

Japan Real Estate Investment

REVIEW

Winter 2001



NOMURA REAL ESTATE INVESTMENT MANAGEMENT



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I. The Increasingly Polarized Office Building Market

Against the stock of rental floor space in the 23 wards of Tokyo of approximately 28,000,000m², the quantity of large office buildings ^{note)} scheduled for completion over the next four years is approximately 2,940,000m². This is a quantity that represents about 10% of the stock. Because this figure includes the space that will be owner-occupied, not all of this new floor space will be added to the rental office building market, but it will still have considerable impact.

Even if it had been possible to avoid the overall recession like that experienced by the office building market in the mid 1990s, there is no doubt that it would have been impacted.

Note: Definition of large office buildings: floor space of at least 10,000m² (approximately 3,000 tsubo).

Background

1. Trends in Supply and Demand of Tokyo Office Building Market

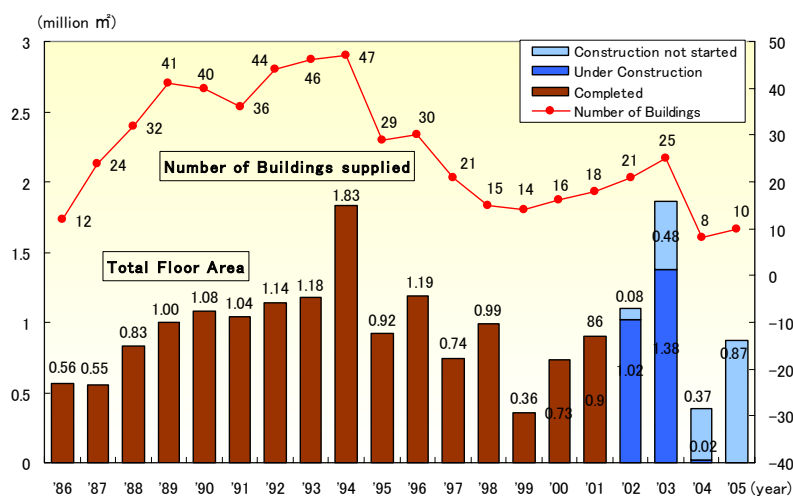
(1) Trends in Supply of Large Office Buildings

a) Supply Forecasts

The quantity of large office buildings supplied in 2000 was 730,000m², approximately double that of the 360,000m² recorded in 1999, which was the lowest figure since 1986. In addition, judging from the floor space currently under construction, supply through 2002 is expected to be around 1,000,000m² each year (Fig. 1-1).

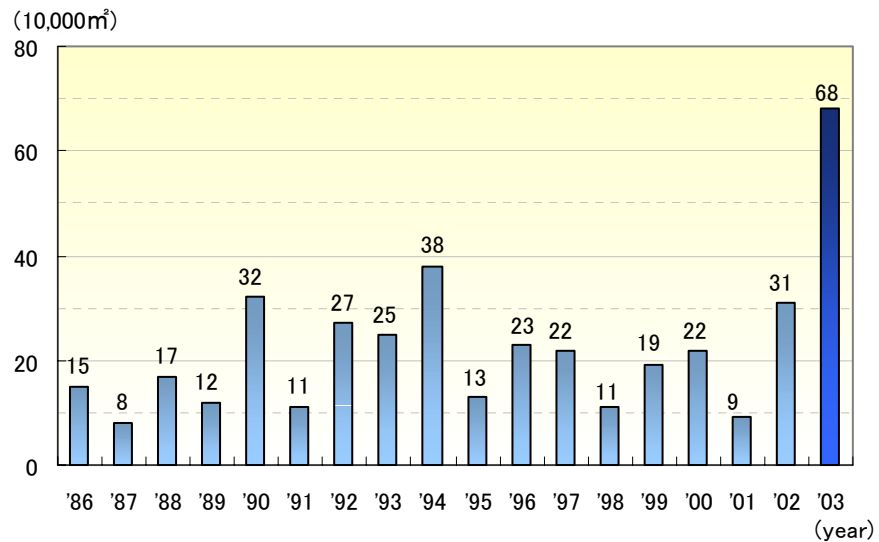
For large office buildings alone, for 2003, large-capacity supply is expected to be 1,860,000m², eclipsing the previous record of 1,830,000m² of 1994. In addition, the new owner-occupied buildings to be completed are expected to be the largest since 1986 (Fig. 1-2).

Fig. 1-1 Trends in Quantity of Large Office Buildings Supplied in the 23 Wards of Tokyo



Source: Mori Building

Fig. 1-2 Quantity Supplied of Owner-occupied Buildings (Tokyo Wards)



Source: Mori Building

b) Characteristics of Buildings to be Supplied

The large Tokyo office buildings to be supplied between now and 2003 have the following five broad characteristics.

- 1) Large size – The percentage of floor space started accounted for by large office buildings, which was around 20% in the early 1990s, is expected to account for 85% in 2000. Furthermore, looking at large office buildings alone, the total floor space per building has risen to double that of the early 1990s, and the floor space per floor has risen similarly.
- 2) Good geographical conditions – Supply in the three central wards of Tokyo did not even account for 30% of the total supply in 1994, but by 2003 this figure will be pushing 90%. The geographical trends of new office buildings supplied to the market are clearly showing a tendency to return to the city center.
- 3) High specifications – Facilities and specifications are rapidly becoming more sophisticated. In all aspects the buildings are high-spec – with seismic control systems and base isolation to strengthen buildings against earthquakes, accommodation for the most sophisticated IT, segmented air-conditioning, and high ceilings.

The three characteristics outlined above may be described as accurately reflecting current tenant needs.

- 4) As for the large number of buildings used by their owners, in 2003 a supply of 680,000m² is expected. This is approximately double the amount in 1994, the largest supply any one year in the past.

There are several motivations for these owner-occupants. In addition to the drop in construction costs and land prices from prior years, companies point out a variety of advantages such as cutting rents paid, integrating offices, and promoting computerization.

The last characteristic is qualitatively different to the preceding four. However, it is expected to have a great impact on the office market in the future.

5) Supply is not based on Economic Principles such as Supply and Demand Balance.

The large-quantity supply of office buildings coming in the future is caused mainly by the supply of a large tract of land in the center of Tokyo sold at once and in large quantities – the land owned by JRCC JNR Settlement Headquarters in the late 1990s.

This supply was developed based solely on supply side circumstances, such as the land's unique location and great value, without considering the amount of demand in the future.

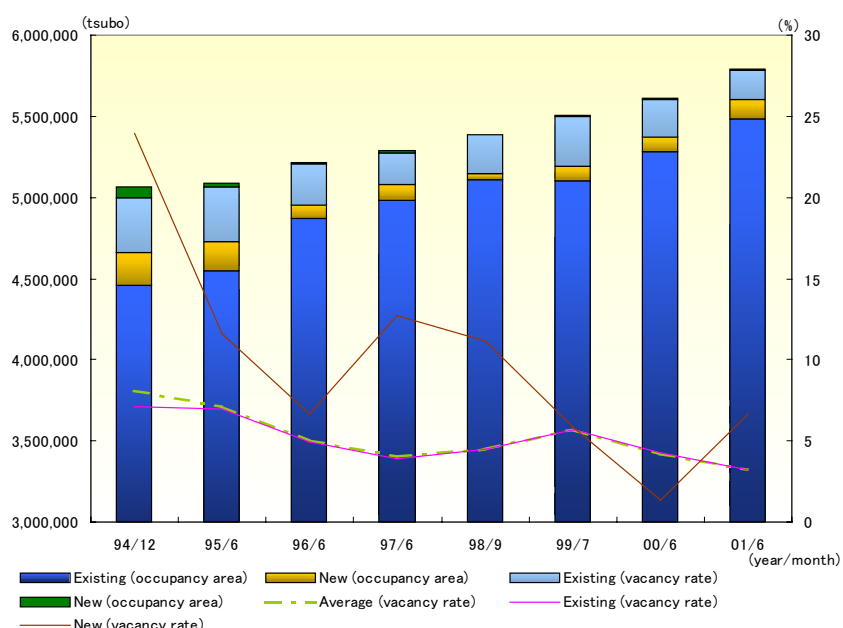
(2) Trends in Demand for Office Buildings

With regard to this supply, what are the characteristics of demand?

a) Trends in Quantity Demanded Up Until Now

Demand for office buildings in Tokyo continues to steadily rise over time, regardless of fluctuations in economic conditions in the past, as can be seen from the graph below. This is a characteristic that does not exist in other cities such as Osaka and Nagoya. This is because demand for office buildings in Tokyo remains strong.

Fig. 2 Trends in Moved Floor Space and Vacant Floor Space in Five Central Wards of Tokyo



Source: Miki Shoji

Note: Surveyed buildings: Major rental buildings with floor space of a typical floor of 100 tsubo or more.

Demand over the past few years has, quite frankly, been supported by four factors:

- (1) Increased demand caused by rapid growth in IT-related industries and by the desire for improved IT by individual companies;
- (2) Foreign companies, especially US companies, establishing offices in Tokyo;
- (3) Increased demand caused by the return to the city center which had been latent;
- (4) Increased demand caused by moving due to reconstruction of currently tenanted buildings.

The motivation for tenants to move is starting to change from negative reasons such as scrap-and-build, withdrawal and contraction to more positive motivations. We have also seen a rise in the rents of some of these office buildings that meet tenants' needs.

b) Future Trends in Demand

A survey carried out by Mori Building studied, the demand for large office buildings (including existing demand), when viewed over the long term of 15 years. It found that even including the "Bubble Economy", new demand of approximately 1,000,000m² is generated each year, virtually regardless of economic conditions.

Say for example, if demand of 1,000,000m² will be generated each year, the supply quantity over the six years from 2000 to 2005 will be only 5,860,000m², so in the total supply-demand balance over the six years, demand is slightly higher than supply.

Making an observation from the past history described above, one can also say that demand for large office buildings remains strong.

However, this simple mathematical exercise needs to be viewed in light of what is going on in the world. In recent times we have seen changes in trends among tenants. Aside from the centralization movement and scrap-and-build related to mergers, movements of tenants have been dampened dramatically. In addition, a shadow has recently been thrown even on the so-called katakana companies (foreign companies and IT-related companies) which have supported office demand up until now.

Firstly, with regard to the IT-related industry, the bursting of the "Net Bubble" and intensifying competition within the industry have resulted not only in the loss of the expectation of the explosive rise in demand that existed at one time, but even in a stalling.

Additionally, although there are some who view it as a temporary phenomenon caused by the multiple acts of terror in the US and the deterioration in the Middle East situation, we are quite clearly seeing a stagnation in foreign firms which have high wage burdens that previously had a passion for new facilities and for raised floors. The main reason for this is thought to be that both the US and Japanese economies are slowing down.

Another factor is that it is regarded as a certainty that a large quantity of high-quality office buildings will be supplied to the market over the next few years.

In other words, in a recession in which a dramatic expansion of demand cannot be expected, this large supply means that competition to attract tenants will intensify. Tenants are therefore watching the situation with the hope that there will be downward pressure on rents, and mainly on high-end rent level office buildings, and that rent will undergo a downward correction to appropriate rent levels.

Polarization of the Market Brought About

2. The Increasingly Polarized Office Market

Over the last few years we have seen a weakening of the impetus of katakana companies (foreign firms and IT-related companies) that had been supporting strong office demand, and judging from the state of the Japanese economy which shows not much in the way of signs of recovery, the large-scale supply coming in the future will further clarify the difference between the winners and losers in the office building market.

The large-capacity supply of newly-constructed large buildings is expected to promote moves of tenants between large office buildings, creating large vacant spaces in existing office buildings. This is because it is inevitable that tenants will move to buildings with better conditions, citing as reasons the better IT accommodation, the centralization of dispersed offices, and revisions of rent paid. It therefore seems that the existing office building market will see a so-called "chain reaction phenomenon."

In particular, the following three events which will likely promote moves of tenants between large office buildings cannot be ignored.

- a) Moves incorporating affiliated companies and promoting the integration of offices due to construction of head office buildings;
- b) Moves resulting from redevelopment and reconstruction of existing office buildings that have become decrepit, mainly around the Marunouchi area;
- c) Rent adjustment centering on high-rent office buildings.

If new demand does not evolve to fill the large quantity of vacancies that will appear as a result of the chain reaction, for example from a sudden recovery in the economy or the prosperity of a new industry, we will see an acceleration in the polarization between office buildings that are able to maintain market competitiveness, and buildings that are unable to do so.

Note: Rentable floor space of large new office buildings: total floor area x 65% (rentable rate)

In specific terms then, what makes an office building a member of the losing side? The following examples are of buildings that cannot satisfy tenant needs.

- a) Low earthquake-resistance, such as meeting only the old earthquake-resistance standards (except for cases where the same level as new earthquake-resistance standards can be achieved through renovations, etc.);
- b) Inadequate equipment or accommodation for IT (except for where renovation potential exists, etc.);

- c) Small size (total rental floor space/floor space per floor);
- d) Poor location (macro/micro);
- e) Extremely high rent;
- f) Lack of tenant trust in, or inadequate management framework of, owner.

Office buildings on the losing side that lack market competitiveness will be forced to choose one of the following three options:

- Option 1: Step up to the winner's group by taking proactive and effective measures such as converting to a different use (residential, retail), large-scale up-grade renovations, or improving management.
- Option 2: Maintain competitiveness by dropping rent dramatically. (Not all tenants that require office buildings need large, high-spec buildings.)
- Option 3: Withdraw from the market and sell the building to a fund or a condominium business.

3. State of Buying and Selling Office Buildings

(1) Characteristics of Buying and Selling Buildings

The reasons for entities to be more inclined to engage in sales of office buildings can be summarized into the following five points.

- a) Implementation of International Accounting Standards (IASC) – Depreciation accounting of fixed assets and market value accounting of investment real estate have been applied to domestic Japanese accounting standards, and lead to increased pressure for selling idle assets.
- b) Improvement of financial strength – Asset sales lead to contraction in interest-bearing liabilities. Also companies can demonstrate that they stress asset efficiency, focusing on ROA (Return on Assets) and ROE (Return on Equity).
- c) Mergers and alliances between companies – Accelerated disposal of duplicated business real estate and welfare facilities makes assets available for sale.
- d) Introduction of consolidated accounting – Due to the expanded number of companies subject to consolidation accounting requirements the ability to book profits by selling to unconsolidated subsidiaries disappears and are replaced by sales to third parties.
- e) Establishment of J-REIT – We have seen a sudden increase in purchases of office buildings by real estate funds with a view to J-REIT transfers. This is bringing about a "fund bubble." This Autumn, following the two leading companies that have already been listed on the stock exchange, the J-REIT movement is expected to continue to grow.

The sales market for office buildings in the future is expected to see an increase in the quantity of buildings available for sale due to the aforementioned reasons, particularly the restructuring of selling companies and the development of J-REIT potential by buying companies. In addition, this will be accompanied by strict selection based on properties that generate (or have the potential to generate) profits, and properties that are less able to do so.

**(2) Current State of
Office Building
Buying and Selling**

It was around 1998, with the enactment of the SPC Law, that real estate trading with the precondition of securitization started to take place in earnest in Japan. Three years have passed since then, and great changes have taken place in buying and selling real estate, in particular buying and selling of office buildings.

According to information disclosed by the Tokyo Stock Exchange, with regard to the form of transactions, 40% of the total is accounted for by the buying and selling of beneficial interests in trusts, a form which hardly existed at all three years ago. Today, buying and selling using schemes such as securitization forms the mainstream of buying and selling office buildings.

It is thought that transactions connected to securitization account for nearly 70% of the total. Approximately half of this number are J-REIT-related (including planned transfers) transactions.

In the future it seems likely that we will see an increase in purchases of office buildings by real estate funds with a view to transfer to a J-REIT, and intensifying competition for outstanding properties.

The Outlook for the Office Building Market

4. Outlook for the Future

a) Vacancy Rates of Losers Rises Above 10%

Office buildings on the winning side, due to the reasons discussed above, have demand and supply that are roughly in equilibrium, and while it may be unavoidable that vacant inventory may increase slightly, the current levels are expected to be able to be (relatively) maintained.

For the losers, however, the majority of the area arrived at by deducting the area lost from the reconstruction planned centering on Marunouchi from the 2,940,000m² set to increase in the future will be added on as is, and levels in excess of 12% are expected. For the newly supplied buildings that are expecting high-end rent levels in particular, it will mean large vacant space inventories will have to be carried.

Vacancy rates for the office building market on the whole are expected to be around 10%.

Note: Percentage of office building market on the losing side: In the five central wards of Tokyo, the percentage of buildings completed in 1980 or later with a total rental floor area of at least 3,000 tsubo is approximately 20%, so this figure was applied (source of data: Ikoma Data Service Systems).

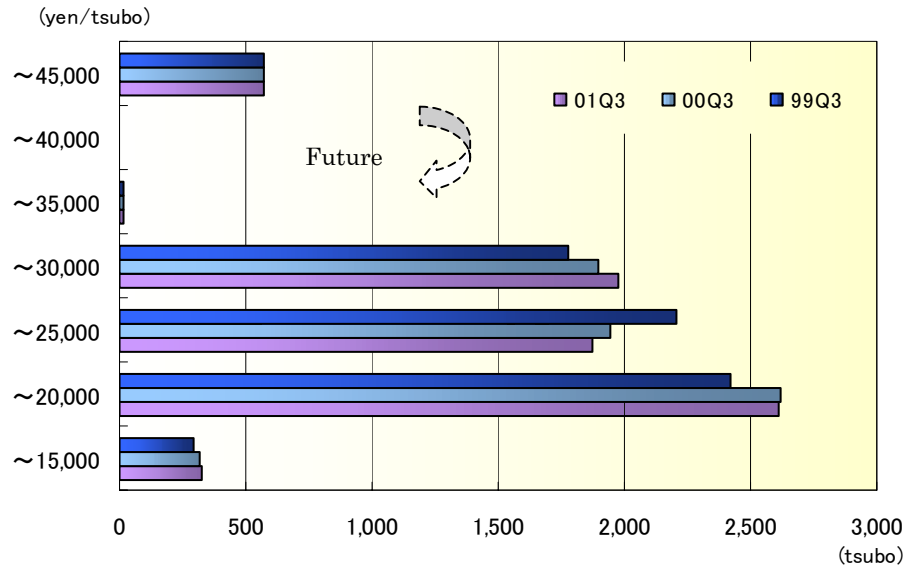
b) High-end Rent Levels Converge to Between 30,000 and 40,000 yen

With intensifying competition to attract tenants, office buildings on the losing side will be unable to maintain current rent levels. Similar to the 1990s, an annual drop in rents of between 20 to 30% or even greater is expected. Buildings that are particularly decrepit or have inferior locations will find it difficult to find tenants no matter how low they drop their rents, which may cause an even greater fall. In addition, it is inevitable that office buildings with high rents of 40,000 yen or more per tsubo will lose their scarcity and be drawn into the whirlpool of price competition. Further, with regard to the ability to pay this level of rent, it is limited to a handful of tenants such as foreign financial institutions, who will have little or no interest in buildings on the losing side, so we believe a major adjustment of rents will occur without a doubt.

Meanwhile, for buildings on the winning side, the percentage of office buildings that meet tenants' needs remains low, so the current rent levels are likely to be retained, or perhaps rents may drop but by no more than 10%.

Therefore, limiting our observation to large office buildings, office buildings with prominently high rents will suffer decreases, with rents in the Marunouchi-Otemachi areas converging to 30,000 to 40,000 yen, and buildings in the five remaining wards of central Tokyo converging to between 20,000 to 40,000 yen per tsubo (Fig. 4)

Fig. 4 Floor Space of New Demand Rental Space by Rent Level for the Five Central Wards of Tokyo



Source: Prepared by NREIM based on Data Processed by Segment (Zone, Age, Size) from Ikoma Data Service Systems

Because the future is largely dependent on future developments in the Japanese economy, it is difficult to make assertions. However, we feel the office building market as a whole seems unlikely to go into recession. However, it is unavoidable that we will see a further polarization into office buildings that can maintain market competitiveness and buildings that are unable to do so, and even for office buildings that are competitive in the market, we will see adjustments in rent levels, although more so for the buildings with higher rents.

While the office building market as a whole will not enter recession, it is unavoidable that we will see a downward adjustments of rents in high-end buildings and polarization of the market for office buildings will advance with increasing rapidity.

II. Market Watch

1. Japan's Economic Environment

(1) Overview

The perception that Japan's economy is continuing to deteriorate has become reality, and the economy is already considered to be in an economic recession.

Taking a look at the current diffusion index (revised value) for July released on September 18 by the Economic and Social Research Institute of the Cabinet Office, the coincident index remained below the turning point (50%) for judging the economy for the seventh straight month, at 12.5%. The leading index recorded was 55.0%, the first time in two months that it exceeded 50%. On the other hand, the lagging index was back at 50.0%, after being under 50% for four consecutive months.

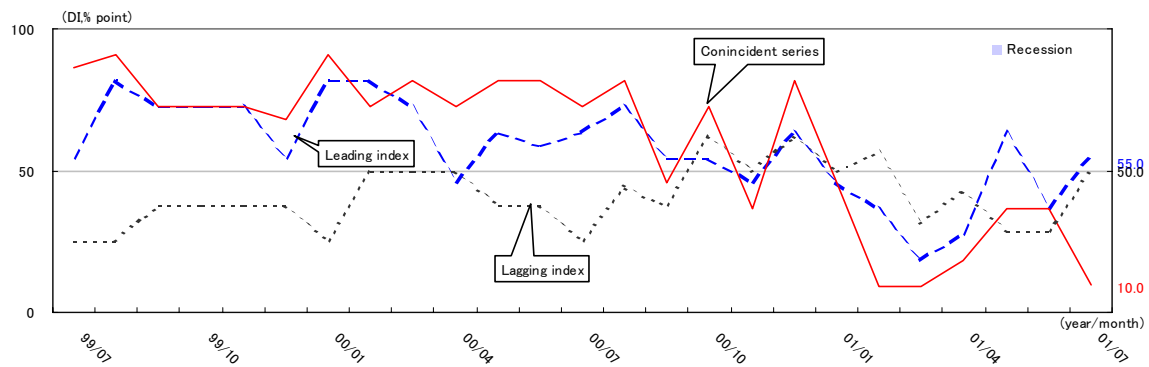
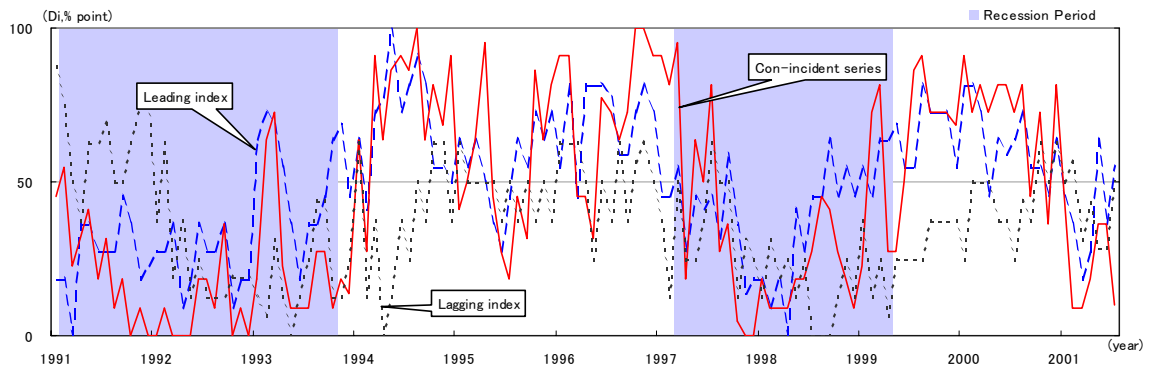
Looking at a breakdown of the coincident series indicators, the production index (mining and manufacturing) and almost all other production-related indices are negative, and department store sales have reverted from positive to negative, meaning that consumption-related and employment-related indices are negative. The only area that showed improvement was major power consumption, which increased as a result of demand for air-conditioning in plants due to the hot summer.

In the monthly economic report released by the government on September 13, although the perception that the economy "continues to deteriorate" is indicated, the Cabinet Office stated its opinion only that "the angle of economic deterioration has not worsened."

While individual investment is hovering around the same level, capital investment, housing construction, mining and industrial output are falling, corporate profits have leveled out, the employment situation remains harsh, and these are weaknesses in the domestic wholesale price index and consumer price index. Taken as a whole, there is little ground for any positive opinion.

This report does not incorporate the impact of September 11 terrorist attacks which took place in the United States. It is extremely likely that this incident will have a negative effect mainly on the manufacturing industry, exacerbating the stagnation in exports caused by the deterioration in the US economy, and this will add further to the already deteriorating trend of the Japanese economy.

Trends in Diffusion Index (DI)



Source: Economic and Social Research Institute, Cabinet Office

**(2) Business Cycles
and the Office
Market**

Business cycles and the office market are closely linked.

We therefore carried out an analysis on the outlook for the office market, using a number of indicators that reveal trends in the economy.

While the observation may be made that the share of Japan's GDP accounted for by the non-manufacturing industries has risen, we focused on movements in the manufacturing industry, which are factors that bring about business cycles, and carried out an analysis of two indicators: "machinery orders (excluding private sector demand and shipping)"; and "index of mining and industrial output (seasonally-adjusted)."

(1) Correlation between Movements in Manufacturing Industry and the Office Market

It is said that office demand increases significantly approximately one year after an economic recovery. With regard to this point, we will look at movements in the manufacturing industry which are closely related to business cycles, and then we will discuss the relationship between business cycles and the office market.

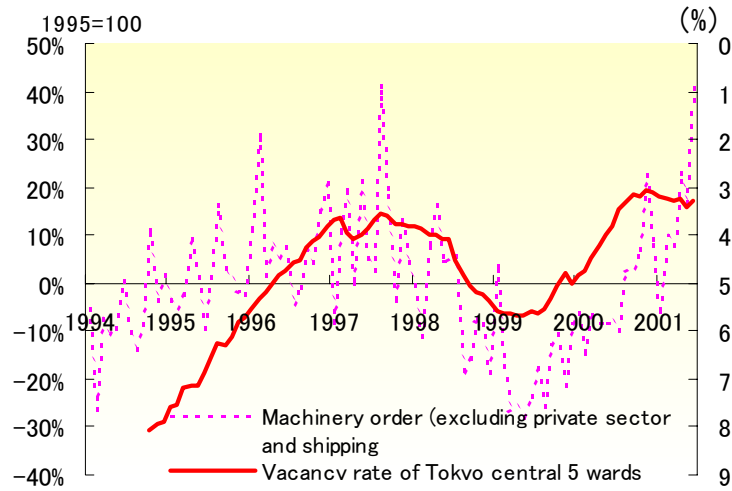
Firstly, during a period of economic recovery, companies in the manufacturing industry actively invest in equipment with the expectation of increased production and sales in the near future, and start to strengthen their production facilities and increase their production capacity. Then, at the next stage, they increase and expand their sales bases in a bid to strengthen their sales capacity. It is only when the latter occurs that we see a marked increase in office demand.

Conversely, during an economic recession, the first things companies do are to reduce capital investment and adjust production. Next, after six months to a year, under a program of cost cutting, they cut fixed costs, in other words we see a movement to integrate and thereby abolish offices. However, there is no sudden reduction in the office floor-space used. This is because when it comes to cost cutting, although personnel cutbacks are also an important factor, Japan does not actively adopt the same approach as in the western countries where a deterioration in performance means immediate layoffs.

We therefore have the situation where the office market gradually improves with a delay of approximately one year after economic recovery, and the office market gradually deteriorates with a delay of six months to a year after economic recession. Another factor of particular importance behind the delay of six months to a year after economic recession is the typical rental agreements that are used in Japan. Specifically, the majority of these agreements can be terminated with six months' notice.

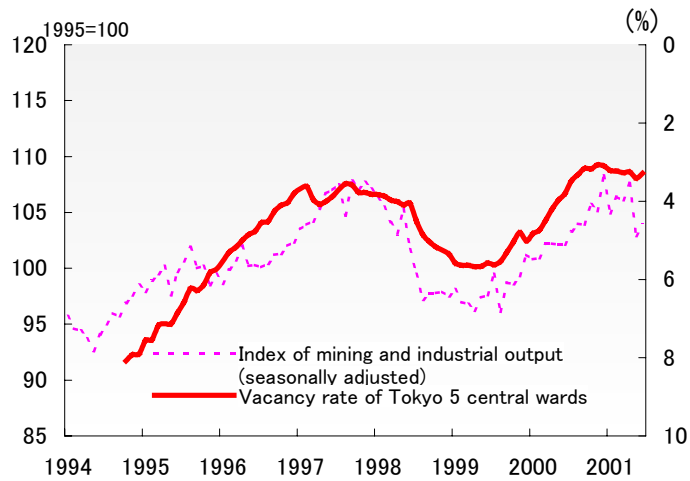
The graph below shows the strong correlation between movements in the office market (vacancy rate) and "machinery orders" a leading index of business momentum, and "index of mining and industrial output," a coincident index.

Graph 2-1 Machinery Orders and Office Vacancy Rates in the 5 Central Wards of Tokyo



Source: Prepared by NREIM based on data from the Economic and Social Research Institute, Cabinet Office and Ikoma CBRE

Graph 2-2 Index of Mining and Industrial Output and Office Vacancy Rates in the 5 Central Wards of Tokyo



Source: Prepared by NREIM based on data from the Ministry of Economy, Trade and Industry and Ikoma CBRE

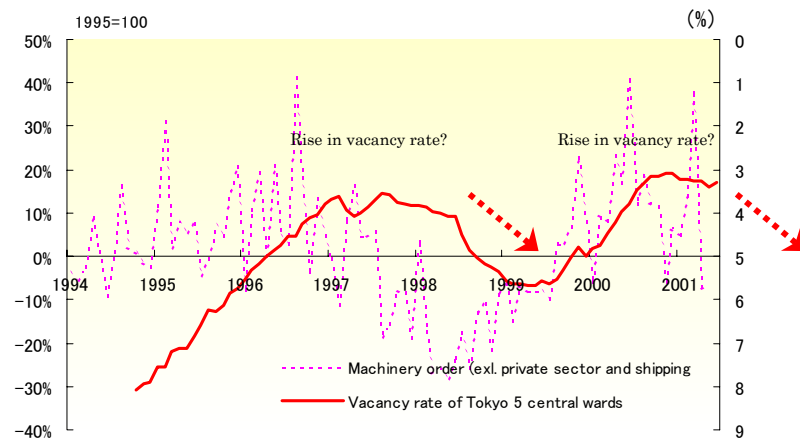
b) The Future of the Office Market

What will happen to the office market in the future?

Let us take a look at recent movements in representative indicators for the manufacturing industry.

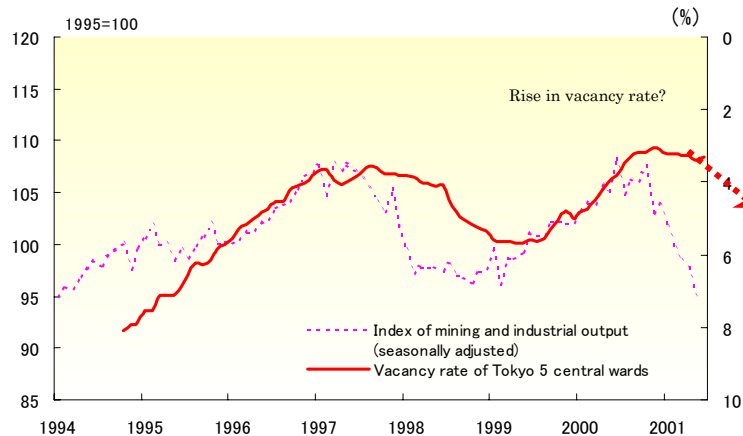
From the graph below it is evident that “machinery orders”, which indicates movements in corporate capital investment, peaked in the first half of 2000, while the “index of mining and industrial output”, which shows the state of corporate production, peaked in the latter half of 2000. Both indices are moving downward (Fig. 3-1, 2).

Graph 3-1 Machinery Orders and Office Vacancy Rates in the 5 Central Wards of Tokyo



Source: Prepared by NREIM based on data from the Economic and Social Research Institute, Cabinet Office and Ikoma CBRE

Graph 3-2 Index of Mining and Industrial Output and Office Vacancy Rates in the 5 Central Wards of Tokyo



Source: Prepared by NREIM based on data from the Ministry of Economy, Trade and Industry and Ikoma CBRE

Although it is clear that the office market cannot be viewed so simplistically, that it fluctuates in response to movements in the manufacturing industry, if the movements in the indices for the manufacturing industry are taken as is, then we can to some extent forecast that the office market will gradually move in a downward direction.

To avoid this deterioration, and to cover the large-scale supply of large buildings in central Tokyo around 2003, the creation of large-scale demand is an absolute must. Of course this demand is most likely to come from non-manufacturing industries.

Based on the foregoing, it is important to look at the corporate employment environment, which as mentioned earlier is not effective immediately but which ultimately has a major impact on office demand. As is evident from the table below, when it comes to corporate employment decisions, the employment environment of the non-manufacturing industries, when compared to manufacturing industry, has an undeniable sense of excess but is in better shape overall.

Table 1 Movements in Personnel Employed by Companies

		June 2001		Sept. 2001			
		Current	Future	Current		Future	
					Difference		Difference
Large companies	Manufacturer	26	23	32	6	30	-2
	Non-manufacturer	14	9	14	0	12	-2
	All industries	21	16	24	3	21	-3
Large-medium size companies	Manufacturer	25	25	33	8	31	-2
	Non-manufacturer	3	2	5	2	4	-1
	All industries	12	11	16	4	14	-2
Medium-small size companies	Manufacturer	24	22	26	2	27	1
	Non-manufacturer	9	9	11	2	12	1
	All industries	15	14	18	3	18	0
Total	Manufacturer	24	23	29	5	29	0
	Non-manufacturer	8	6	9	1	9	0
	All industries	15	14	18	3	18	0
Major companies	Manufacturer	27	23	32	5	29	-3
	Non-manufacturer	13	11	14	1	11	-3
	All industries	21	17	24	3	21	-3

Source: Bank of Japan's quarterly short-term economic survey

However, with the bursting of the so-called "IT bubble," companies such as IT related companies and foreign financial institutions, which have been key players in supporting office demand in the past few years, do not have the space needs as before.

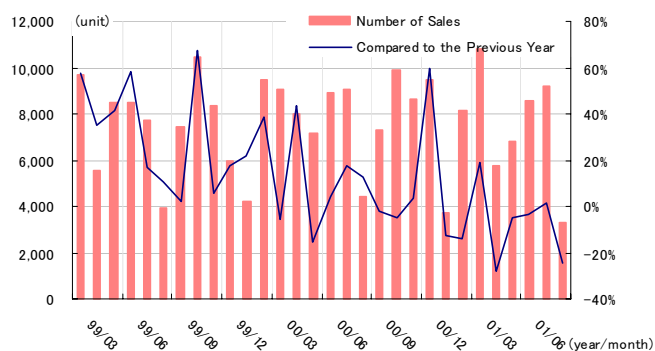
Unfortunately, it must be said that expectations as to the identity of the new demand that can be created to replace these users are unclear at this stage.

**2. Real Estate
Market Trends**

**(1) Trends in the
Condo Market**

a) Trends in the Number of Sales

<Tokyo Metropolitan Area>

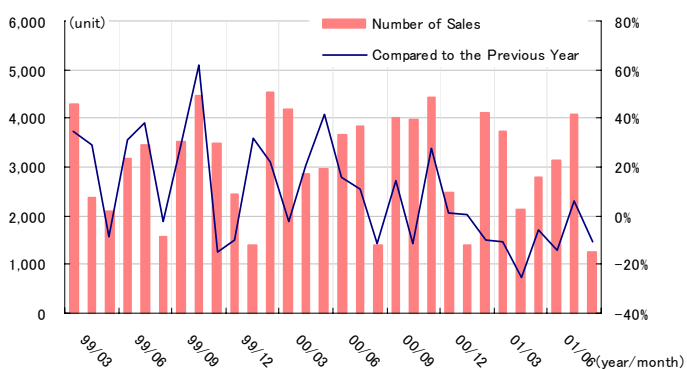


Source: Real Estate Economic Institute

According to the Real Estate Economic Institute, the number of condos sold in August 2001 was 3,319 units, the first time in two months in which a year-on-year decrease was recorded (24.9% decrease). In fact, it was the smallest number of condos supplied since January 1999.

These results were caused by a lack of large buildings in the highly popular city centre areas, and the holding back of releases in anticipation of the autumn selling season.

<Kinki Area>

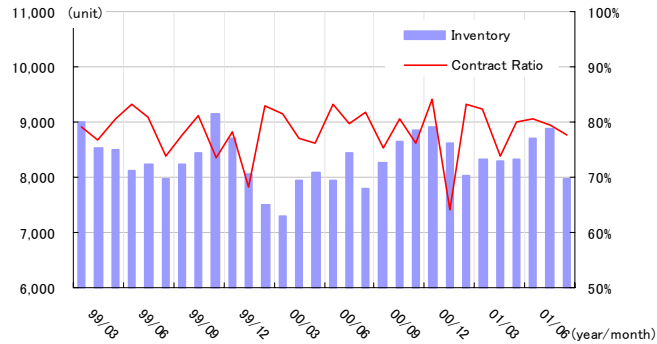


Source: Real Estate Economic Institute

Some 1,252 condos were sold in the Kinki Area in August 2001, the first year-on-year decrease in two months, a reduction of 10.7%. It was also the first month-on-month decrease in two months.

b) Trends in Contract Ratio and Inventory

<Tokyo Metropolitan Area>

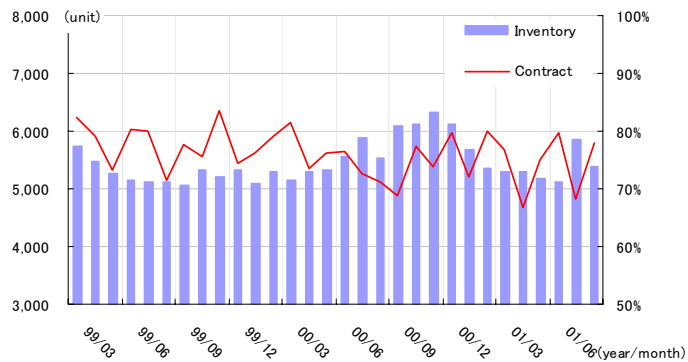


Source: Real Estate Economic Institute

August 2001's contract ratio remained satisfactory at 77.7%. However, year-on-year this was the third subsequent month in which a decrease was recorded.

The inventory at the end of July was 7,980 units (up 2.5% year-on-year). August saw progress in the sales of existing properties, with inventory dropping for the first time in four months on a month-on-month basis, but it was the 9th consecutive month in which a year-on-year increase was recorded.

<Kinki Area>



Source: Real Estate Economic Institute

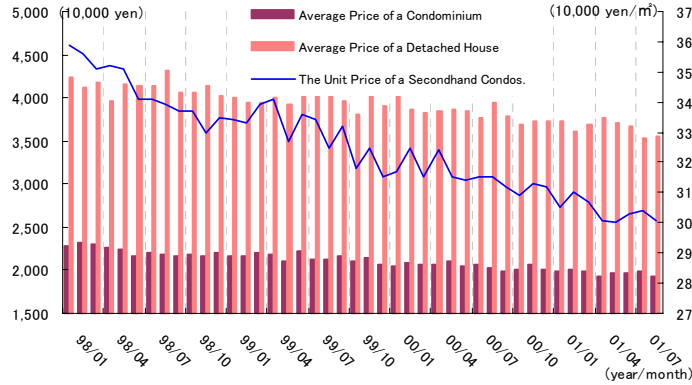
The contract ratio for August 2001 was 78.0%, maintaining a high level. On a year-on-year basis this figure represents a 6.7% increase, and it was the first time in two months that such an improvement was recorded.

The inventory as at the end of July was 5,386 units (down 2.4% year-on-year). Month-on-month it was the second consecutive decrease, and year-on-year it was the fourth consecutive month in which a decrease was recorded.

(2) Trends in the Distribution Market

a) Trends in the Average Contract Price

<Tokyo Metropolitan Area>

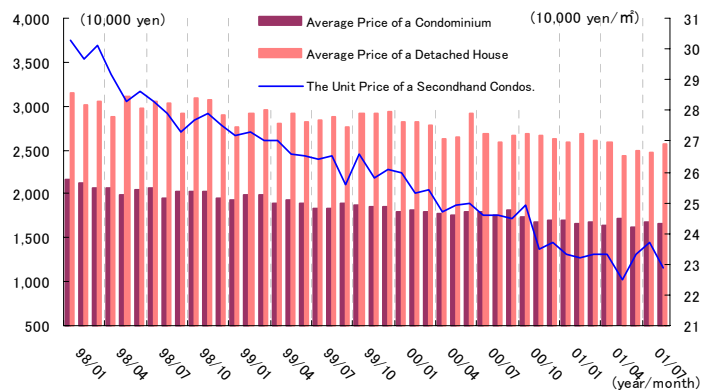


Source: Real Estate Information Network System

According to the Real Estate Information Network for East Japan, the average price of condominiums sold in August 2001 was 19.34 million yen, down for the 23rd consecutive month on a year-on-year basis, but the first drop in two months on a month-on-month basis. Going forward, we expect the average price to range between 19 and 19.5 million yen.

The price of second-hand detached houses was 35.61 million yen, the 19th consecutive month in which a year-on-year fall was recorded, but the first month-on-month increase in four months.

<Kyo Hanshin Area>



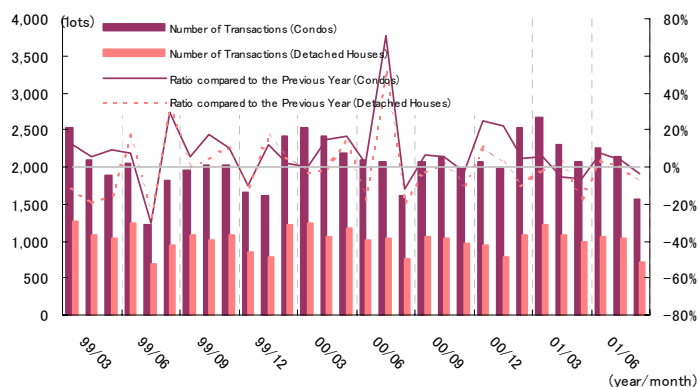
Source: Real Estate Information Network System

According to the Real Estate Information Network for Kinki Region, the average price of condominiums sold in August 2001 was 16.6 million yen, the 56th consecutive month in which a year-on-year decrease was recorded since January 1997, but the first time in two months that a month-on-month decrease was recorded.

In addition, the average price of detached houses was 25.62 million yen, the 14th consecutive month in which a year-on-year decrease was recorded, but the first month-on-month increase in two months.

b) Trends in Number of Contracts

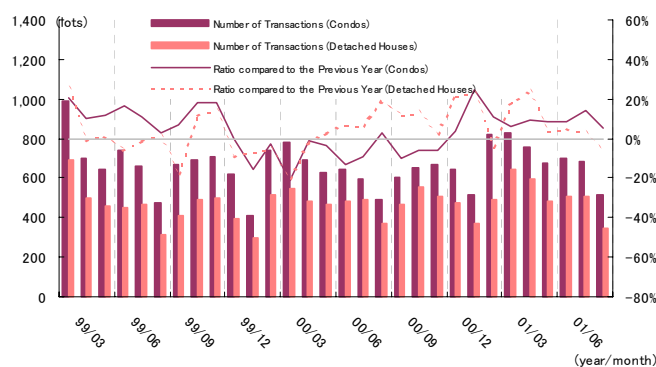
<Tokyo Metropolitan Area>



Source: Real Estate Information Network System

According to the Real Estate Information Network for East Japan, the number of contracts signed for existing condos in August 2001 was 1,554 (the first fall in three months year-on-year, and the second straight month-on-month decrease). The number of contracts signed for detached houses was 704 units, down 3.7% year-on-year. This was the third consecutive month in which a year-on-year decrease was recorded, and the second consecutive month-on-month decrease.

<Kyo Hanshin Area>



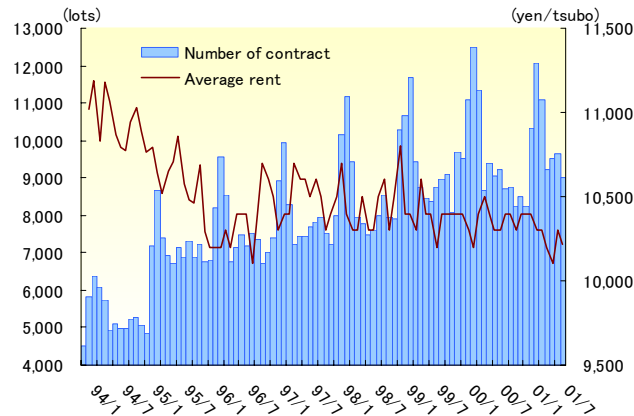
Source: Real Estate Information Network System

According to the Real Estate Information Network for Kinki Region, 516 contracts were signed for existing condos in August 2001 (up 5.1% year-on-year). Although this was the 9th consecutive month in which a year-on-year increase was recorded, it was the second straight month-on-month decrease. The number of contracts signed for detached houses was 347 units. This figure was the first time in six months that a year-on-year decrease (0.9%) was recorded, and the second consecutive month-on-month decrease.

(3) Trends in the Rental Condominium Market

Trends in Average Rent and Number of Contracts Concluded

<Tokyo>



Source: Recruit

According to Recruit, the number of rental contracts terminated in Tokyo City in August 2001 was 9,024, down 6.6% month-on-month, and down 2.3% year-on-year.

On the other hand, average rent was 10,220 yen/tsubo, the first fall in two months on both a year-on-year and month-on-month basis.

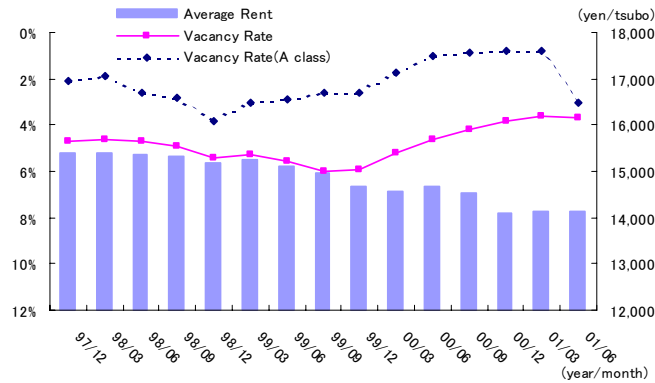
By area, in Jonan Area, there was a slight fall in August but the rent per tsubo had risen in the 14 consecutive months up until July (year-on-year). In Josai Area rents have risen for 5 consecutive months, and rents for the city centre have risen for 4 consecutive months. There is, however, a widening gap between these and other areas.

By room configuration, while prices are basically remaining constant, for 4LDK units (four rooms and a combined living/dining room/kitchen), which previously had a high total rent, rent is continuing to fall dramatically.

(4) Trends in the Office Market

Trends in Asking Rents and Vacancy Rates

<Tokyo 23 Wards>

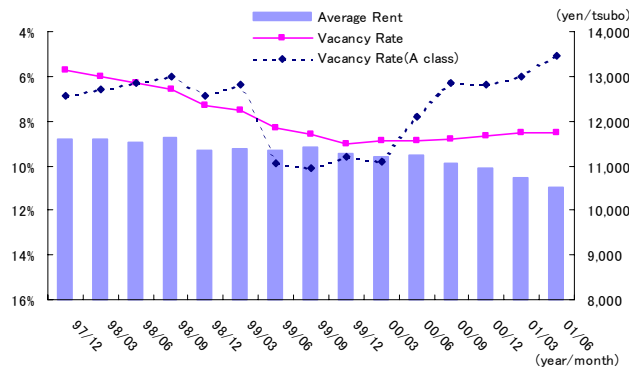


Source: Ikoma CBRE

According to Ikoma CBRE, the average office vacancy rate for June 2001 for Tokyo's 23 wards was 3.7%, down 0.1% month-on-month. The average monthly asking rent was 14,130 yen/tsubo, up 0.1%.

The vacancy rate for A-class buildings was 3.0%, a 2.2% increase month-on-month, denoting a major deterioration in the market.

<Osaka City>



Source: Ikoma CBRE

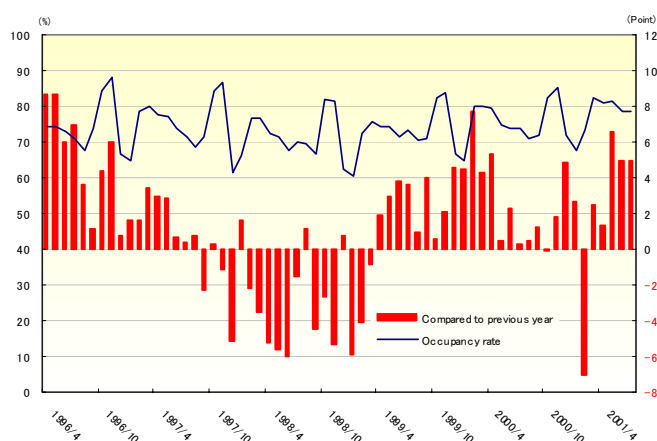
According to Ikoma CBRE, the average vacancy rate for Osaka City in June 2001 was 8.5%, roughly the same as the previous month. Average asking rent fell 2.2% to 10,500 yen/tsubo, however.

On the other hand, the vacancy rate for A-class buildings improved 0.9% points month-on-month and was lowered to 5.1%.

(5) Trends in the Hotel Market

Trends in Occupancy Rates

<Tokyo and Osaka Areas>



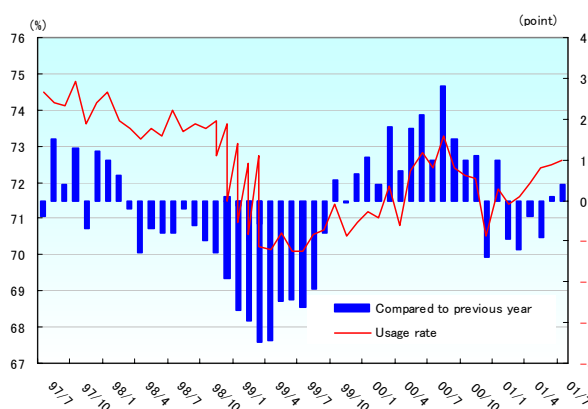
Source: Ministry of Land, Infrastructure and Transportation

According to the National Land and Transportation Ministry, the hotel occupancy rate for July 2001 improved 5% year-on-year to 78.7%, maintaining a high level. Although this figure remained constant month-on-month, it was the fifth straight month in which a year-on-year rise was recorded.

(6) Trends in the Logistics Market

Trends in Warehouse Usage Rates

<Major 21 Companies>



Source: Japan Warehousing Association, Inc.

According to the Japan Warehousing Association, the warehouse usage rates for 21 major warehousing companies improved 0.4% year-on-year to 72.6%. This figure was the second consecutive rise year-on-year, and the fifth consecutive month-on-month rise.

On the other hand, the freight turnover rate was 46.6%, the fourth consecutive month in which a year-on-year decrease was recorded.

III. J-REIT Review

On September 10, 2001, the first two Real Estate Investment Trusts (J-REITs) instruments in Japan were listed on the Tokyo Stock Exchange.

This report will review the trends in primary and secondary markets for the J-REIT, based on case studies of these two listed J-REIT instruments: Office Building Fund of Japan (NBF) and Japan Real Estate Investment Company (JRE).

Please note that this document is studied based on the information as of 31 October 2001.

1. Primary Market (1) Active Investor Demand

Although this is not official data, investor demand for both J-REITs during the pre-initial public offering period was at the high level of eight times the number of investments offered.

Converting this figure to total market capitalization, for the offering for both J-REITs together of approximately 135 billion yen, demand of 1 trillion yen was received.

Considering the fact that a track record and any awareness of J-REITs was virtually nonexistent, and that hardly any institutional investors such as pension or investment trusts participated in the offering, the first listing of J-REITs can be described as a major success.

The most significant reason for such popularity for J-REITs is that the relatively high dividend yield of J-REITs (4.2 to 4.4% based on subscription price) against the background of a lingering low-interest policy and the struggling stock market was attractive to investors.

(2) Premium on NAV

The premium on NAV, calculated by dividing the issue price for both J-REITs by the net assets per unit according to the prospectus, was from 5 to 25%.

Possible causes behind the excessive premiums on NAV are the reduced risk due to the effective diversification and the improved liquidity achieved by listing investments on the stock exchange. However, considering that in this offering the main investors were individual investors and regional financial institutions with expectations for yield, it is appropriate to take the attitude that a premium was generated as the result of pricing based on expected (projected) returns from these investors.

We may therefore expect that if the expected returns of investors rise, or if J-REIT's profitability or divided payments deteriorate, there is a danger that discounts may occur immediately.

(3) Composition of Investors

In these offerings, it appears that individual investors and regional financial institutions were core investors for both J-REITs. This can be attributed to the fact that the listed J-REITs are appropriate sized investment products, and that their bond-like nature

which provides a stable operating profit corresponded to the investment objectives of these groups.

On the other hand, with regard to institutional investors, while some operating capital apparently flowed in from overseas investors, Japanese life and nonlife insurance companies and investment trusts apparently found it difficult to adopt a clear investment stance for this new type of product.

Therefore, once a given track record of operation has been established, investments from Japanese and foreign institutional investors are expected to gradually increase. In the future there are plans for new listings of J-REITs, and the degree of attention paid by institutional investors is expected to rise with the expansion in the size of the market.

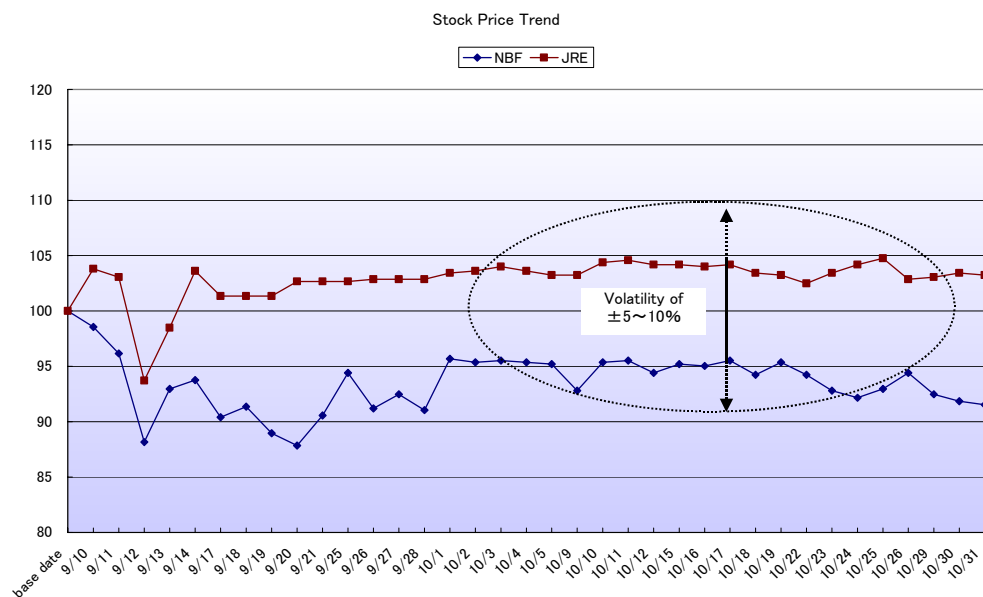
2. Secondary Market

(1) Fluctuations in Market Price (from listing date to October 31)

	NBF	JRE
Highest price	616,000 yen (Sept. 10)	550,000 yen (Oct. 25)
Lowest price	549,000 yen (Sept. 20)	492,000 yen (Sept. 12)
Average price	583,472 yen	540,167 yen

In September, the month the J-REITs were listed, there were a variety of speculative stances taken by investors, making stock prices somewhat unstable, but this has been rectified (with resultant stability) since the start of October.

JRE made an additional acquisition of a large office building (approximately 35 billion yen) after its listing, but the market has not made a conspicuous reaction. This was expected, because since investors would view J-REITs principally as a yield product, it is difficult for them to conclude how expansion of the scale of assets would impact on performance.

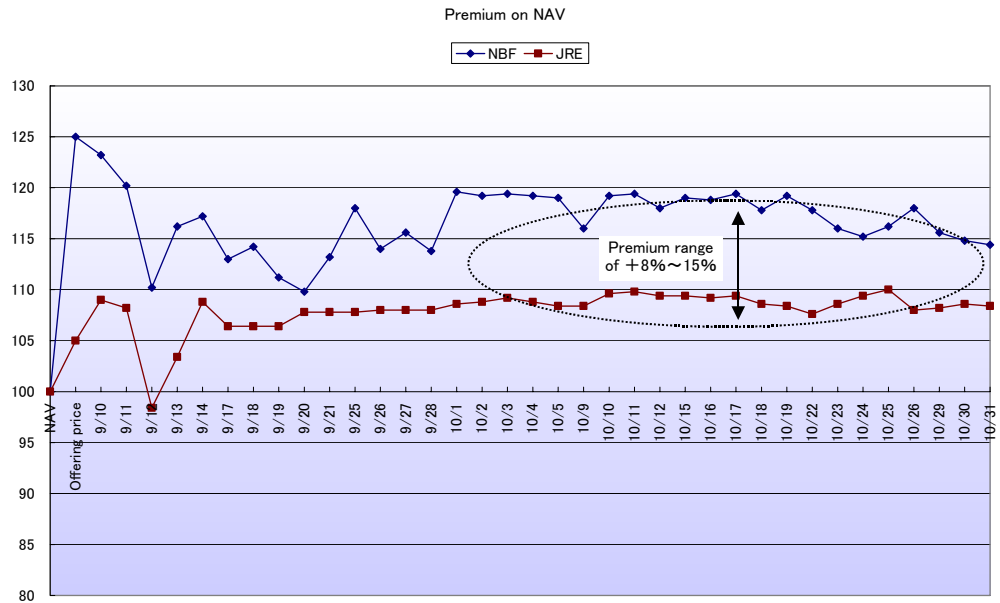


(2) Premium on NAV (from listing date to October 31)

	NBF	JRE
Premium at IPO	25% (Sept. 10)	5% (Sept. 10)
Highest premium	23.2% (Sept. 10)	10% (Oct. 25)
Lowest premium (discount)	9.8% (Sept. 20)	-1.6% (Sept. 12)
Average premium	17.8%	8.9%

Although the factors that are generating a significant premium on NAV are unclear, considering that about 80% of investors purchased J-REIT interests based on expectation of better yields, it seems likely that the source of the premium is stock price formation based on such yields.

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(3) Liquidity (from listing date to October 31)

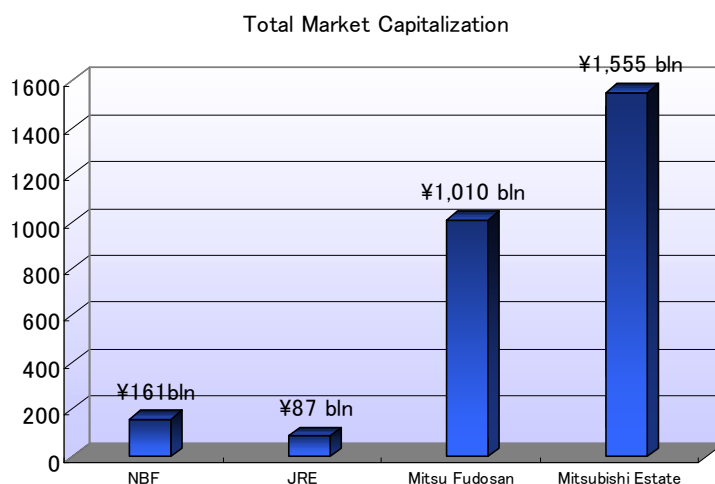
	NBF	JRE
Average transaction volume	1,503	1,389
Average transaction volume (excl. 1st and 2nd days of IPO)	867	694
Average transaction value	500 million yen	380 million yen

The daily average for J-REIT transactions is 500 to 1,000 transactions, with the average total value of such transactions amounting to 400 billion to 500 billion yen.

3. Product Characteristics of J-REIT

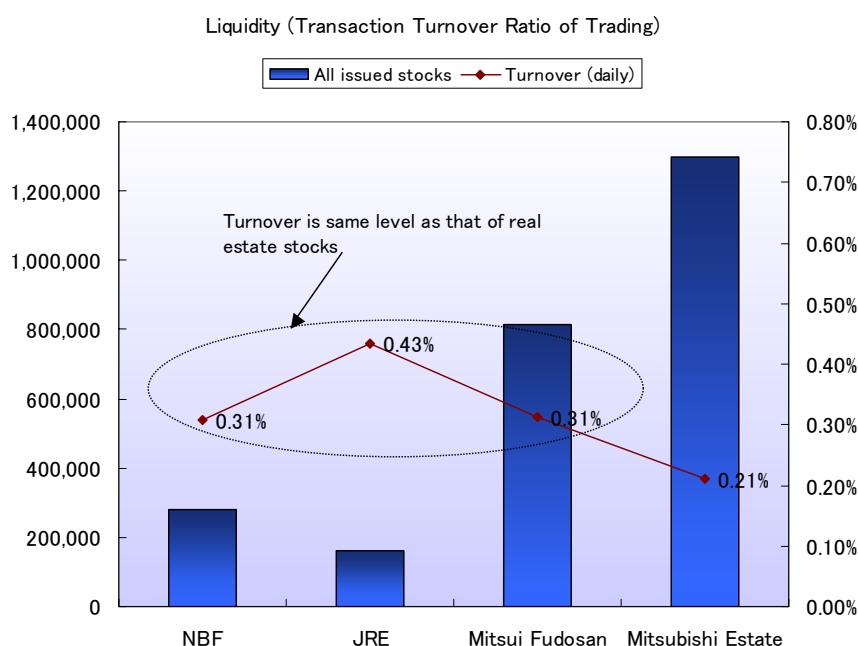
(1) Liquidity

The J-REIT market is small in absolute terms with regard to total market capitalization, number of instruments, and the number of investments in circulation, making the market volume too small to easily absorb large transactions.



However, viewed from the turnover ratio of trading which indicates the percentage of all listed stocks that have changed hands over a given period, it appears that a certain level of fluidity commensurate with the size of the market has been established.

If the listing of other J-REITs and the inclusion into TOPIX instruments planned for the future goes according to plan, then it is hoped that market volume will expand explosively.



	NBF	JRE	Mitsui Fudosan	Mitsubishi Estate
All issued stocks (unit)	280,700	160,400	812,560	1,299,185
Average transaction volume (unit)	867	694	2,549	2,744
Turnover (daily)	0.31%	0.43%	0.31%	0.21%
Turnover (annual)	76%	107%	77%	52%
Average transaction value (100 million)	5.0	3.8	32.8	32.7

Note 1: The numbers of issued shares and average capitalization for Mitsui Fudosan and Mitsubishi Estate are shown on a per-share basis.

Note 2: The average capitalization is the average for the period from September 12 to October 31.

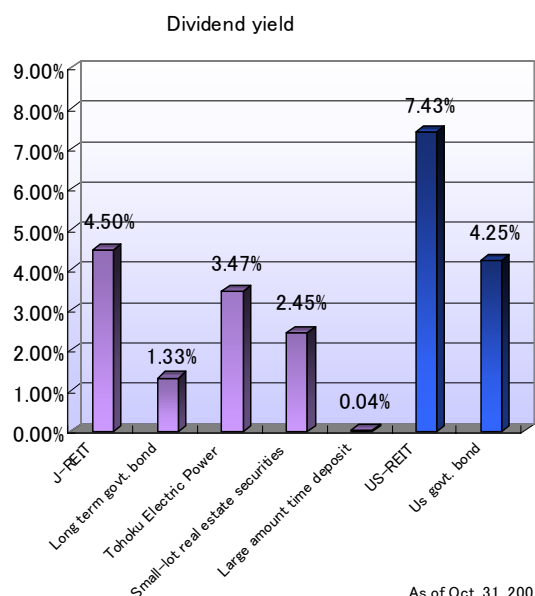
(2) Yield

One can surmise that the point which was most attractive to investors in this IPO was the high expected yield of J-REITs in comparison to other financial assets. In a comparison with general yield products in the domestic Japanese market, as shown in the diagram below, at this point J-REITs are providing the highest returns.

Naturally, J-REITs resemble stocks in nature, and stock prices do not result from dividend yield alone. In the future we expect to see yield levels set to reflect the spread of risk-adjusted return including capital growth, changes in the real estate market and the rationality of investment strategies.

However, since no valuation method for J-REITs has been established in the market to date, yield is the only criteria that can be used.

According to interviews with investors that actually participated in the IPOs, the prevalent needs were expressed by the following sentiment: "taking the risk-free rate in the medium term as 2 to 3%, and adding on a risk premium for real estate investment of 2%, we expect a dividend yield around the 4% to 5% level."



Relationship Between Stock Prices and Dividend Yield

NBF

	Offering price	Highest price	Lowest price	Average
Stock price	625,000	616,000	549,000	583,472
Dividend	16,200	16,200	16,200	16,200
Term	223	223	223	223
Dividend yield	4.2%	4.3%	4.8%	4.5%

JRE

	Offering price	Highest price	Lowest price	Average
Stock price	525,000	550,000	492,000	540,167
Dividend	13,000	13,000	13,000	13,000
Term	203	203	203	203
Dividend yield	4.5%	4.2%	4.8%	4.3%

Dividend yield, determined by dividing the expected dividends for the current term by the stock price from September 10 to October 31 (maximum price/minimum price/average), ranges from 4.2% to 4.8%.

(3) Stability

J-REITs are essentially about the business of owning and operating real estate, so as long as the cash flow obtained from the assets held by the J-REIT is stable, the business may be described as extremely stable. Therefore, with regard to fluctuations in stock prices, long-term volatility may be expected to be considerably lower than for other stocks in general.

Volatility of J-REITs

Of the six instruments, JRE has the lowest volatility.

October	NBF	JRE	Mitsui Fudosan	Mitsubishi Estate	Tokyo Electirc	Nikkei Avg.
Average	0.04%	0.02%	-0.39%	0.07%	0.12%	0.28%
Standard deviation	1.66%	0.64%	1.90%	1.78%	1.54%	1.87%

(4) Alternative Investment

With regard to the matter of whether J-REITs can become an alternative investment in relation to other asset classes (general stocks, bonds, actual real estate), testing is required over the long term, therefore we will look at past trends in the relationship with general stocks (real estate stocks, power company stocks and the Nikkei Industrial Average).

October	NBF	JRE	Mitsui Fudosan	Mitsubishi Estate	Tokyo Electirc	Nikkei Avg.
NBF	1.00	0.15	0.48	0.55	0.04	0.19
JRE	0.15	1.00	0.11	0.25	0.18	0.15
Mitsui Fudosan	0.48	0.11	1.00	0.73	0.04	0.53
Mitsubishi Estate	0.55	0.25	0.73	1.00	0.27	0.55
Tokyo Electirc	0.04	0.18	0.04	0.27	1.00	0.29
Nikkei Avg.	0.19	0.15	0.53	0.55	0.29	1.00

J-REITs have low correlation with the Nikkei Industrial Average and power company stocks, but there is a tendency for correlation with real estate stocks to be relatively high, particularly with Mitsubishi Estate whose business is to own and lease buildings.

4. J-REIT Risk Factors

(1) Movements in Interest Rates

Currently interest rates in Japan are at their lowest levels ever. If interest rates rise in the future, J-REITs will be faced with two problems: refinance risk and rise in demanded yield.

Some of the ways in which these problems may be tackled are: (1) maintain a conservative LTV ratio, (2) acquire a high rating, and (3) seek a pricing formation that does not equate to the yield approach (differentiate investment strategy, make the scale vastly superior to other alternatives, etc.).

(2) Conflict of Interest

Currently valuations of J-REITs can be defined as being based largely on the perception for the strength of the brand power of the parent real estate companies that are behind the management companies.

J-REITs and their parent real estate companies that are both engaged in building investment programs are constantly in a relationship where there are inherent potential competition and conflict problems.

In the future, with regard to allocations for building acquisition and contributions to properties owned or developed by the parent real estate company, it is expected that investors and potential investors in the respective companies will be very interested to see how much conflicts are dealt with, and if not handled well, there is a possibility that there may be a lack of confidence from investors.

(3) Growth

With respect to the current J-REIT pricing, it is not necessarily the case that expansion of scale by acquiring properties is rated as a positive factor.

For example, even if nominal FFO were to grow, if a deterioration in profitability results from the acquisition of additional properties or if there is a dilution from issuance of additional stock, then it is quite possible that growth in size may be rated as a negative factor.

On the other hand, expansion of scale is also a vital business strategy to improve the efficiency of administration costs, diversify portfolios, and enable a liquidity premium to J-REIT investments.

Considering that J-REITs are a new market that is about to experience full-scale competition, we believe that for the time being, priority must be placed on establishing a firm position in the market, rather than emphasizing growth.

Furthermore, for the reasons outlined above, there is a possibility that it may become difficult for J-REITs to procure funds from either the debt or equity markets, which means there is a risk that property acquisition may not go as smoothly as planned.

(4) Capital Market

The major difference between Public Real Estate and Private Real Estate is the difference in market risk.

J-REITs, which are Public Real Estate, are highly likely to be affected greatly by the

impact of market fluctuations: not only the real estate markets, which impact the core assets, but also fluctuations in the capital markets.

Value stocks generally have a tendency to move in the opposite direction from rises in interest rates (diversification of asset management possibilities) and rises in the stock market (attention on gross shares) when economies are booming, and macroeconomic recovery may result in a backlash in some cases.

J-REITs are based on real estate which has a high correlation with inflation, so although there is no guarantee that they will move in the same way as value stocks, capital markets generally reflect the diverse speculations of investors, so there is always the possibility that J-REIT stock prices may be subject to price fluctuations unrelated to the real estate market.

(5) Disclosure

As is evident from the prospectuses at the time of listing, the current J-REITs hardly disclosed any information, especially information concerning the profitability of their real estate which forms the basis of investment decisions.

Information concerning the profitability of real estate may be described as an essential requirement for attracting traditional institutional investors, and unless this problem is overcome there can be little expectation for an expanding the interest of this class of investors.

We fear that a capital structure which is biased too much towards individual investors is easily influenced by short-term market fluctuations, and may destabilize the long-term management infrastructure, including strategies to increase capital.

In addition, the lack of disclosure makes it difficult to carry out comparative analysis between J-REITs, so there is a risk that a J-REIT's investment strategies and portfolio differentiation may not be valued appropriately.

