower South in 2022. This compares to increasing demolition averaging 77,400 sq metres per year, keeping the net supply negative at least until 2021.

Additional supply from existing buildings is possible if they can be repurposed for office use. However, near-term demand for retail and hotel assets is high with the latest demand coming from the Osaka World Expo exhibition in 2025. Given that office demand should remain steady, averaging around 1.2% of historical supply, we expect demand to outstrip the net supply at least until 2021.

Altogether, we expect that the low vacancy rate, of below 0.9% for Grade A buildings and 3.8% for all-grade office buildings, will continue to drift lower at least until 2021. Limited available space throughout the greater Osaka area also means that most new tenants will be required to accept a minimum asking rent increase of 6.0% per annum in the coming years. We expect the overall rent increase for all-grade office buildings will be pushed up toward 3.0% as available building supply will be further limited.

An equivalent economic scale to Paris and Hong Kong

Located in the Greater Kansai metropolitan area featuring Osaka, Kyoto and Kobe, the greater Osaka metropolitan area represents around 17% of Japan's GDP. It has around 17 million residents with virtually no population increase since 2007. Along with its older demographic profile, the average income per capita has also been drifting lower, to JPY2.9 million or about 67% of that in Tokyo.

Relative to Tokyo, Osaka’s economy is characterised by lower economic growth averaging 0.3% over the past three years, a secular trend prevailing throughout sixteen designated regional cities in Japan. However, unlike any other city, Osaka’s lost business confidence after experiencing the country’s largest property price drop from the financial crisis, resulting in the most protracted price recovery among major cities.

➢ More cyclical economic structure than other cities

With more corporate headquarters relocating to Tokyo, Osaka’s share of the national economy has continued to decline since the 1970s. Its economic structure is more cyclical than the national average as nearly three-fourths of its GDP is attributed to service industries that include 15% exposure to the retail and wholesale sectors. Fortunately, with larger foreign tourist arrivals from Kansai International Airport, the city also benefits from cyclical tailwinds; for example, Osaka’s department store sales growth on average has turned positive again over the past three years, with discretionary tourist spending increasing as much as 10% yoy. However, these cyclical swings, stemming predominantly from stronger links to Greater China and Korea, can move both ways. It remains a challenge for Osaka to retain increasing tourist demand and improve its competitive advantage in the pharmaceutical and chemical industries.

1PwC Global City GDP forecast, Oxford Economics. Osaka’s economic scale was equivalent to that of Paris in 2008, and is forecast to be equivalent in that of Hong Kong in 2025.
Osaka: mapping current rent cycle (1990-2018)

18 month forecast: +2.8%

Source: Colliers International, Sanko Estate

Osaka: supply and net absorption (1,000 sq metres)

1990 - 2018

Source: Colliers International

Osaka: workforce distribution compared to national average (2020)

Consumer services (32.6%)
Transport & communications (8.8%)
Financial & business services (13.2%)
Industry (22.9%)

Source: Colliers International, Oxford Economics, the City of Osaka

Osaka: submarket comparison (2010 index= 100)

Source: Colliers International, J-REI data as of September 2018
Osaka: Comparison of capital value and annualised NOI yields (in %) for selected Grade A and B office buildings

**SUBMARKET OVERVIEW**

**Rent Trend**

Large station-front redevelopments surrounding Umeda (+3.1% y/y) continue to lead the city’s rental increases with the highest concentration of quality office space. Our base case assumes up to a 40% location premium in this area.

A shortage of prime grade office space at affordable rents has lifted demand in surrounding business districts such as Yodoyabashi (+1.1% y/y) and Minamimorimachi (+1.2% y/y). A concentration of high-street brands in Shinsaibashi (+1.2% y/y) has also started to lift office building performance with more tourist arrivals from Kansai International Airport boosting retail performance in this district.

**Capital value**

Most institutional holdings are concentrated along Midosuji Street with some in Shin Osaka Station Front with direct access to the Shinkansen. Capital values remain high near Umeda and Shinsaibashi and are trending higher around Shin Osaka Station. Osaka’s service economy-oriented business structure also means that tenants tend to be less sticky. This means that rent increases as well as rent falls tend to be faster than other cities in Japan.

All told, Osaka’s average prime office net yield ranges from 3.8% to 5.4%, tracking around 1.2-1.5 percentage points above that in Tokyo. However, these buildings also come with stable cashflows with significantly lower vacancy rates. In our view, smaller buildings that can be refurbished should be an increasingly attractive option for experienced real estate investors.
LESS ACTIVITY IN NAGOYA

A cautious respite from the recent heavy new supply defines the current market condition in Nagoya. We still see more tenants eager to accept further rent increases for upscale offices directly connected to JR Nagoya Station, given the scheduled opening of the maglev Shinkansen bullet train over the next decade. While underlying office demand is likely to remain steady, there has been no notable supply after a few buildings were completed in 2017, including JR Gate Tower (NFA: 46,200 sq metres) and Global Gate (NFA: 33,000 sq metres). Looking ahead, new supply will comprise significantly smaller buildings such as Kajima Fushimi Building (NFA: 10,000 sq metres) in 2019 and the Meieki-1 chome project (NFA: 13,860 sq metres) in 2020 until Nagoya Mitsui building (NFA: 29,700 sq metres) is completed in 2021. This limited outlook for supply compares to increasing demolition averaging 19,800 sq metres per year, keeping the net supply negative at least until 2021.

- Stable demand continues to outstrip lower incoming supply

With the gross new supply scheduled to be below 0.3% of existing stock until 2020 and below 1.0% until 2022, more tenants will be forced to postpone relocating, leading to fewer transactions and less rental increases compared to other cities. However, demand remains stable with both job and economic growth still better than the national average, tracking at above 1.0% and 1.2% respectively for the past three years.

With Nagoya’s job to applicants ratio tracking above 1.0x, more employers are expanding their reach into neighbouring suburban cities in Aichi and Gifu Prefectures. Cost rationalisation has become less important for most tenants to attract top talent. Most tenants are willing to accept higher rents for station-front locations as a result.

- Urban revitalization in the Sakae special district could spread demand beyond the station front facilities

The Sakae district is likely to see additional demand boost from 2020; the city’s planning bureau has appointed a consortium led by Mitsui Fudosan to execute private financing initiatives for the Hisaya-Odori Park (GFA: 54,500 sq metres) in exchange for less restriction on urban revitalisation initiatives. Although the project is primarily targeted at attracting more retail traffic, the area’s larger stock of obsolescent buildings, amounting to 36% of the total versus 25% for the city as a whole, could attract more developers with local market expertise.

- Declining activities from very tight vacancy in two-tier markets

Tight vacancy is also sapping the market turnover that could boost rental growth, limiting Nagoya’s growth rate relative to other cities.

Lending conditions remain easy for investment-grade investors although limited non-investment grade borrowers have started to see small lending cost increases since early Q2 2018.
Nagoya: mapping current rent cycle (1990-2018)

18 month forecast: +1.9%

Source: Colliers International

Nagoya: new supply and net absorption (1,000 m2)

Source: Colliers International

Demolition average: 19,800 m²

Nagoya: submarket comparison

Source: Colliers International, J-REI data as of September 2018

Future work force distribution as % of total vs national average (2020)

Industry (22.9%)
Consumer services (32.6%)
Transport & communications (8.8%)
Financial & business services (13.2%)

Source: Colliers International, Oxford Economics, Aichi Prefecture – statistical bureau
SUBMARKET OVERVIEW

According to Real Capital Analytics, office transaction volumes in Nagoya totalled USD104 million (JPY11.4 billion) in 2018, equivalent to only 1% of the total commercial property volume in Tokyo. Uniquely, the ownership structure is more fragmented in Nagoya; many smaller local landlords prefer to engage in fewer transactions with limited service offerings.

Rent Trend

Large redevelopments around Nagoya Station (+4.3% y/y) continue to lead rent increases as the supply of prime office space remains limited. We expect the area’s stronger rent increases will continue at least until a few years after 2025, when the new maglev Shinkansen starts to connect Tokyo and Nagoya within 40 minutes. Our base case assumes a 20% location premium in this area. A shortage of prime grade office space has lifted demand in surrounding business districts, leading to steady rent increases in Fushimi (+1.7% y/y) as more tenants are seeking more affordable rents and larger office space.

Capital value

Most institutional holdings are concentrated along Hirokoji Street and Nishikibashi as illustrated below. Capital values remain high near Nagoya Station front and are trending higher around Fushimi Station. Nagoya’s average prime office yield ranges from 4.2% to 5.8%, tracking around 1.2 percentage points above that in Tokyo. However, these buildings also come with stable cashflows with similarly low vacancy rates. In our view, obsolescent office buildings in front of Nagoya Station should remain an increasingly attractive option to investors and tenants in the future.

Source: Colliers International, JPX disclosure on listed REITs for the fiscal period ended September 2018. Note: the circle size indicates available rentable place.
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