



Autumn 2009 Part II

Japan Real Estate Investment

REVIEW

Nomura Real Estate Development Co., Ltd.

Overview

Part II of this Review consists of a general overview of the logistics facility market, followed by a scenario analysis of future market trends. Post-financial crisis investment strategies for the logistics sector are then considered for each scenario.

All five basic indices of the logistics facilities sector show the market has reached a tipping point

Our discussion of the logistics facility sector begins with an analysis of the following five basic indicators: (1) rents, (2) vacancy rates, (3) new supply, (4) net absorption, and (5) cap rates.

All five of these indicators showed signs of reaching a tipping point from 2008 ~ 2009. Rents fell sharply in June 2009, and vacancy rates jumped to 11.9%, up from only 3.4% in June 2008. New supply, which had been growing rapidly since 2005, reached an all-time high in 2008 but is now expected to fall by more than 50% in 2009. Changes in net absorption, while relatively moderate, have been trending downward since reaching a peak in 2007. Cap rates had been falling steadily since 2003, but they started to rebound in October 2008.

Our investment analysis shows that even in a pessimistic scenario returns are relatively stable

We developed a model framework for analyzing investments in logistics facilities that used rent levels and vacancy rates to explain income returns, and cap rates to explain capital returns. We then calculated total returns under three different scenarios: basic, pessimistic, and optimistic.

The results demonstrated that total returns are explained almost completely by changes in the cap rate, whereas rents and vacancy rates had a relatively small impact. Even under our pessimistic scenario, total returns were negative in only one half-year period, as stable income returns tended to offset any negative capital returns. However, this analysis assumed the use of equity capital rather than borrowed funds. Particular care should be taken when interpreting these results if a significant percentage of the funds to be invested consist of borrowed money.

Current investors and new investors will have different investment strategies

Optimal investment strategies in the logistics facility sector will differ between current investors and new investors.

The primary concern of those who are already invested in logistics facilities will be to develop an exit strategy. Under the pessimistic scenario, the best strategy is to sell, whereas under the optimistic scenario the best course of action is to stay the course. In the basic scenario, which is considered the most realistic, the key will be to accurately distinguish between those properties that can achieve stable operations through additional investment,

and those properties from which financial support should be withdrawn in order to limit losses.

For new investors the current downturn in the market represents an opportunity to invest at a discount. Under the pessimistic scenario, the new investor will want to bide his time and take an opportunistic approach, whereas under the optimistic scenario time will be of the essence, as the window of opportunity for buying at a discount will close very quickly if the economy stages a rapid recovery. Under our basic scenario we envisage that excellent opportunities for long-term investment will emerge, but timing and property selection will be a challenge.

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Strategies for investment in Tokyo area logistics facilities (2009)

Introduction

Investment strategies at a time of transition in the logistics facility market

The sudden contraction of the world's economy as a result of the global financial crisis has affected the logistics facility market, producing large fluctuations in basic indices such as rent levels, vacancy rates, new supply, net absorption, and cap rates. The market for leased facilities has expanded rapidly since 2005, but all the leading indicators suggest that the market is at a tipping point.

In Part II of this Investment Review we examine the present state of the logistics property market and discuss several possible future scenarios, in the hope that we may be able to assist investors make informed investment decisions during this period of transition.

Toward a more intuitive understanding of the overall logistics property sector

Little reliable data is available with regard to the real estate market in Japan, and no adequate market analysis has ever been performed. This is especially true of the logistics property market, which has a shorter history and is less transparent than the Office and other sectors. This lack of transparency tends to breed both excessive expectations and excessive pessimism among investors, and is an impediment to the stable growth of the market.

To help address this problem, in the present report we combine our own data from Part I (Note 1) with other previously published data, and try to help the reader to gain a more intuitive understanding of the overall logistics property sector.

After reviewing the overall logistics property sector, we discuss possible investment strategies, based on scenario analyses

In Section I we introduce five basic indicators essential for an overall understanding of the logistics sector, covering the leasing market, supply-demand balance, and capital markets, and we present a general overview of the current state of the logistics property sector.

In Section II we develop three possible future scenarios (Basic, Pessimistic, Optimistic) with regard to rents, vacancy rates, and cap rates, and calculate future returns for each scenario.

In Section III we use the findings in Sections I and II as the basis for a discussion of possible investment strategies for the current investor looking for an exit strategy, as well as for the new investor looking for investment opportunities that may present themselves during the current downswing in the market.

Note 1 : See "Large-scale Logistics Facilities in Metropolitan Tokyo: Survey of Market Trends (2009)" (NRE)

1. Five basic indicators of the logistics facility sector

Any study of the logistics facility sector from the standpoint of investment must begin with an analysis of the following five fundamental indicators: (1) rents, (2) vacancy rates, (3) new supply, (4) net absorption, and (5) cap rates (capitalization rates, expected returns) (See Notes 2, 3).

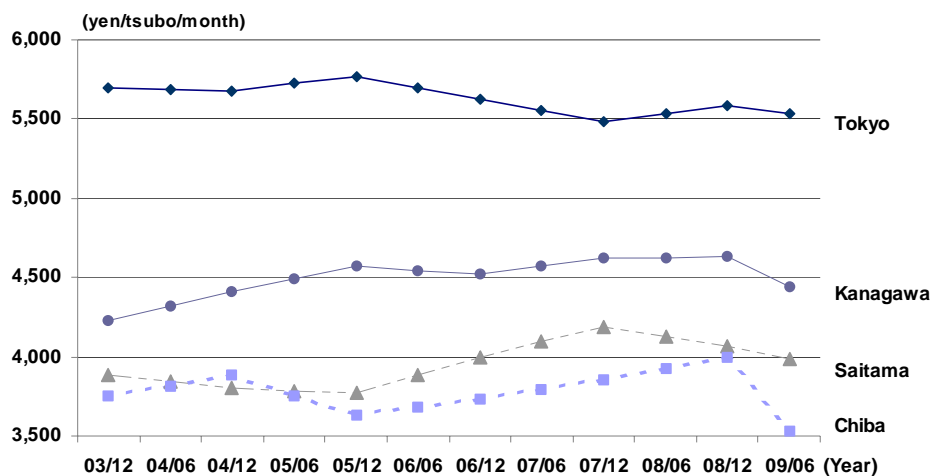
1-1 Leasing market indicators

The leasing market for logistics facilities reached a turning point in 2008

Asking rents in the leasing market for logistics facilities, while showing some regional variability, generally followed a moderate upward trend through December 2008. In June 2009, however, asking rents began to fall sharply, especially in Chiba and Kanagawa (Fig. 1).

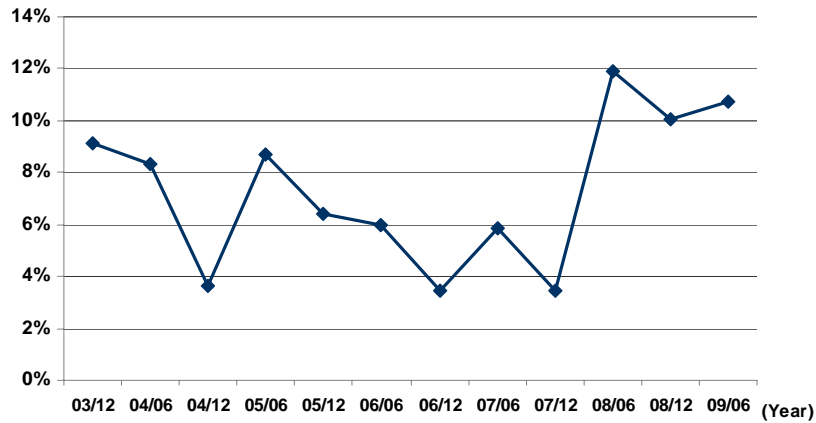
Vacancy rates had begun to change about six months earlier. After declining slowly with a few ups and downs, vacancy rates suddenly shot up from 3.4% in December 2007, to 11.9% in December 2008 (Fig. 2). It is quite clear from this data that asking rents fell in response to an increase in vacancies.

Figure 1 Asking rents for logistics facilities in metropolitan Tokyo



Source : Estimates compiled by NRE using data from CBRE's "Warehouse Market Report"

Figure 2 Vacancy rates at large-scale logistics facilities in metropolitan Tokyo

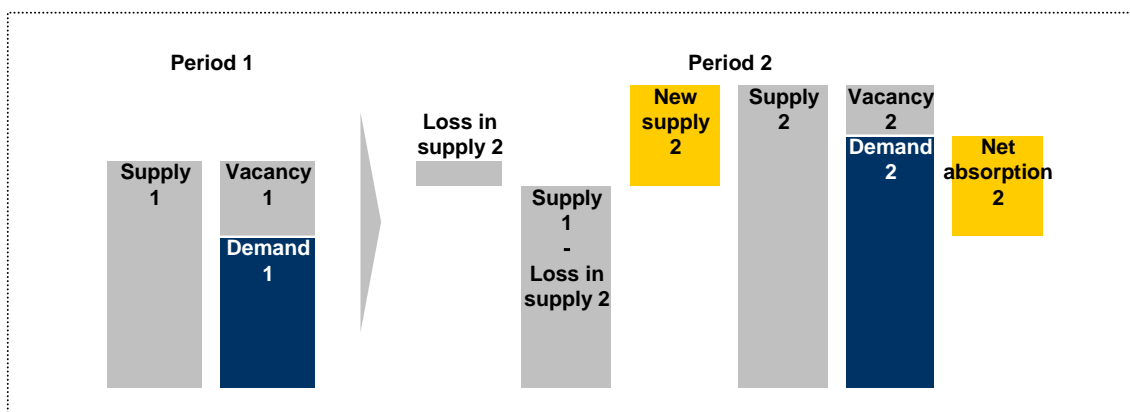


Source : Estimates compiled by NRE using data from CBRE's "Warehouse Market Report"

Note 2 : Real estate values are expressed according to the formula $\text{Value} = \text{Net cash flow} / \text{cap rate}$. Net cash flow, the numerator in this equation, consists of gross rental income less management and other expenses (property taxes, repair costs, etc.), and is almost completely determined by rent and vacancy rates. Cap Rate in the denominator stands for capitalization rate, and reflects the rate of return relative to the current value of the asset. An increase in net cash flow in the numerator reflects an increase in the value of the property, whereas conversely a decline in net cash flow represents a decline in the value of the property. On the other hand, a fall in the cap rate will push up the property value, while a rise in the cap rate will cause the property value to fall.

Note 3 : When analyzing real estate markets, supply (stock) comes in discrete units that can be measured relatively easily, but demand is more difficult to calculate. Moreover, overall demand and supply do not tend to fluctuate greatly, so it is common to discuss these factors in terms of new supply and net absorption, which reflect the marginal changes in supply and demand, respectively (Fig. 3). "Vacancy 1" in the Figure represents vacancies as of the end of the first period, and "Vacancy 2" represents vacancies at the end of the second period. In view of the fact that our present purpose is to paint a more intuitively understandable picture of this market, it should be understood that when we talk about 'supply' we are in fact referring to new supply, and when we mention 'demand' we are referring to net absorption.

Figure 3 Method of calculating new supply and net absorption



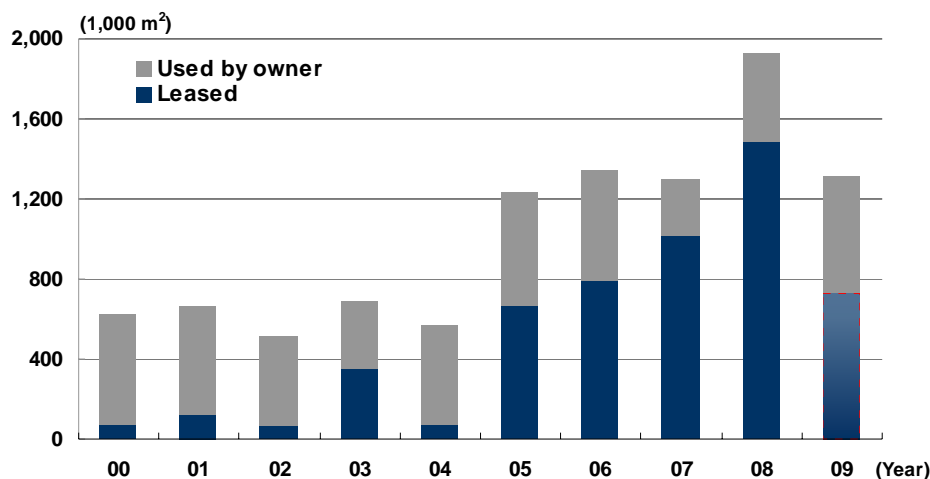
1-2 Indicators of the relation between supply and demand

In 2003 the ownership structure of logistics facilities began to shift from ownership to leasing

In looking at supply, the first things we want to focus on are the leasing and ownership ratios (Fig. 4). Until around 2002 it was pretty much taken for granted that companies would own their own warehouse facilities. However, in 2003 there was a large influx of new supply, and this apparently prompted users to conclude that if appropriate facilities were available for lease on the open market, it would no longer be necessary to expend the time and money required to construct their own warehouses.

New supply of logistics facilities declined in 2004, but the shift toward leased facilities became very obvious in 2005. This provided the impetus for a full-blown revolution in the logistics market, opening the way to introduction of Supply Chain Management (SCM) and Third Party Logistics (3PL) (Note 4).

Figure 4 New supply of large-scale logistics facilities in the Tokyo metropolitan region



Source: Compiled by NRE

Net absorption expanded from 2005~2007, but began contracting in 2008

Net absorption expanded steadily from 2005 through 2007 (Fig. 5). The generation of new supply in the form of leased facilities eliminated the need for cargo owners to come up with the several billions of yen required as the initial cost of constructing their own warehouse facilities, and thus exposed a large amount of latent demand.

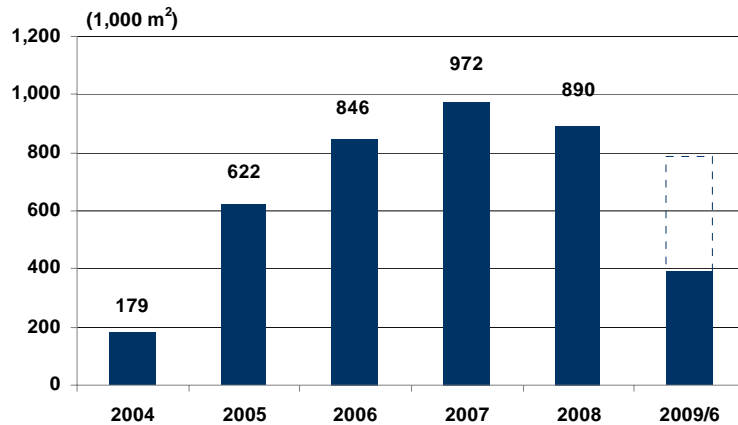
However, in 2008 the economic uncertainty engendered by the sub-prime loan crisis put a damper on net absorption, and this had the effect of boosting vacancy rates.

Note 4: Supply Chain Management (SCM) refers to management of a comprehensive distribution system involving a network of interconnected businesses rather than one limited to a single company. Designed

to improve business performance, SCM was first introduced to Japan in the 1990s and has since developed hand in hand with the evolution of information technology.

Third Party Logistics (3PL) refers to the outsourcing of all or part of a shipper's (cargo owner's) logistics operations to a third party. The idea is to take advantage of specialization to achieve significant improvements in operational efficiency.

Figure 5 Net absorption of large-scale logistics facilities in the Tokyo metropolitan area



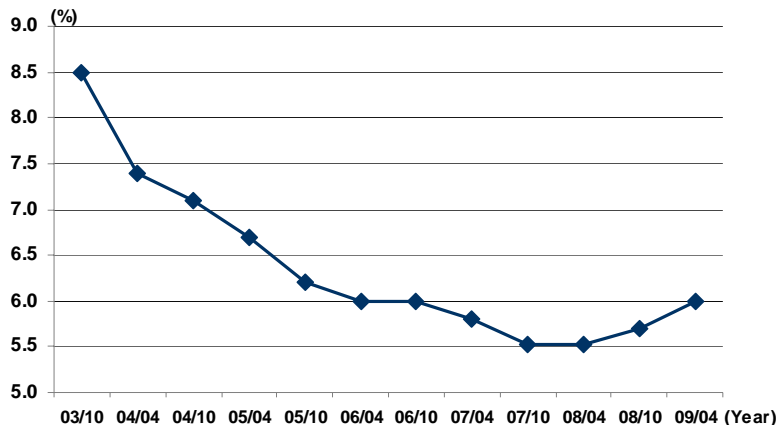
Source: NRE estimates

1-3 Capital market indicators

Cap rates began rising since in second half of 2008

Capitalization rates (the ratio between net operating income and capital cost or current market value) had been falling steadily since the birth of the investment market for leased logistics facilities in Japan in 2003, but they began to turn upward in the last half of 2008 (Fig. 6). Any recovery in the real estate market will depend largely on the movement of cap rates, which reflect trends in the leasing market as well as the supply-demand balance, so changes in cap rates must be monitored carefully as a general index of the capital markets.

Figure 6 Cap rates of large-scale logistics facilities in the Tokyo metropolitan area



Source: Compiled by NRE based on data from the Japan Real Estate Institute

(Column) Three factors to keep in mind when reviewing analyses of the logistics property sector

The leasing market for logistics facilities developed rapidly after 2000 as a result of the trend toward securitization and liquidation in the real estate market. In view of the short history of the logistics facility market, there are three particular factors that need to be kept in mind when looking at a market analysis of this sector.

- (1) The distinction between leased and owned facilities
- (2) The distinction between single-tenant and multi-tenant facilities
- (3) The size criteria used to distinguish between investment grade and non-investment grade facilities

Check to see whether the data also includes owned facilities

The distinction between leased and owned facilities is important when analyzing the relationship between supply and demand. Prior to the emergence of the current trend toward securitization and liquidation of real estate assets in 2002, nearly all companies owned their own warehouse and distribution facilities. In other words, demand for logistics facilities was met by companies constructing and maintaining their own facilities. Beginning in 2003, however, the supply of leased facilities began to increase significantly. The number of companies electing to shift warehouse assets off of their balance sheets through sale and lease back arrangements also began increasing at this time.

In order to make appropriate investment decisions it is necessary to be aware of changes in the relative percentages of leased and owned facilities, and of how these changes may affect the market. When looking at logistics property data, therefore, it is important to be aware of whether it covers only leased facilities, or whether it includes both leased and owned facilities.

Investment decision-making requires data that includes both single and multi tenant properties

The distinction between single tenant and multi tenant facilities affects the analysis of vacancy rates (Note 5). From the point of view of tenant brokerage, single tenant facilities are by definition fully leased, and therefore must be excluded from calculations of vacancy rates.

On the other hand, from the investor's point of view, single tenant facilities may also be targets for investment, so it is desirable that the vacancy rates used in calculations of total return should include data on single tenant facilities.

Vacancy rates and other indices will vary depending on the sizes of the facilities covered by the data

Calculations of market size and vacancy rates will differ depending on the criteria used to determine how large a facility must be to be considered investment grade. Based on our own survey comparing the sizes of new facilities coming onto the market (new supply), and the

actual investment decisions of real estate investment funds, we determined for the purposes of this study that facilities with at least 3,000 tsubo of floor space should be included in our investment analysis, recognizing of course that location, building specifications, and rent levels will also be important factors.

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Note 5 : In the case of “Single tenant facilities”, also referred to as “Built to Suit”(BTS) facilities, the leasing contract is concluded prior to construction of the facility, which is then designed and built to order precisely according to the tenant’s needs. In contrast, multi-tenant facilities are built before tenants have been recruited, and are designed to serve multiple tenants in the same facility. In most cases tenant recruitment takes place during construction or after the building has been completed. Vacancies are not unusual at multi-tenant properties, so it is relatively easy to discuss vacancy rates in these facilities.

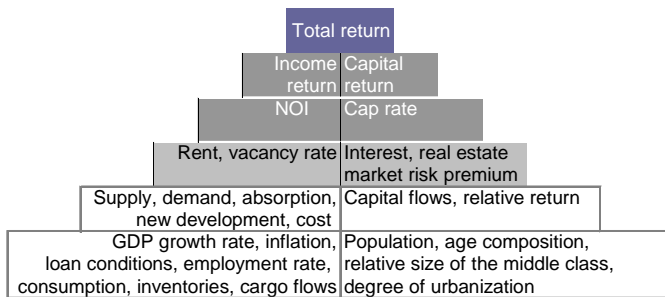
2. Analysis of logistics facility investment scenarios

2-1 Overall view of the scenario analysis

Estimation of past and future returns using a simple analytical model

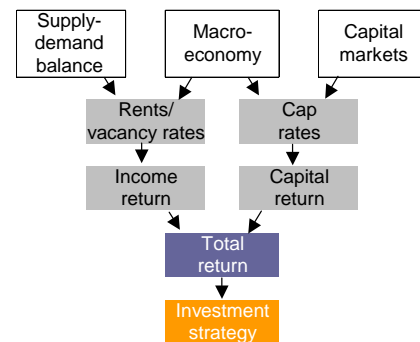
One type of framework that can be used to analyze real estate investments is shown in Figure 7. Total returns are shown at the top of the pyramid, and the various contributing factors beneath it can then be analyzed sequentially. This format, however, is very complex and not suitable for the present analysis. Therefore we developed a simplified model as shown in the gray portion of Fig. 8 (Note 6). After running simulations of various future scenarios using this model, we calculated the results and discussed potential investment strategies.

Figure 7 Framework for analyzing real estate investments



Source: Compiled by NRE from data published by Partners.

Figure 8 Analytical model



Source: NRE

Subjects of the study were 138 facilities in metropolitan Tokyo

The present analysis utilizes basic data from the following three sources: rent and vacancy data from the “Warehouse Market Report” published by CB Richard Ellis (CBRE); data on expected cap rates from “The Japanese Real Estate Investor Survey” published by the Japan Real Estate Institute; and data from our own surveys.

Our object was to analyze the total return from a portfolio consisting of all investment grade logistics facilities available on the market since 2003. The subject universe consisted of 138 logistics facilities located in the greater Tokyo area (Tokyo, Kanagawa, Saitama, Chiba; Note 7).

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 Note 6 : To build a detailed model would involve first setting up variables to represent the supply-demand balance, macroeconomic conditions, and capital markets, then deriving rents, vacancy rates and cap rates, and finally performing a sequential calculation of total returns. To simplify this process we have started with rents, vacancy rates, and cap rates.

Note 7 : The CBRE report provides data on 45 warehouse/ distribution facilities with a floor space of 10,000 tsubo or greater. Our own study covered 126 facilities constructed since 2000 with a floor space of at least 3,000 tsubo, and included both single tenant and multi-tenant properties. We combined the data from these two reports, eliminated overlapping results, and ended up with an available subject population (universe) consisting of 138 facilities.

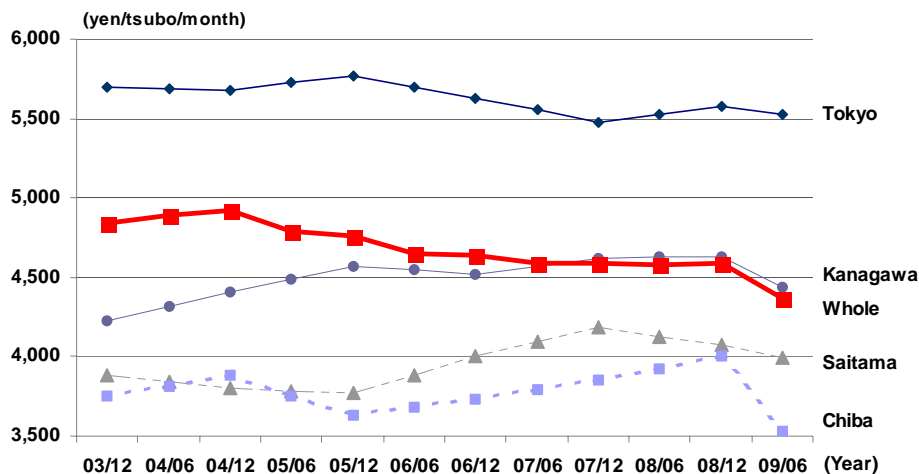
2-2 Rents and Vacancy rates

Asking rents fell after the Lehman shock

According to the CBRE report, asking rents for logistics facilities in the greater Tokyo area were generally stable from 2003~2008. However, the market changed drastically after the Lehman shock in September 2008. In the six-month period from January through June 2009, asking rents fell significantly, especially in Chiba and Kanagawa. As a result, overall asking rents are plummeting (Fig. 9).

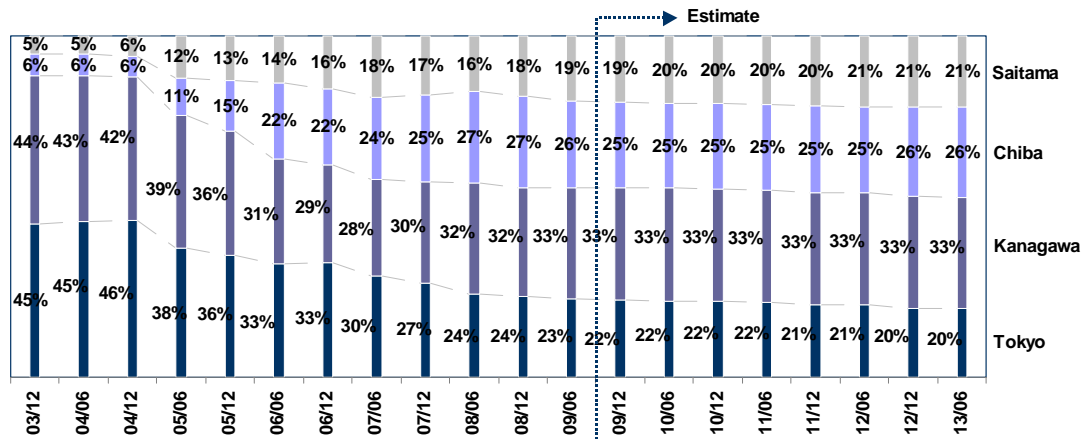
Looking at rents by area, one notices from this Figure that in some cases asking rents were in fact rising during some periods prior to 2008. In spite of this, overall asking rents show a gradual downward trend. This is primarily due to changes in the relative amounts of available floor space in each area. Fig. 10 shows that Tokyo and Kanagawa, where rent levels are relatively high, have generated very little new supply, whereas many new logistics facilities have been developed in Saitama and Chiba, where rents are relatively low. This has pulled down the overall weighted average for asking rents (Note 8).

Figure 9 Asking rents for logistics facilities in metropolitan Tokyo, by district



Source: NRE estimates, based on data from CBRE's "Warehouse Market Report"

Figure 10 Ratio of logistics floor space by area (metropolitan Tokyo)



Source: NRE estimates, based on data from CBRE's 'Warehouse Market Report'

Under the Basic scenario, vacancy rates improve, but rents gradually fall

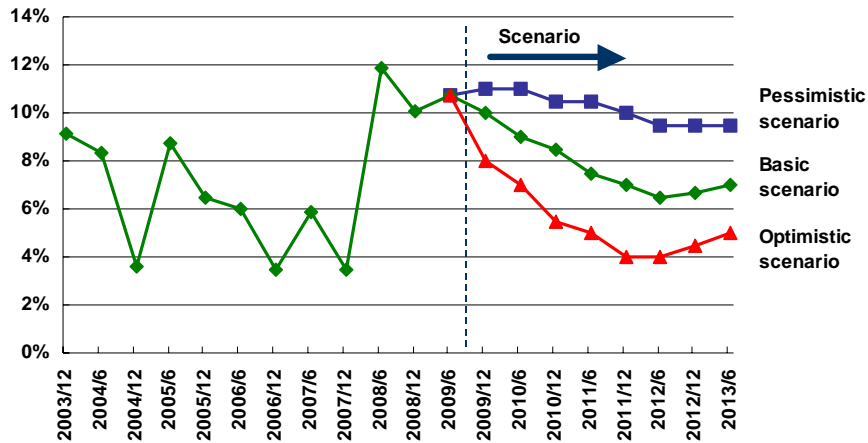
Logistics facility vacancy rates in metropolitan Tokyo have fluctuated somewhat since 2003 in response to changes in the amount of new supply, but the general trend has been downward due to a strong underlying demand for leased facilities. However, in June 2008 the vacancy rate shot up to 11.9%, and our most recent data show that as of June 2009 the rate was still quite high at 10.7% (Fig. 11; Note 9). Under these conditions, there have been no new warehouse starts since the start of 2009 except for single-tenant facilities where the tenant had already been recruited in advance. As a result, as described in Part I of this Review, new supply has contracted significantly. For this reason we expect that vacancy rates will gradually start to come down.

Our Basic scenario assumes the following (Fig. 12).

- Vacancy rates will fall to 6.5% by 2012, and will then turn back upward due to a recovery in construction of new supply
- As the absolute vacancy rate remains high, rents will gradually fall. Rents will begin to rebound once the vacancy rate falls below 7%.

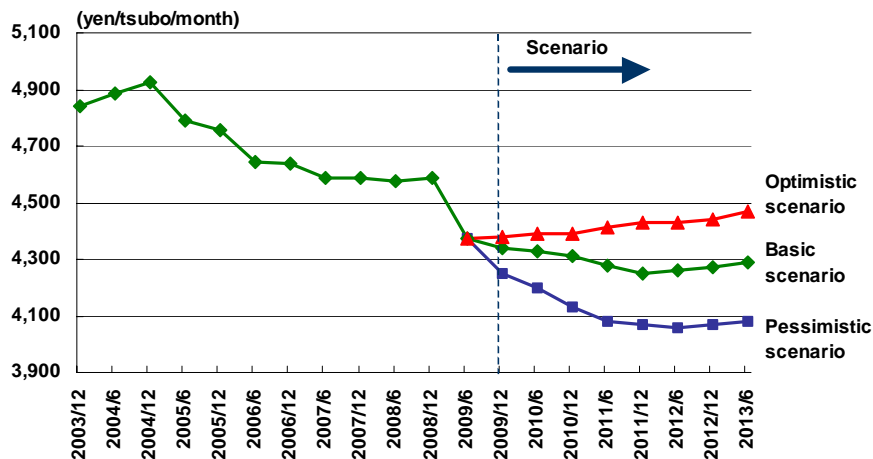
The Pessimistic and Optimistic scenarios use rents and vacancy rates representing what we currently consider to be the worst conceivable case and the best conceivable case, respectively.

Figure 11 Vacancy rate scenarios for logistics facilities



Source: NRE estimates, based on data from CBRE's "Warehouse Market Report"

Figure 12 Rent scenarios for logistics facilities



Source: NRE estimates, based on data from CBRE's "Warehouse Market Report"

Note 8: In these total return calculations we have used actual rents as the asking rents. It is true that the difference between contracted rents and asking rents may vary somewhat depending on the supply-demand balance, but as our purpose was to obtain a grasp of overall trends to aid our discussion of investment strategies, we judged that the difference would not significantly affect our conclusions.

Note 9: The vacancy rates used here are based on a universe of 138 warehouses, including single tenant facilities. These rates are slightly lower than those in CBRE's report covering 45 multi-tenant facilities. We believe that it is necessary to include single tenant facilities when conducting an investment analysis of a market portfolio (see discussion in the "Column" section on page 9).

2-3 Cap rates

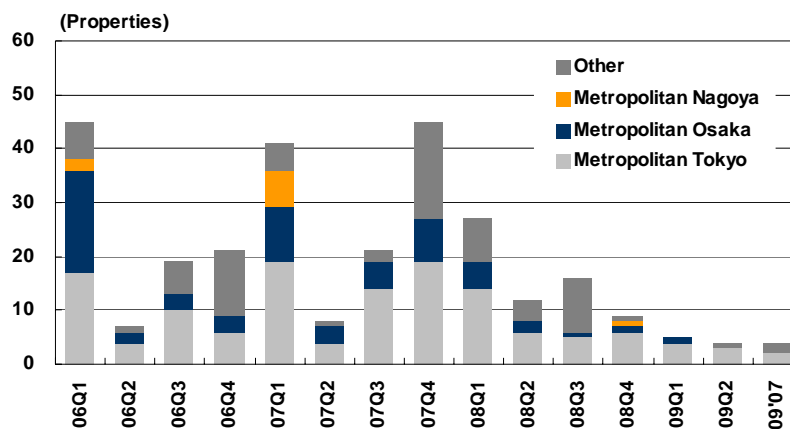
Sales of logistics facilities have ground to a halt; cap rates are also on the rise

Data from our own study indicate that after reaching a peak in the fourth quarter of 2007 (October~December), sales transactions of logistics facilities have dropped sharply (Fig. 13; Note 10). Cap rates had been steadily declining since 2003, but they rebounded after property sales had come to a standstill, and have been on the rise since October 2008 (Fig. 14; Notes 11, 12, 13).

Under the Basic scenario cap rates will continue rising till the middle of 2010

Keeping in mind the fact that equity investors and lenders remain on the sidelines, we believe it will be some time before capital starts flowing back into the logistics facility sector. In our Basic scenario, cap rates will rise from their current 6.0% until they reach about 6.4% sometime in the middle of 2010, after which they will gradually start falling. As was the case with vacancy rates and rents, our Pessimistic and Optimistic models use cap rates representing what we currently consider to be the worst conceivable case and the best conceivable case, respectively.

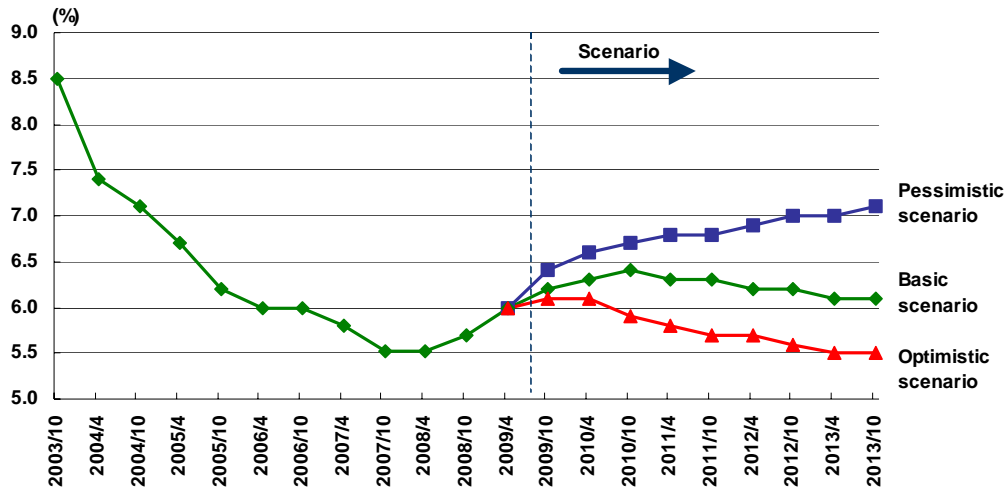
Figure 13 Sales transactions of logistics facilities (by area)



Source: NRE

* 06Q1 in the Figure stands for "First quarter of 2006 (January~March)"

Figure 14 Cap rates in logistics facilities



Source: Compiled by NRE based on data published by the Japan Real Estate Institute

Note 10 : Sales transactions of logistics facilities have a seasonal component, tending to rise in the last quarter of the fiscal year (January–March). This is because most companies looking to sell their warehouses as part of restructuring efforts tend to do so toward the end of the fiscal year, in conjunction with end of term account settlement adjustments.

Note 11 : The Japan Real Estate Institute (JREI) calculated expected cap rates based on investor surveys, and we believe that actual cap rates are probably lower than the figures in their report. On the other hand, the weighted average cap rate for a portfolio containing all the properties in metropolitan Tokyo is believed to be higher than the cap rates in the most popular areas. JREI investor survey calculated expected cap rates from multiple areas, in our present total return calculations we used the lowest of these cap rates (Tokyo, Koto ward) as the benchmark cap rate, instead of the weighted average.

Note 12 : The Japan Real Estate Institute investor surveys of expected cap rates for logistics facilities and warehouse began in April 2005, so figures for the previous three periods are estimates based on NRE research.

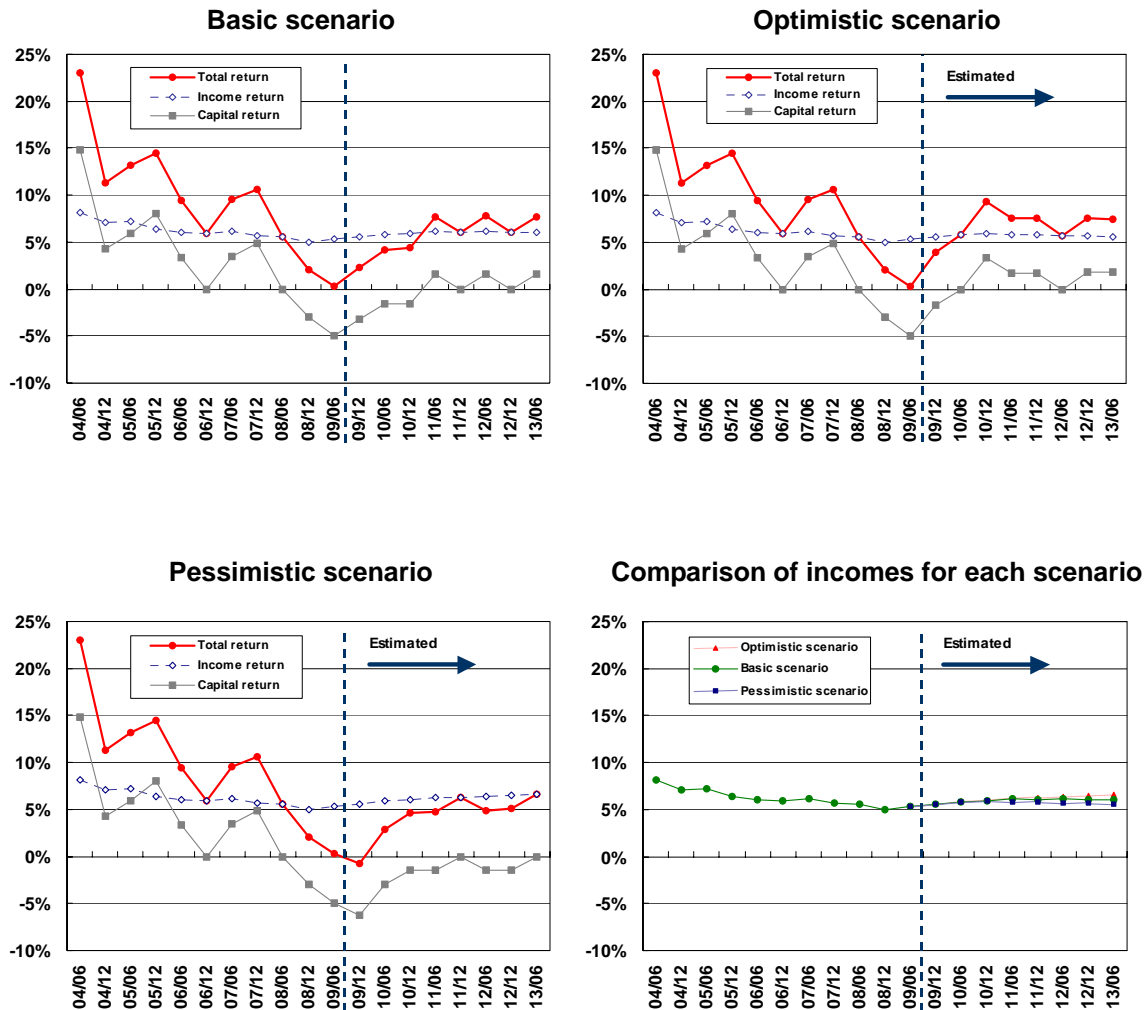
Note 13 : Figure 14 uses expected cap rates from The Japan Real Estate Institute investor surveys, which are conducted in April and October. Our simulations of total returns, however, were calculated as of June and December. For the purposes of these calculations we assume that the cap rates remained unchanged during this interval.

2-4 Total returns

Total return on real estate investments depends almost completely on capital return

Total returns under our three scenarios are shown in Fig. 15.

Figure 15 Scenario analysis of total returns



Source: NRE estimates

Let us first look at our estimates of actual returns for 2004~June 2009. Income returns are falling during this period because lower cap rates have led to lower yields at time of acquisition, lower rents, and higher vacancies. However, the amount of decline is very moderate. The effect on income returns of an increase to around 10% in the vacancy rate is negligible.

Turning next to capital returns, cap rates began gradually declining in 2003, and this generated a steady positive flow of capital returns. The major reason for this was the increase in liquidity that came about as a result of the transition from a stage when investment in logistics facilities was uncommon, to the expansion in investment in logistics facilities that occurred after the listing of the Japan Logistics Fund in 2005, and the subsequent entry of new

domestic players into the market.

In Fig. 15 we see that the line representing total returns, which are the sum of income returns and capital returns, looks just like the line showing capital returns, only shifted upward. Returns on all types of real estate investments, not only logistics properties, are said to be primarily dependent on capital returns, and these results confirm that view. From 2004~2007 total returns of more than 10% were recorded for nearly every reporting period, demonstrating that the market was in an upward phase of the real estate investment cycle.

Under our Basic scenario total returns will stage a gradual recovery

Our simulations for 2009 and beyond under our Basic scenario indicate that capital returns will be negative until 2010 and will return to positive territory in 2011. Because the decline in cap rates will be moderate, however, total returns will remain positive, and investors will post stable returns.

However, these calculations assume non-leveraged full equity investments without the use of ordinary loans. If money is borrowed and the investment is leveraged, it should be noted that the potential upward and downward fluctuations are significantly amplified (Note 14).

Under the Pessimistic scenario capital returns remain negative

Our worst-case scenario assumes that current fears about the global and domestic Japanese economies are realized. In this case the recovery in cap rates will be significantly delayed, but nevertheless our model indicates a relatively gentle decline with no 'fire sales'.

The calculations from our simulations show total returns that, while low, remain positive. These levels should not be a problem for the full equity investor, but declines in appraised land values could well put the leveraged investor at risk of falling out of compliance with loan covenants. This could result in the termination of dividend payments or other problems.

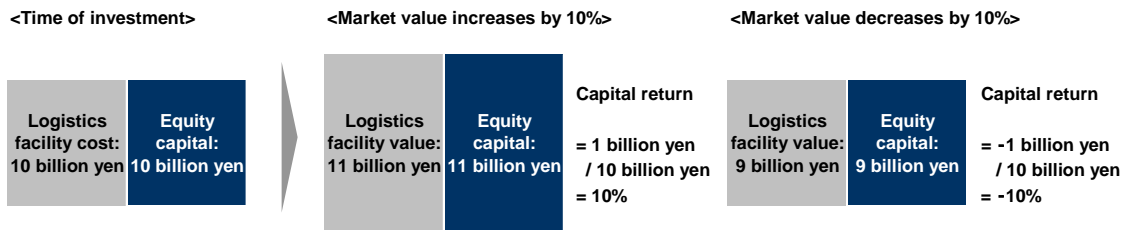
Under the Optimistic scenario there will be opportunities to achieve capital gains

Our best-case scenario assumes a vigorous recovery in both Japan's and the global economy, and a gradual recovery in cap rates to their previous levels. During this process there will be opportunities to earn capital gains, but movements in global money markets will be so rapid that the window of opportunity for such gains will tend to close very rapidly.

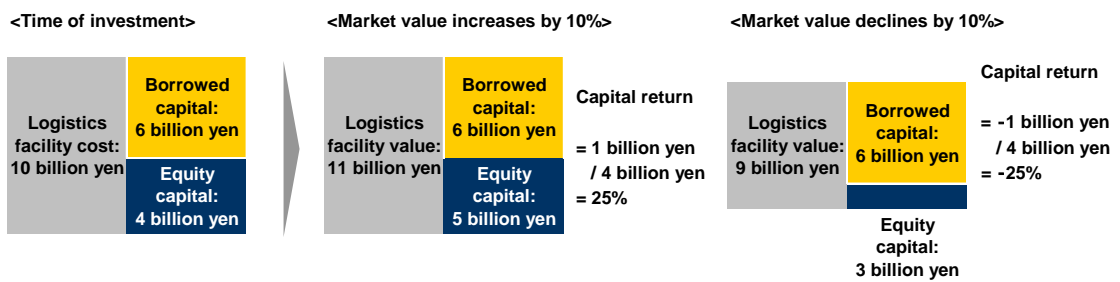
Note 14 : Suppose an investment of 10 billion yen consists of 40% equity capital and 60% loans. If the assessed value of the property should rise by 10%, the value of the investment would increase by 1 billion yen, which represents a 25% return relative to the initial equity capital input of 4 billion yen. However, should the assessed value of the property decline by 10%, the amount of loss would be similarly amplified (Fig. 16).

Figure 16 Analysis of the effect of leveraging

Investment made with 100% equity capital



Investment made with 40% equity capital and 60% borrowed capital



3. Investment strategies for the logistics property sector

3-1 Investment strategies for current investors

The analysis of total returns in this report assumes a full equity, non-leveraged investment with no borrowed capital. Practically speaking, however, full equity investments are the exception, and most investments are leveraged to some extent. In case of a leveraged investment it is essential to keep the amount of leverage (0%–80%) in mind at all times when contemplating an investment strategy. Recent trends indicate that the degree of leverage appears to be falling from its former level of around 70% to something closer to 50%. It is against this backdrop that we now turn our attention to optimal investment strategies.

Under the Basic scenario, careful evaluation of existing facilities is essential

Under the Basic scenario, vacancy rates are expected to fall steadily, but rents and cap rates will remain relatively unchanged. For the market as a whole, total returns will be stable, but properties that are at a disadvantage in terms of location or design may continue to experience difficulty in attracting tenants.

Most logistics facilities have long-term lease contracts of around ten years. Therefore, unless the assessed property value declines to the point that loan covenants require an additional capital infusion, once the facility is operating at full capacity it is possible to maintain stable returns. Currently, the majority of logistics facilities have reached this stage, but some facilities still have multiple vacancies.

Therefore, under our Basic scenario, the strategic challenge for a current investor will be to determine which properties or investment funds are capable of reaching stable operations through infusions of new capital, and which properties should be cut off from further financial support even if a loss is incurred.

Under the Pessimistic scenario the best strategy is to sell out as soon as possible

Under our worst case scenario vacancy rates recover slowly, and will remain at around 10% for some time. Rents will also fall, so leasing income will tend to decline. Cap rates will rise, so asset values will continue to fall. If the investments are leveraged, the leveraging effect will generate large losses, so the best strategy is to sell as quickly as possible.

This worst-case scenario assumes that current signs of economic recovery are temporary, and that the market will soon head for a new low. This should be accompanied by a temporary recovery in the capital market, and that will be the time to sell in order to keep losses to a minimum.

Optimistic scenario calls for aggressive re-financing and new infusions of capital

The best strategy under our optimistic scenario is to “hold”. This scenario assumes that rents, vacancy rates, and cap rates will all begin to improve rapidly in 2010. Under this scenario, the

best way to avoid losses and return to stable operations would be to aggressively refinance troubled assets through infusions of new capital whenever necessary.

3-2 Investment strategies for new investors

Under the Basic scenario, selection of optimal investment properties is the key

For new investors in this market, current conditions represent an excellent opportunity to acquire assets that can generate stable long-term returns, but investment timing will be a challenge. Under our Basic scenario, land prices will continue to fall for about another year, so the best strategy will be to watch for opportunities to purchase superior facilities with stable operations at a discounted price. In this scenario the market will not recover rapidly, nor it will worsen significantly. The ability to evaluate factors such as location, tenants, lease contracts, etc will be the key to success.

Under the Pessimistic scenario, look for opportunistic investments

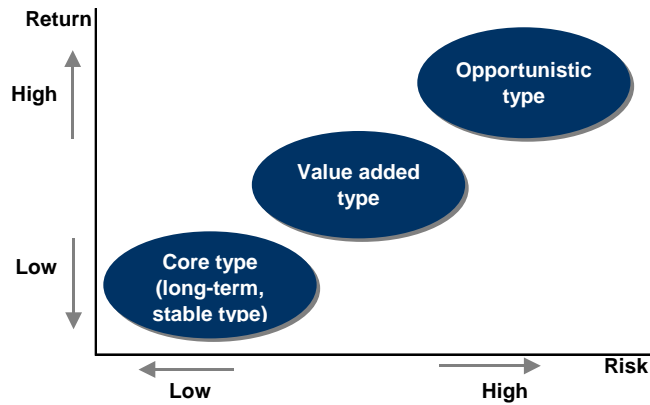
The worst-case scenario calls for adoption of an opportunistic investment strategy (Note 15). Property values in this model are assumed to decline for several years, so investment funds will be unable to repay the loans on some facilities. Ownership of these properties will revert to the lenders, and will be sold off as part of the process of disposal of bad debts. Most of these will probably be second-class properties, but they may well be available at a steep discount, so a high return can be expected within a few years.

An opportunity similar to this arose once before in the late 90s, but at that time Japanese investors failed to take full advantage of it. This time investment firm infrastructure and know how have become more widely disseminated, so should this scenario be realized, Japanese investors may be able to benefit from it this time around.

In the Optimistic scenario the key will be to invest quickly

The best case scenario assumes that rents and vacancy rates will show signs of rapid improvement, that this will stimulate the capital markets to renewed activity, and that global money will start flowing back into the market. Under these conditions the opportunity to invest at current discounted prices will be very short, and within the blink of an eye the market's former equilibrium will be restored. Therefore, the optimal strategy under this scenario will be to make preparations to invest quickly in superior properties. Even if prices may seem a bit high for the current market, they are still at a discount compared with previous levels. This opportunity will not last for long, however.

Figure 17 Risk-return characteristics in real estate investment



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Note 15 : Real estate investments can be divided into three categories according to their risk/reward characteristics:

Core type (long-term, stable type), Value added, and Opportunistic (Fig. 17).

As its name implies, the Core strategy involves investing in superior properties over a long-term. Value added investments involve the purchase of properties with vacancies or older properties and creating added value through renovation or more aggressive tenant recruitment in order to raise the capacity utilization rate. Opportunistic investment involves the purchase of properties during economic downturns that become available as a result of corporate restructuring, or bulk purchases of foreclosed properties at discounted prices. Such properties can then be sold off individually, or sold later after the economy has recovered. This latter strategy has a very high degree of difficulty.

Conclusion

The market looks different from the investor's point of view

When we look at the logistics facility sector from the investor's point of view, we discover that factors related to the leasing market, such as rising vacancy rates and falling rents, have less impact on total returns than factors related to the capital markets, such as the loss of liquidity in sales transactions and the rise in cap rates.

Since investors are chiefly concerned with total returns, we should expect to see a different picture emerge when we perform a factor analysis of income returns and capital returns.

Once we grasp the big picture, the gaps in our current research become clear

Once we gain an overall understanding of the market, we begin to see the gaps in the state of our current research. One example is the global money flows that make up the capital markets. Specifically, this refers to activities of equity investors such as institutional investors and pension funds, financial institutions that provide non-recourse loans, and debt investors that invest in commercial mortgage backed securities (CMBS).

Another important theme is the behaviour of players (management companies) in the logistics facility sector. Global companies play an important role in this sector, even in Japan, so it will be necessary to discuss the activities of these companies with reference to trends in the global logistics facility sector.

In addition, quantitative analyses based on macroeconomic conditions and capital market data should become an important theme of future research. As a result of the integration of real estate and finance, players in the real estate sector have acquired, through non-recourse loan contracts and other means, a pro forma understanding of financial mechanisms. However, there are still very few trained economists in the real estate sector, and we can't yet say that the human resources in this sector have an adequate understanding of the financial markets.

The logistics facility sector represents the foundation of Japan's industrial structure, and Japan must continue to promote the current logistics revolution if it is to increase its competitiveness. To achieve this, a stable flow of investment capital into this sector is desirable, but for that to happen it will first be necessary for the industry as a whole to earn the trust of investors by making available a wide variety of analytical reports that present a multi-dimensional view of the logistics facility sector from a number of different viewpoints.

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