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OSAKA: STILL THE CITY OF HOPE?

Osaka's large cost differential from Tokyo still can justify additional demand with incoming policy incentives,

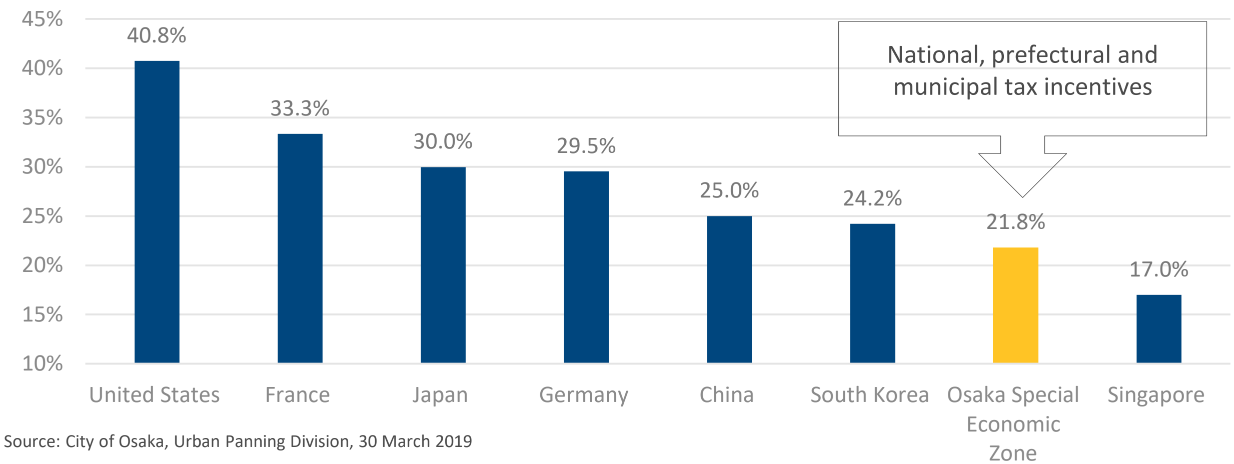
Summary & Recommendations

Tighter market dynamics and a lower cost of doing business support our expectation of increased investment in Osaka. We still see some upside in Osaka as its faster CPPI [1] increases are only 86% of those in Tokyo over the past decade.

We recommend:

- Investors to explore wider investment options given increased building repurposing to address the market imbalance.
- Landlords to be flexible in negotiating leases considering Osaka's higher sensitivity to economic cycles
- Tenants to adjust their expectations to prepare for rising rents with tighter market dynamics ahead

Effective tax rates : Comparison of select cities' aggregated tax incentives



Source: City of Osaka, Urban Panning Division, 30 March 2019

Seven years into Abenomics, the longest postwar economic expansion is sending mixed signals with rising trade tensions and pause in investment activities surrounding Brexit. Japan's aging and shrinking population also means that its natural rate of interest should drift lower in the coming decades. However, it is important to note that urban migration to Tokyo, recording an inflow of 79,844 people in 2018, has started to have adverse effects as Tokyo's price increases continue to outpace those of its peer cities. Since Tokyo and Osaka both dipped to a market-wide cyclical low in 2012, Tokyo's capital value appreciation has remained respectable, keeping a 5.6% CPPI[1] CAGR, compared to 3.5% in Osaka.

Despite a more challenging economic base than comparable cities, Osaka still benefits from a lower cost of doing business than Tokyo, a 60% discount on land prices and a 15% discount on average wages. This, on the city's GDP of USD188 billion (JPY21 trillion)[2], which is equivalent to that of Vietnam. Osaka also benefits from larger policy supports, reducing the effective tax rate to between zero and 21.8%, mostly through five-year tax breaks for qualified investors within the national strategic zone[3]. Additionally, the city's value-added investment strategy of converting existing buildings has become more common with the introduction of major foreign capital players; Osaka's average annualized total returns on office buildings have improved to 7.9% according to the ARES data.

[1]Refers to the Commercial Property Price Index from the Ministry of Land, Infrastrcuture and Transportation. [2]As per the National Statistic Bureau of Japan, OECD.
[3]Refers to two designated districts surrounding the Grand Osaka station facilities and Osaka Bay area, totaling less than 1% of the city's total area of 223 sq kilometers.

IMPLICATIONS & STRATEGIES FOR DIFFERENT SECTORS

Office: Aim for Refurbishment

We still see sufficient room for price growth in all-grade office buildings, largely from the NOI improvements on refurbished buildings. Given no notable building supply is planned until 2021, the city's vacancy rate should remain below 2.0% at least until after H2 2021.

Rents in Umeda, where about half the Grade A office stock exists, are likely to benefit the most with its asking rents surging over 40% since mid-2014. Rising rents in more convenient locations should also benefit from ongoing infrastructure improvements surrounding the north side of Umeda station as well as the 2025 World Expo facilities in the newly developed Yumeshima / Sakishima bay area.

Retail: Flexibility on smaller sizes

While mainland Chinese tourists had been the major demand driver since 2014, leasing momentum has somewhat faded with the onset of the trade war since 2018. The weakening purchasing power of Chinese tourists, who represented 46% of total tourist shopping spending in 2018[2], could turn into headwinds should the trade tension continue.

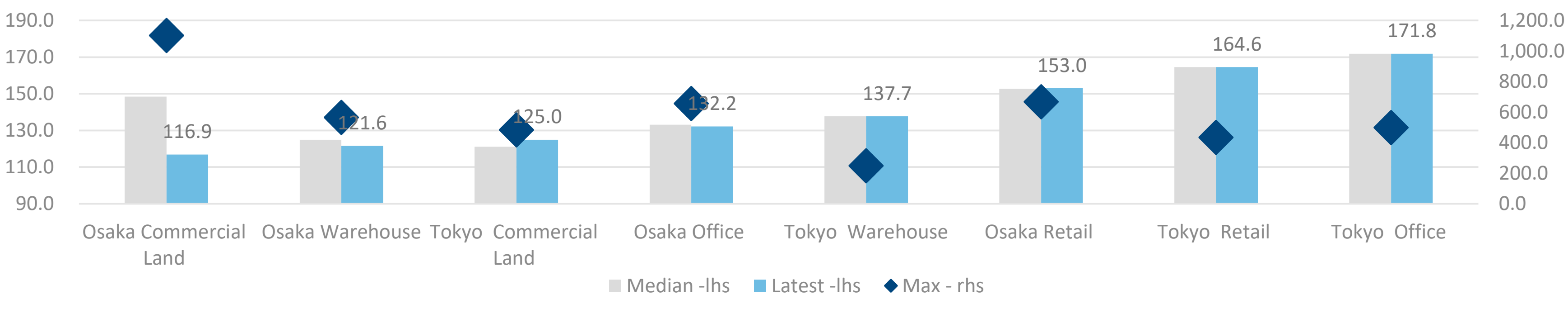
Given the more dynamic and fast-moving retail landscape ahead, landlords should be more accommodating to tenants' requirements for smaller shops and greater flexibility. We remain positive regarding the Osaka retail market. While more online retailers are looking for a physical presence on main street, the growing number of repurposed office buildings can also accommodate likely retail market downside as well.

Land: Aim for Development

A continuingly large price gap compared to Tokyo provides an opportunity for arbitrage investments in Osaka. We recommend landlords in the CBD, especially those with outdated facilities, proactively consider repurposing of their existing properties given the airtight supply in office markets. The lack of new supply, with the smaller stock of larger floor plates in the Midosuji area, should continue to support positive rental and price growth in this historic district.

We recommend investors add more flexibility through development as the best mode to adjust for rising market imbalance in limited supply. Taking advantage of various tax incentives to lure non-domestic companies and creative industries should also improve the NOI yields for landlords.

Annualized CPPI returns since 1984 (2010=100) : Comparing the current price level against historical peak / median by asset class



Source: Ministry of Land, Infrastructure and Transportation, annual data as of April 2019.
[2] 61% including Taiwan or the Greater China region, based on the 2018 data from the Japan Tourist Association

STILL TESTING NEW PRICE HIGHS

According to Real Capital Analytics, in 2018 Tokyo ranked as Asia's second largest investment destination (USD17.2 billion) after Hong Kong (USD26.1 billion) and before Seoul (USD 16.3 billion). The city's total office investment volume in Q1 2019 remained low, dipping by 22.0% QOQ to JPY299.5 billion (USD2.6 billion) even from the uninspiring Q4 2018. We maintain our view that the overall price of Grade A offices will continue to test new price highs, even after having increased 4.5% QOQ.

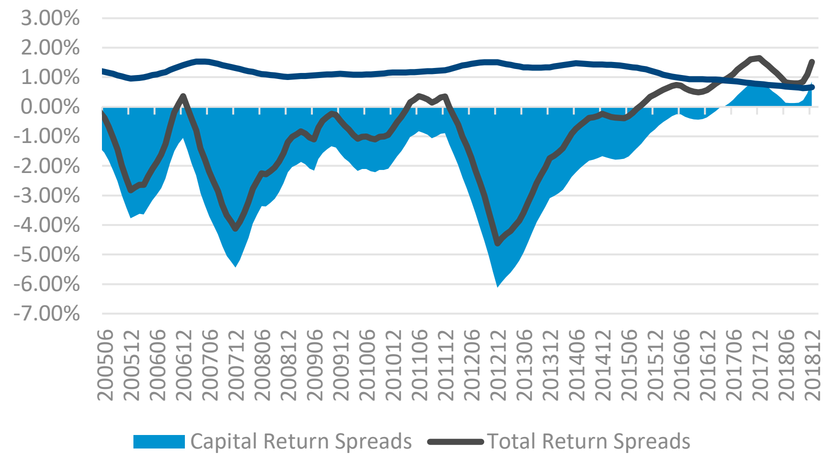
With few investment alternatives in sight, funds with abundant liquidity were active in seeking beyond core or core-plus assets as new competition from corporations and life insurance companies has been adding pressure. While a lack of tradable property continues to define the *wait-and-see* attitudes in Tokyo, Osaka's investors remain active with more creative deal making[2] in recent quarters, including Green Oak's purchase from Takeda Pharma totaling JPY50 billion (USD582 million) or 21 buildings in Osaka's main Midosuji area in late January2019. Although it still lacks the scale of Tokyo, Osaka's transaction volume has nearly tripled year on year to JPY31.8 billion (USD341 million) as its unit price remains more affordable, mostly tracking around JPY2 million per tsubo less, or one-third of that in Tokyo.

Older buildings in Osaka are prime targets for redevelopment as the cyclical recovery of both income and capital returns significantly lags behind that in Tokyo that maintains a larger and more diversified ownership base. With our expectation that Osaka's overall positive rental momentum will continue for a few more years compared to Tokyo, we maintain our forecast that Osaka's ongoing market correction, keeping the 2.5% total return growth on average, will persist at least until late 2020.

Elsewhere, the US Federal Reserve indicated on 20 March that it would not increase interest rates in 2019. In our view, net impacts from a major policy recalibration toward lower interest rates globally remains mixed. Although a lower currency hedging discount through a lower interest rate differential could siphon some foreign investment away from local markets, the opposite is also true for the large domestic investor base as the pause in interest rate hikes globally also means more appeal to their growing domestic real estate investments.

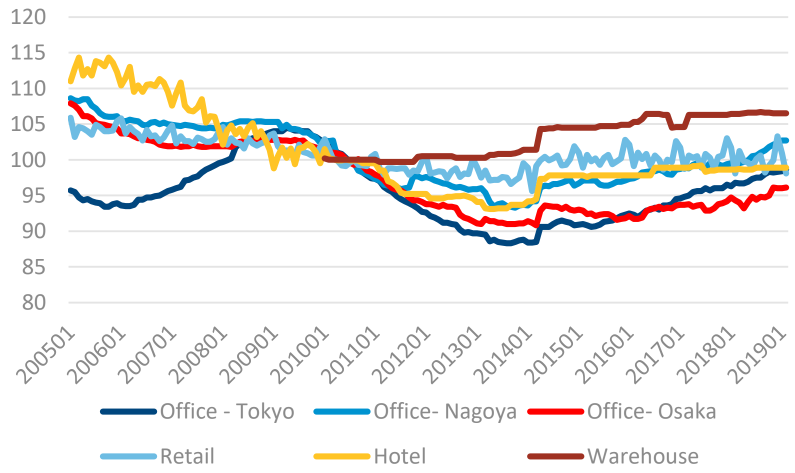
[2]*GreenOak to acquire 21 properties from Takeda Pharma for over JPY 50 billion*, Nikkei Real Estate Market Report, January 30 2019.

Comparison of historical return spreads, Osaka and Tokyo, 2005-2018



Note: $10M Global Transaction Price Floor Applied, Source: Colliers International, ARES

Rental price trends by asset class, 2005-2019 (2010=100)



Source: Colliers International, Bank of Japan

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