Japan Real Estate Investment

REVIEW

Summer 2003

NOMURA REAL ESTATE INVESTMENT MANAGEMENT

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Ⅰ. NREIM's Capitalization and Liquidity Monitor

Background

In August 2003, the Land Institute of Japan (LIJ) published an index measuring real estate investment related attitude based on the survey of the main domestic real estate investors (Life and insurance companies, large real estate corporations, and investment advisory companies). The value of the index is determined by calculating the ratio between the number of investors who answered they were actively looking forwards to purchasing real estate and the number of investors who answered they were sluggish towards purchasing real estate. The index revealed that the positive attitude toward real estate investment as of July 1st 2003 was 72.7, a dramatic increase over the previous survey results of 36.3 of half a year ago.

Moreover, as we previously highlighted in Topics (Investing Japan, an American Perspective, January 22, 2003) more foreign investors (American investors in particular) are considering Japan as an object of long-term investment.

This creates for domestic and foreign investors the need to define their allocation to the Japanese real estate. Determining an allocation to real estate is a complex process that requires the knowledge of a multitude of market-related parameters. Among them, two critical parameters are the value (capitalization) and the liquidity of the real estate market.

Objective

As currently no information exists on the capitalization and on the liquidity of the Japanese real estate market, the first objective of this report is to provide investors with reliable estimates. The second objective of this report is to compare (tentatively) those estimates to the Japanese traditional investments and to the American real estate market.

This report is not intended to provide investors with recommendations regarding their allocation to Japan but should be considered as a first step in this enterprise.

Organization

(1) In the first part, we present our results related to the capitalization of the Japanese real estate. (2) In the second part, we present our estimate of the liquidity of the Japanese real estate market. (3) The third part is dedicated to the comparison between Japanese and American real estate markets. (4) In the fourth part, we compare those results with the capitalization and liquidity of Japanese traditional investments.

1. Estimating the Capitalization of the Japanese Real Estate Market

This estimate aims at determining the capitalization of the five main commercial real estate sectors: office, residential, retail, warehouse and hotel (government owned properties excluded). The term "commercial" means that we consider exclusively properties that host a commercial activity, thus we exclude detached houses from this estimate. Our results are presented on the chart below.

Figure 1: Capitalization of the Japanese real estate market as of year-end 2001

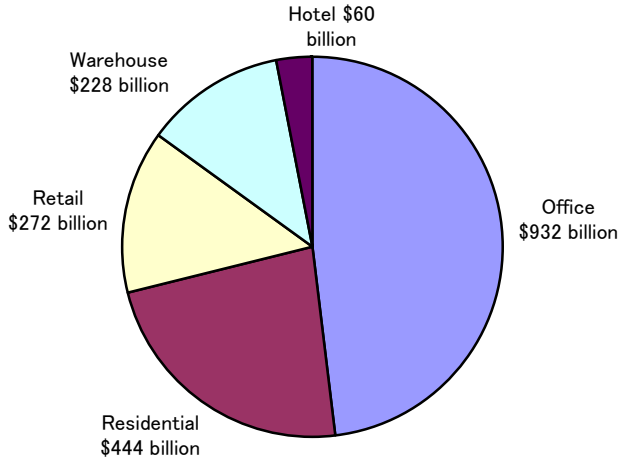


Table 1: Capitalization of the Japanese real estate market as of year-end 2001

Sector	Capitalization ($ Billion) @ 1 $ = 115 yen	Weight
Office	932	48%
Residential	444	23%
Retail	272	14%
Warehouse	228	12%
Hotel	60	3%
Total	1,936	100%

Source: NREIM estimate, based on the data provided by Ikoma, Miki, the Ministry of Public Management, Home Affairs, Post and Telecommunication, Ministry of Land, and Infrastructure and Transports

As of year-end 2001, the total Japanese real estate market capitalization is estimated at approximately 2 trillion dollars, of which nearly 50% is represented by the office sector. This makes the office sector by far the largest market in Japan.

Our estimate uses a *capitalization approach*. The *capitalization approach* consists of computing the present value of the *net cash flows* generated by each sector. These cash flows are considered as perpetuities, i.e. they are considered as infinitely long and constant. In order to illustrate this method, we briefly introduce the example of the office market. The estimate of the office market is comprised of the capitalization of the *rental market* and of the *owner-occupied* market.

1-1 Estimating the Capitalization of the Office Rental Market

We have estimated the capitalization of the rental office market area by area before aggregating them at the national level. For a given area the formula we used is below:

$$Market\,Cap = \frac{Net\,Rentable\,Area \times Monthly\,Rent \times (1 - Vacancy\,Rate) \times 12 \times (1 - OER)}{Cap\,Rate}$$

OER refers to the Operating Expense Ratio. It is defined as the proportion of the operating expenses to gross income.

The current net rentable areas, rents and vacancy rates are provided by Ikoma Data System, who boasts a coverage of more than 90% of the rental market countrywide. The estimates of the cap rates and the OER are based on the analysis of our proprietary data.

1-2 Estimating the Capitalization of the Office Owner-Occupied Market

We calculated the size (net rentable area) of the owner-occupied market by subtracting the stock of rental office from the total office stock.

In Japan, there is no official figure on the total stock of office buildings currently constructed, thus our first task was to estimate it. Our estimate is mainly based on two sets of data. Firstly, the MPMHAPT (Ministry of Public Management, Home Affairs, Post and Telecommunication) publishes[1], for each year and each town, the *aggregated amount of office, bank and retail space (a).* Secondly, the MLIT (Ministry of Land, Infrastructure and Transports) publishes[2] since 1977 the *amount of space started for office and retail separately (b).* Based on (b) we could estimate the *percentage*[3] *of office space (c)* in the aggregate *office + retail started space*. Thus, by multiplying (a) and (c) we could estimate the current stock of office space for each town in Japan.

Our estimate of the value for the owner-occupied market uses the same formula as that described above for the tenant market.

1: Report on the Overview of the fixed assets prices, FY 2001
2: Annual Report of Building Statistics, FY 2001
3: We assumed this percentage to be close to the current percentage of office space in the aggregated retail and office stock

2. Estimating the Liquidity of the Japanese Real Estate Market

Based on our estimate of the real estate market capitalization and our knowledge of transactions, we have estimated the *liquidity* of the Japanese real estate market for each one of the five real estate sectors. The liquidity of a market refers to the ability to sell or buy an asset with minimum price disturbance on this market. We define quantitatively the liquidity of the Japanese real estate market in year 2002 as the ratio of the value of transactions that occurred during calendar year 2002 divided by the capitalization of the real estate market as of year-end 2001. Our results are presented in the table below.

Table 2: Liquidity ratio as of 2002 for Japanese Real Estate

Sector	Capitalization ($ Billion)	Transactions ($ Billion)	Liquidity ratio
Office	932	19	2.0%
Apartments	444	7	1.5%
Retail	272	7	2.4%
Warehouse	228	1	0.4%
Hotel	60	1	1.7%
Total	1,936	35	1.8%

Source: NREIM estimate based on transactions related data provided by the Nikkei

Office and retail show levels of liquidity (respectively 2.0% and 2.4%) higher than the market average (1.8%).

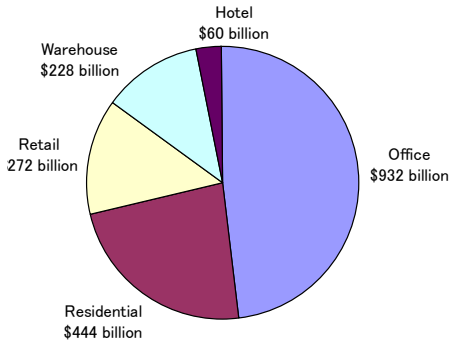
3. Japanese Real Estate Market vs. the U.S. Real Estate Market

3-1. One third of the U.S. market cap

The results obtained for the Japanese commercial real estate market are compared in the following chart with the American commercial real estate. For the American real estate capitalization, we have selected the estimate provided by Prudential Real Estate Investors (PREI).

Figure 2: Capitalization, Japan vs. the USA

Japan Real Estate Market Cap: $1,936 billion



American Real Estate Market Cap: $6,274 billion

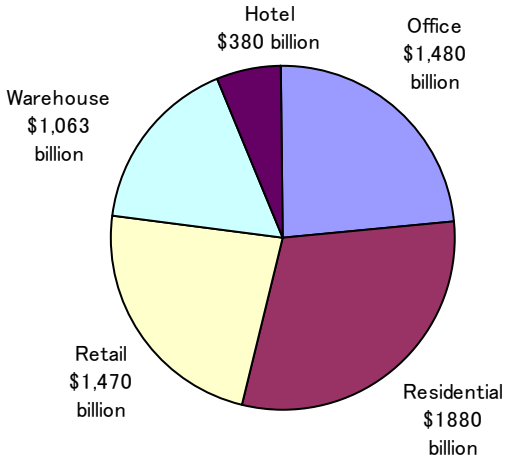


Table 3: Capitalizations of Japanese real estate and American real estate

Sector	Japan ($ Billion)	Weight	America ($ Billion)	Weight
Office	932	48%	1,480	24%
Residential	444	23%	1,880	30%
Retail	272	14%	1,470	23%
Warehouse	228	12%	1,063	17%
Hotel	60	3%	380	6%
Total	1,936	100%	6,274	100%

Source: NREIM, Prudential Real Estate Investors

The total capitalization of the Japanese real estate market is approximately $2 trillion, which presents one third of its American counterpart. Although in Japan the capitalization of the office market represents nearly 50% of the total, for the U.S. the distribution of value is relatively equilibrated among the four main sectors (office, residential, retail and warehouse). What could explain this difference?

One explanation is that Japanese retail is not as centralized into large shopping centres as in the U.S. Thus in Japan the proportion of small shops is relatively higher than in the U.S. Consequently, as our estimate of the Japanese retail sector capitalization excludes small shops, the weight of the retail sector is lower than in the U.S., pushing up the weight of the office sector.

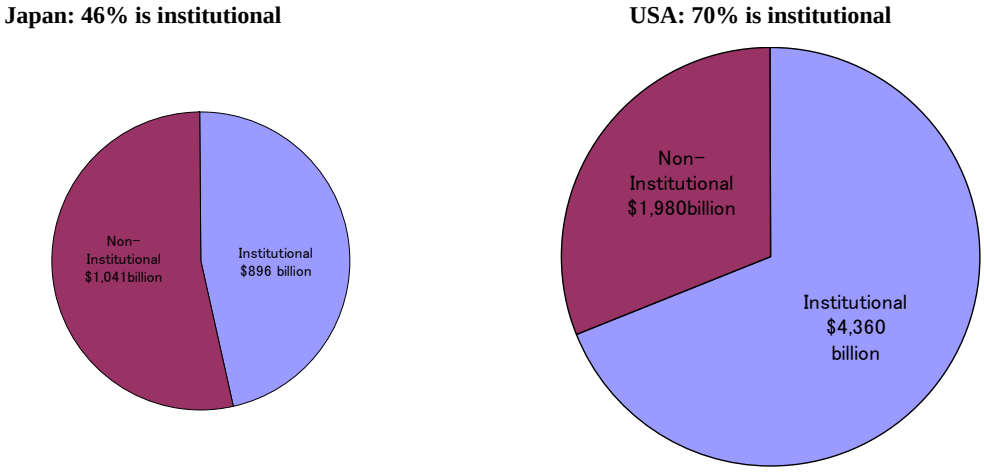
3-2. Institutional vs. Non-Institutional

Some foreign institutional investors may consider the overall capitalization of the office market. Others may consider using the size of the segment comprised of (1) the properties that are likely to be available for investment and (2) that correspond to their preferences (in terms of size for example). In order to answer these investors' needs, we have aggregated our results in an *institutional segment* and a *non-institutional segment* according to Prudential Real Estate Investors' definition.

According to this definition, the *institutional segment* is comprised of institutional investor-owned real estate and *investment-grade* real estate that is non-investor-owned. *Investment-grade* means that most institutional investors (investment banks, pension funds, REITs, investment advisors, etc.) would consider it as proper for investment (for example, corporate-owned office buildings with a floor-plate larger than 300 sq. m). Consequently it excludes owner-occupied properties for the office and warehouse sectors and smaller properties that are likely to be considered as non-investment grade by most institutions. On the contrary, the *non-institutional segment* is comprised of properties that are less likely to be available for investment (owner-occupied properties) and of properties that may not correspond to most institutional investors' preferences (smaller properties).

The chart below compares the capitalization of each segment of the Japanese and the American real estate markets.

Figure 3: Institutional and non-institutional segments, Japan vs. the U.S.*



Source: NREIM, Prudential Real Estate Investors, in Sizing-up the U.S. Real Estate Investment Market,
*: Details of the institutional segment per sector are not published upon PREI's request

The Japanese institutional segment is equal to 1/5 of its American counterpart. Although the institutional segment represents 70% of the American real estate, this ratio falls to 46% for Japan. This lower ratio for Japan is mostly due to the higher proportion of owner-occupied office buildings. In Japan, approximately 70% of the office space is owner-occupied.

As we highlighted in our Topics (*Japanese structural changes Vol. 2 Asset Holding Structures, August 1, 2003*), pressures for increasing profitability from shareholders and the introduction of the new mark-to-market accounting system (April 2005) should provide additional incentives to Japanese corporations to rent instead of owning their office building. Thus, although the proportion of rental office space will probably not change in the U.S. (because it is a mature market in which the profitable assets have already been acquired by institutions), this proportion is expected to increase in Japan.

3-3. The Adjusted Institutional Segment: 1/4 of the U.S. Institutional Segment

Thus, the measure that should be considered by the foreign investors when determining their neutral weighting to Japan should not merely be the current institutional segment, but instead the institutional segment together with its potential, the *adjusted institutional segment*. We define the *adjusted institutional segment* as the sum of the institutional segment and the non-institutional segment, the latter weighted by its potential to be acquired. What is this potential?

In September 2001, the TMRI (*Toshi Mirai Research Institute*) published the result of a survey on the "Awareness of the Japanese corporations regarding the introduction of the new accounting rules and the evolution of their policy vis-à-vis the ownership of real estate". Those results were based on the answers of 400 companies. Of the corporations that answered, 18% said they would shift from *ownership to rental* as a consequence of the introduction of the new accounting rules.

Assuming that 18% of the Japanese corporations shift from ownership to rental and that all this office space is investment grade, an estimate of the *adjusted institutional segment* is as follow.

$$Adjusted\ \ Institutio\,nal\ Segment = Institutio\,nal\ Segment\ Cap + Owner\ occupied\ \ office\ Cap \times 0.18$$
$$\fallingdotseq \$1{,}100 \text{ billion}$$

Thus, based on the size of its *adjusted institutional segment*, Japan increases from 1/5 to 1/4 of the American *institutional segment*.

3-4. Liquidity: Japan vs. the U.S.

Based on the liquidity ratio as defined in part 2, we compare in the table below our results for the Japanese liquidity to that of the American real estate market.

Table 4: Commercial Market Based On Liquidity Comparison

	Japan	United States
Office	2.0%	3.4%
Residential	1.5%	1.3%
Retail	2.4%	2.2%
Warehouse	0.4%	1.1%
Hotel	1.7%	N/A
Total	1.8%	1.9%
Total (ex-hotel)	1.8%	2.0%

Source: NREIM's estimate based on Prudential Real Estate Investors, in Sizing-up the U.S. real estate investment market and Real Estate Capital Analytics

Although foreign investors perceive the Japanese market as being illiquid, the liquidity of the Japanese market (1.8%) is very close to that of the American market (1.9%, or 2.0% if excluding the hotel sector whose transaction amount is not available for the U.S.).

As was the case for Japan, the American sectors that showed above-average liquidity levels in 2002 were the office sector (3.4%) and the retail sector (2.2%). Furthermore, although the overall liquidity ratio is higher for the U.S., individual liquidities for the Japanese retail and residential sectors seem to be slightly higher.

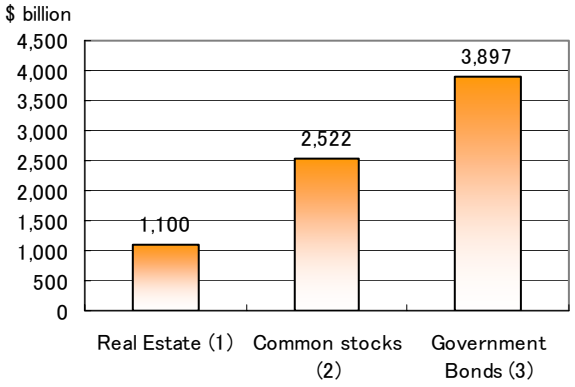
The reason why foreign investors see the Japanese market as relatively illiquid is probably due to the fact that they found it difficult to source deals as a large number of transactions are still off-market deals. This, more than anything, emphasizes the need for an off-shore investor to join forces with a "local" partner.

4. Comparing the Japanese Real Estate Market with Japanese traditional investments

4-1. Capitalization: real estate as a significant part of the investment universe

The chart below presents a comparison of real estate and Japanese traditional investments (common stocks and government bonds) based on their respective capitalization. The value used for real estate capitalization is its *adjusted institutional segment* as estimated in part 3.

Figure 4: Japanese Real Estate vs. traditional investments



Source: (1) NREIM, (2) Tokyo Stock Exchange (as of August 26th, 2003), (3) Institute of Post and Telecommunications Policy (IPTP, as of November 2002)

Compared with the capitalization of the Japanese traditional investment universe, the Japanese real estate market is equivalent to nearly 44% of the Japanese common stocks capitalization and 28% of the Japanese government bonds capitalization.

4-2. Can an allocation to real estate be based on liquidity?

The table below presents a comparison of the liquidity of Japanese real estate and traditional investments.

Table 5: Liquidity: Japanese real estate vs. traditional investments

Asset classes	Liquidity
Real Estate	1.8%
Common stocks (1)	58%
Government Bonds (2)	650%

Source: (1) Tokyo Stock Exchange (as of August 26th, 2003), (2) Institute of Post and Telecommunications Policy (IPTP, as of November 2002)

As the liquidity of real estate properties is several tens to hundreds of times lower than that of traditional securities, liquidity cannot be a meaningful criterion for deciding real estate allocation. Investors considering investing in real estate are willing to take on the liquidity risk in order to enjoy two main benefits. As we highlighted last year in our review: "*The benefit of including real estate as part of a mixed-asset portfolio is primarily the result of its very low correlation to other assets (diversification benefit) and its ability to partially hedge inflation in mature markets (markets at equilibrium). Real estate investments deliver their greater diversification benefits on shorter-term investment periods (5years approximately) and at lower risk-return levels, i.e. returns generally targeted by pension funds.*" (See Review July 2002, *Rationale for Including Real Estate as Part of a Mixed-Asset Portfolio*)

Next steps towards a strategic allocation recommendation

According to Jacques Gordon (*Investment Strategy Annual 2003*, LaSalle Investment) "an international strategic allocation is comprised of five main steps.

Step 1: Define the eligible country
Step 2: Establish a 'neutral strategic weighting' according to an appropriate metric
Step 3: Develop forecasts of expected returns and risks to set a strategic balance
Step 4: Use country and market factors to set risk premier and required returns
Step 5: Compare the expected and required returns to finalize tactical tilts."

By comparing American and Japanese real estate market capitalizations we support the establishment of the neutral weighting (step 2), with the appropriate metric being the capitalizations of each market. The neutral weighting is determined in order to ensure that portfolios do not become over exposed to specific markets and economies. Moreover an investors' biggest bet is frequently how far they deviate from a known benchmark; this bet should be made consciously and strategically, not by chance. By comparing liquidities we contribute to the determination of the markets relative risk (step 4).

Reliable estimates of the capitalization and liquidity of the Japanese real estate market represent a first step in our enterprise to provide our clients with recommendations regarding their allocation to this market. From here, further research is required in the following fields:

1. Inventory of the methods to decide an allocation to real estate for domestic and foreign investors, and their utilization
2. Extension of the international comparison to other main foreign markets (Australia, Europe, etc.)
3. Analysis of the Japanese and foreign institutions' preference vis-à-vis real estate assets

II. Current State of the Tokyo Office Market

(Progress Report on the "2003 Problem")

In our previous report in the Winter Issue of 2002, we analysed and forecasted the Tokyo office market's "2003 Problem." Here, with the passing of 6 months since the previous report, we now present a progress report on the "2003 Problem."

We shall give a final report on the "2003 Problem" in the Summer Issue of 2004. Please note that this is only a progress report.

1. Current Lease Status of Major Office Buildings Completed or to be Completed in 2003

First, we would like to set forth the current status of the lease-up of office buildings completed or to be completed in Tokyo in 2003, which is the fundamental cause of the "2003 Problem."

Tables 1 and 2 show that most of the buildings already completed have made good starts with some exceptions (those completed in April). We can also see that over time, vacancy rates of the buildings, which are yet to be completed and therefore have not attracted many tenants, have been decreasing.

What then is the situation of the whole market including existing properties? Is the general assumption "that newly built large buildings may have an effect on the whole office market" correct? Have they really caused a chain reaction that damages existing large building, eventually reaching small buildings?

Table 1: Vacancy Rate of Buildings Completed in 2003

Actual or Scheduled Date of Completion	As of the End of Mar.	As of the End of May	Fluctuation
January	3%	3%	0%
February	0%	0%	0%
March	14%	14%	0%
April	43%	31%	-12%
May	20%	15%	-5%
June	69%	45%	-23%
July	41%	37%	-4%
August	97%	35%	-62%
September	42%	42%	0%
October	76%	76%	0%
November	100%	100%	0%
December	100%	100%	0%
Total/Average	27%	24%	-3%

Source:Miki Shoji

Table 2: Percentage of Buildings Completed in 2003 with above 90% Occupancy

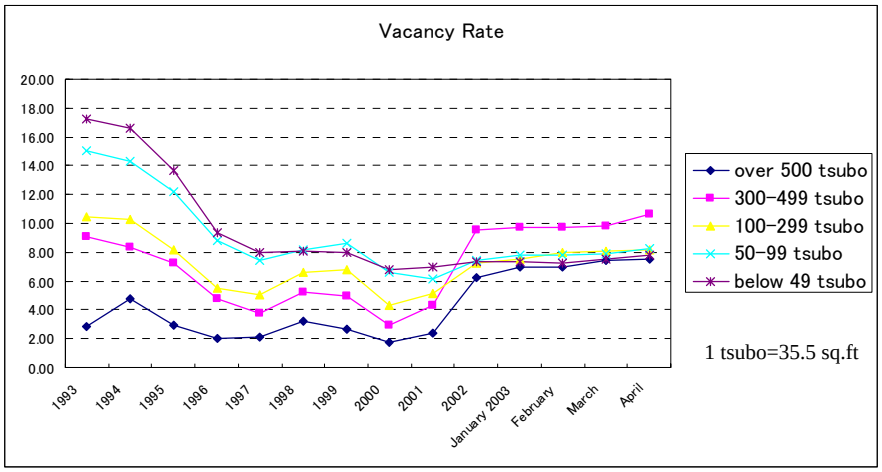
Actual or Scheduled Date of Completion	As of the End of Mar.	As of the End of May	Fluctuation
January	67%	67%	0%
February	100%	100%	0%
March	78%	78%	0%
April	13%	13%	0%
May	33%	67%	33%
June	25%	50%	25%
July	50%	50%	0%
August	0%	50%	50%
September	33%	33%	0%
October	0%	0%	0%
November	0%	0%	0%
December	0%	0%	0%
Total/Average	37%	43%	6%

Source:Miki Shoji

2. Vacancy Rate by Scale

Chart 1 shows the trend of vacancy rates by scale (standard floor area basis) of the office buildings in central Tokyo's 6 wards. In the Japanese real estate market in the past, office buildings had to meet three requirements of "near, new and large", in order to be competitive. The Chart shows the occupancy rates (using floor area as the standard) for buildings. Recently, as we can see there has been a fundamental change—the vacancy rates of large buildings have become higher than those of small-to medium-sized buildings. In the real estate market, which started to reflect the knowledge of the "2003 Problem" in 2001, the vacancy rates increased in larger buildings that were in the same category as the new developments and therefore came into competition with the "near, new and large" buildings that would be supplied in large quantities. The key question to us is whether this is temporary—in other words, whether the increase in the vacancy rates will extend to small- to medium-sized buildings, whose vacancy rates would return the their historic norms of being greater than those of large buildings. (Our answer to this question is "No," as stated in the previous issue. We expect that the increase will have only a limited effect on smaller and lower rent office buildings.)

Figure1 Trend of Vacancy Rate by Floor Area

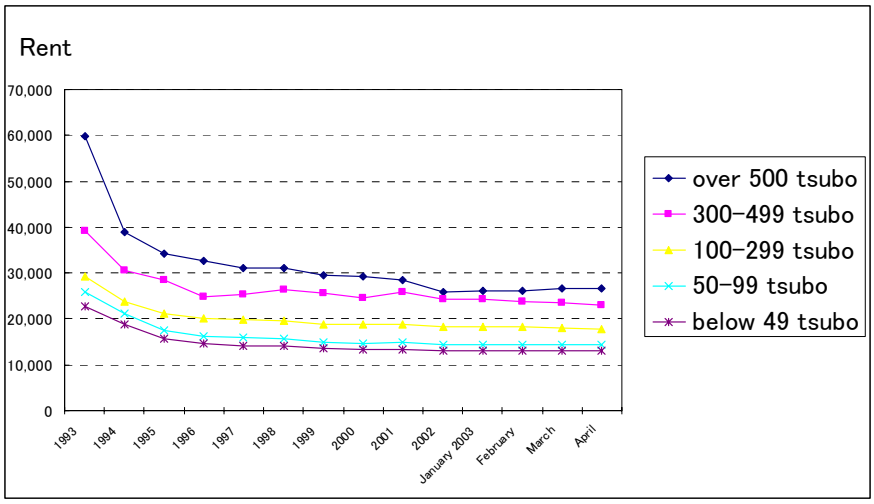


Source:Miki Shoji

3. Rent by Scale

Chart 2 shows the trend of rents by scale (floor area basis) of the office buildings in central Tokyo's 6 wards. The chart illustrates that the rents of the buildings with floor areas of 500 tsubo or more have recently risen (slightly) while the rents of lower rank (floor area of 300 to 499 tsubo) buildings have continued to fall. This is because ultra-large buildings with floor areas of 500 or more tsubo, are the major cause of the "2003 Problem". On the other hand, large buildings in the 300-499 tsubo range are still feeling the impact of the supply increase. As a result, the rental gap between 300 to 499 tsubo class buildings and those of the 100 to 299 tsubo class has narrowed. A key question is whether the fall in rents will spread to small- to medium-sized buildings. (Our answer is again "No.")

Figure 2 Office Buildings in Tokyo - Rent by Floor Area



Source:Miki Shoji

4. Vacancy Rate by Rent Level

We have so far classified office buildings based on floor areas. From this point on, our analysis shall classify them based on rent levels.

In Japan, classifying office buildings is often quite subjective. Also, office buildings may be assigned to classes according to (1) specification or (2) both specification and location.

If, however, we take into account tenants' assessments of the value (class) of office buildings, office buildings should be classified according to both specification and location. On the assumption that the market determines such value in a rational way, we analysed the effects of the "2003 Problem" on office buildings classified by rent level.

Since our purpose here is to analyse the effects of the new supply of buildings on the existing market, only pre-existing buildings are covered by the analysis and those newly built that were completed in 2002 or later have been excluded.

Furthermore, the analysis is based on the efficiency of the office building market, a similar assumption made in our previous report. This means that we have assumed (1) tenants and owners started to negotiate on rents and some tenants started to move beginning in 2002 since, around 2001, there was information in the market that a large supply of office buildings would become available around 2003 and, therefore, (2) the market already began discounting the "2003 Problem" at the beginning of 2002.

Table 3 shows the trend of vacancy rates by rent level. The table shows that the average vacancy rate has been increasing. At the same time, it shows that the lower the rent level, the more moderate the increase. In particular, the vacancy rate for the buildings whose rents are below the level of 15,000 yen per tsubo has decreased somewhat (from 6.1% in December 2001 to 5.6% in March 2003).

Table 3: Office Buildings in Central Tokyo's 6 Wards--Vacancy Rate by Rent Level

Rent	Dec. 2001	Mar. 2002	Jun. 2002	Sep. 2002	Dec. 2002	Mar. 2003
10000-14999	6.1%	5.8%	4.3%	5.6%	5.0%	5.6%
15000-19999	6.1%	6.5%	6.3%	6.1%	7.1%	7.8%
20000-24999	5.6%	6.3%	6.6%	6.9%	8.0%	9.2%
25000-29999	5.4%	5.4%	6.4%	6.7%	6.6%	7.1%
30000-34999	4.3%	4.8%	5.8%	5.5%	5.9%	9.6%
Over 35000	3.6%	5.2%	5.4%	5.8%	6.4%	8.3%
Average	4.9%	5.6%	6.0%	6.2%	6.7%	8.3%

Source:Miki Shoji

5. Rent by Rent Level

Table 4 shows the trend of rents by rent level. The Table shows that the average rent of all levels of buildings has been decreasing as time passes, but the decrease is more moderate at lower rent levels just as in the case of the vacancy rate. We can also see that the rents of the buildings at the less than 15,000 yen per tsubo level increased (from 100 in December 2001 to 103.9 in March 2003).

Table 4 Office Buildings in Central Tokyo's 6 Wards--Rent by Rent Level (December 2001=100)

Rent	Dec. 2001	Mar. 2002	Jun. 2002	Sep. 2002	Dec. 2002	Mar. 2003
10000-14999	100.0	101.0	101.0	102.8	102.8	103.9
15000-19999	100.0	99.8	99.8	99.4	99.4	98.8
20000-24999	100.0	99.7	99.5	98.8	98.2	97.4
25000-29999	100.0	99.7	99.2	98.2	97.2	96.2
30000-34999	100.0	98.7	97.9	97.5	97.3	95.5
Over 35000	100.0	98.8	98.3	95.9	94.4	91.7
Average	100.0	99.7	99.4	98.8	98.4	97.5

Source:Miki Shoji

Table 5 shows the percentage of buildings whose rents dropped by more than 5% from the levels in December 2001. (For example, among the 106 buildings in the 10,000 to 14,999 yen class, there were 2 buildings whose rent in March 2002 dropped by more than 5% from the rents in December 2001. 2÷106=1.9%)

We can ascertain from this table that the "2003 Problem" has had a great impact mainly on buildings at higher rent levels and the impact has been smaller on buildings at lower rent levels.

Table 5 Percentage of Buildings with Rent Reductions of Over 5% Since December 2001

Rent	Mar. 2002	Jun.2002	Sep.2002	Dec.2002	Mar. 2003	Cumulative Total
10000-14999	1.9%	0.9%	0.0%	0.0%	2.8%	5.7%
15000-19999	4.6%	1.8%	2.8%	3.8%	4.6%	17.6%
20000-24999	4.9%	2.7%	5.4%	3.5%	7.0%	23.5%
25000-29999	5.7%	5.7%	6.0%	6.9%	7.2%	31.4%
30000-34999	10.7%	7.6%	5.3%	3.1%	9.2%	35.9%
Over 35000-	10.1%	5.1%	12.7%	7.6%	12.7%	48.1%
Average	5.5%	3.5%	4.8%	4.2%	6.6%	24.8%

Source:Miki Shoji

What can we gather from such data? Do the data simply mean that building owners who have lost their tenants to newly built office buildings are siphoning tenants from lower class buildings while accepting a reduction in rents but that this phenomenon has not yet occurred in the lower rent levels? Or do the data mean that new players such as investors, asset managers and property managers have entered the real estate market for small to medium-sized buildings and as a result, such buildings, which have been less professionally managed, are now in the process of being transformed into competitive properties? Or do they mean that aside from the "2003 Problem," companies setting their sights on restructuring through a reduction in rental costs are simply moving to buildings with lower rents thereby stabilizing the demand for such space and keeping rental levels relatively constant? As yet, we have been unable to answer these questions definitely. The present situation is likely to be a composition of all these factors.

6. Size, Building Year and Area

Here, we shall describe some of the characteristics of the buildings affected by the "2003 Problem" as of March 2003.

Table 6 shows comparisons between all buildings and buildings whose rents have dropped by more than 5% in each rent level, from the perspective of (1) rentable area, (2) floor area, and (3) building age. (For example, the average rentable area of the 10,000 to 14,999 yen class of buildings was 1,028 tsubo. Among such buildings, there were some buildings whose rents in March 2003 were more than 5% lower than those in December 2001 and their average rentable area was 856 tsubo.)

Table 6 All Buildings/ Buildings with Rent Drops of Over 5%

Rent	Rentable Area (tsubo)		Floor Area (tsubo)		Building Age (tsubo)	
		Rent dropped Bldgs.		Rent dropped Bldgs.		Rent dropped Bldgs.
10000-14999	1,028	856	165	182	24.3	16.9
15000-19999	1,068	987	149	138	22.4	22.3
20000-24999	1,414	1,433	175	174	22.1	22.0
25000-29999	2,240	2,060	222	212	20.8	20.6
30000-34999	4,930	5,467	310	356	21.1	21.0
Over 35000	10,088	12,227	433	472	18.7	17.9
Average	2,224	3,106	203	230	22.0	21.1

Source:Miki Shoji

As wee see it, the table shows:

(1) At higher rent levels (30,000 yen or more per tsubo), "new and large" buildings were weaker, and

(2) At all levels, "new" buildings were weaker.

In other words, at least as of March 2003, "new and large" buildings, which had generally been expected to be the most competitive, have been most greatly affected by the "2003 Problem." It may be that buildings promoting their newness and size are more susceptible to losing their advantages and sooner becoming less desirable when even newer and larger properties are supplied. In future, the repercussions may gradually spread to buildings at middle to low rent levels, but we expect that such effects, if any, will be mild. (For details, see our report in the Winter Issue of 2002.)

Table 7 shows rents of the buildings at each rental level in the 6 areas (wards in central Tokyo) in March 2003 as represented in percentages (December 2001=100). Here, relatively competitive areas (wards) at each rent level are highlighted in yellow.

Table 7 Rents in the 6 Wards as of March 2003 (December 2001=100)

Rent	Chiyoda-ku	Minato-ku	Chuo-ku	Shinjuku-ku	Shibuya-ku	Shinagawa -ku	Average
10000-14999	103.6	101.4	105.7	104.8	102.6	106.1	103.9
15000-19999	97.9	98.9	97.6	99.2	102.5	98.0	98.8
20000-24999	97.6	97.0	97.3	96.4	98.8	96.9	97.4
25000-29999	96.3	95.9	95.8	95.7	97.5	95.3	96.2
30000-34999	94.7	94.1	97.1	95.8	97.4	76.2	95.5
Over 35000	95.9	89.6	88.8	89.3	87.4	-	91.7
Total	97.2	96.9	97.0	98.5	99.0	98.4	97.5

Source:Miki Shoji

Will the rental levels for the areas highlighted in yellow continue to be competitive? Table 8 shows the trend of vacancy rates of the buildings at each rental level in the 6 areas (wards) whose rents fell by less than 5% or rose. Here, the areas (wards) where vacancy rates increased by more than 3% are highlighted in blue, and the areas (wards) where vacancy rates decreased are highlighted in yellow. (For example, there were 14 buildings at the 10,000 to 14,999 yen rental level in Chiyoda-ku, and one of them saw a fall in rent of more than 5%. The vacancy rates of the remaining 13 buildings in December 2001 and March 2003 were 4.6% and 6.8%, respectively.)

The Table highlights where vacancy rates have been increasing even if no rental rate drops have occurred and where the weakened areas and rent levels in which downward pressures on rents will, we believe, increase in the future.

Table 8 Rent

	Chiyoda-ku		Minato-ku		Chuo-ku		Shinjuku-ku		Shibuya-ku		Shinagawa -ku		Average	
	Dec.2001	Mar. 2003	Dec.2001	Mar. 2003	Dec. 2001	Mar.2003	Dec. 2001	Mar. 2003	Dec. 2001	Mar. 2003	Dec. 2001	Mar. 2003	Dec. 2001	Mar. 2003
10000-14999	4.6%	6.8%	9.2%	7.1%	6.7%	3.9%	4.5%	5.7%	0.0%	0.0%	7.9%	4.1%	5.9%	5.5%
15000-19999	5.9%	6.6%	7.2%	4.7%	5.9%	5.1%	2.5%	7.1%	4.9%	9.6%	3.8%	9.4%	5.4%	6.4%
20000-24999	4.2%	7.4%	5.6%	8.7%	5.4%	8.9%	3.3%	7.6%	7.9%	8.1%	1.2%	5.1%	5.1%	8.1%
25000-29999	3.6%	4.2%	4.1%	4.6%	5.1%	5.6%	3.8%	4.6%	3.9%	4.1%	2.8%	4.9%	4.1%	4.6%
30000-34999	2.5%	10.1%	2.4%	4.3%	6.9%	7.8%	4.5%	2.9%	4.0%	5.3%	-	-	4.1%	5.9%
Over 35000	3.8%	6.5%	1.2%	3.7%	4.9%	9.1%	4.2%	5.3%	6.4%	3.9%	-	-	3.2%	6.9%
Total	3.8%	6.5%	4.6%	5.7%	5.8%	7.0%	3.7%	5.3%	5.1%	5.8%	3.2%	6.9%	4.5%	6.2%

= Over 3% increase in vacancy rate
=Decrease in vacancy rate

Source:Miki Shoji

Up to this point, this article has focused on an analysing the impact of the “2003 Problem”. We have concluded that our forecast last winter was basically accurate: the “2003 Problem” will have the greatest impact on buildings in the same markets, at the same rent levels and with the same specifications as the buildings supplied in large quantities, and its effect on buildings with lower rental rates would be limited.

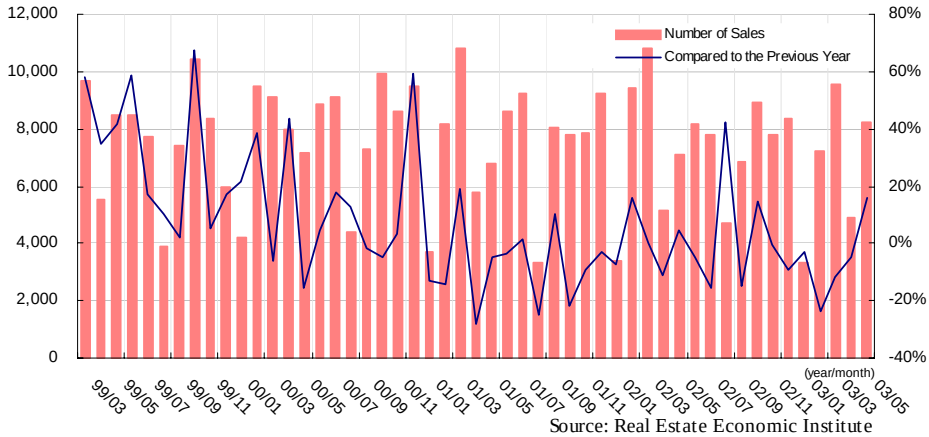
However, let us repeat that this is just a progress report as of March 2003. The rent levels, areas or specifications we have described above as “strong” or “weak” may be susceptible to further changes over time. We shall continue to monitor the trend and make a final report on the “2003 Problem” in the Summer Issue of 2004.

III Real Estate Market Trends

1. Trends in the Condo Market

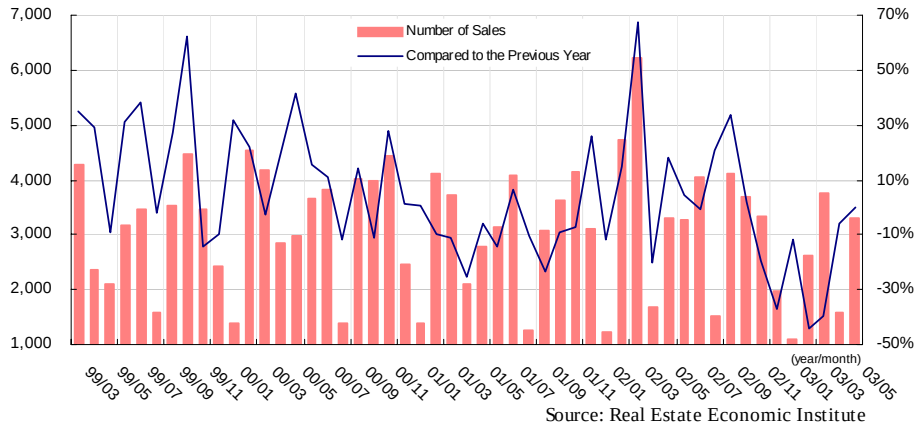
① Trends in the Number of Sales

Tokyo Metropolitan Area



Source: Real Estate Economic Institute

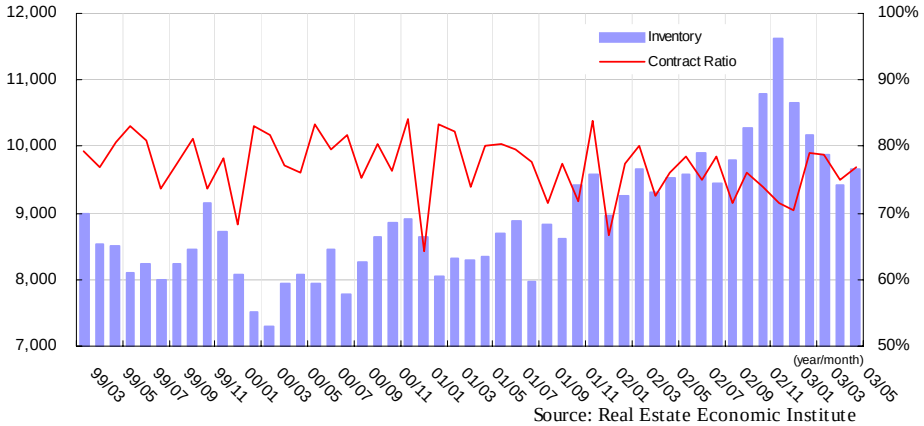
Kinki Area



Source: Real Estate Economic Institute

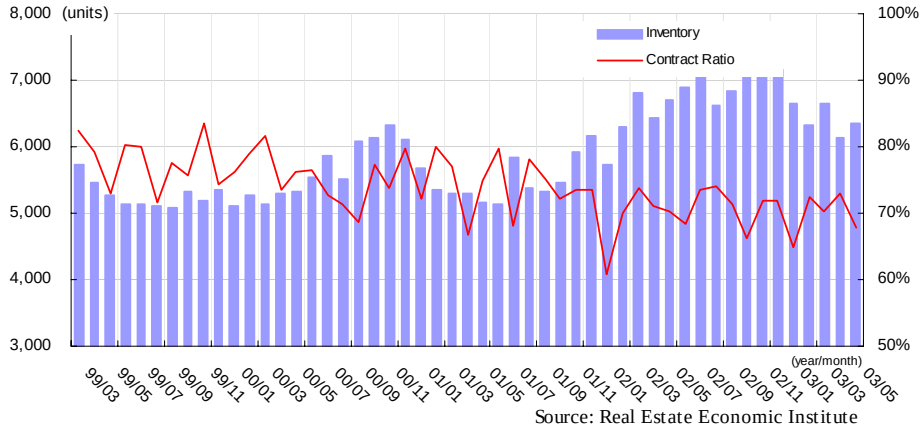
② Trends in Contract Ratio and Inventory

Tokyo Metropolitan Area



Source: Real Estate Economic Institute

Kinki Area

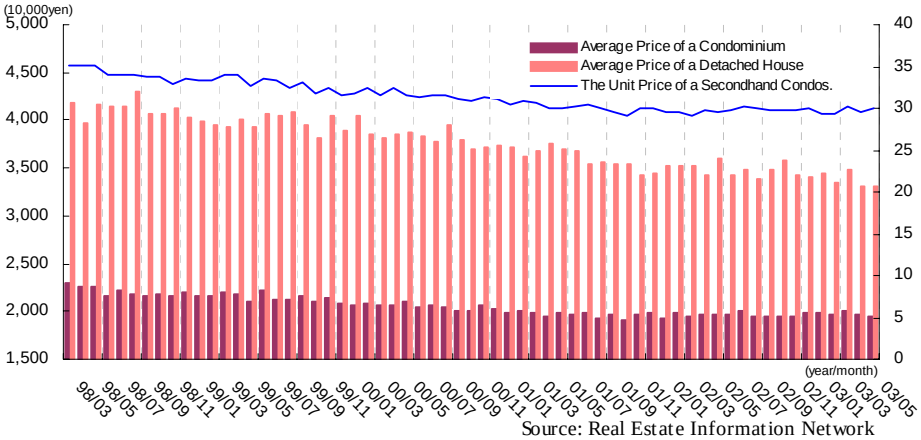


Source: Real Estate Economic Institute

2. Trends in the Distribution Market

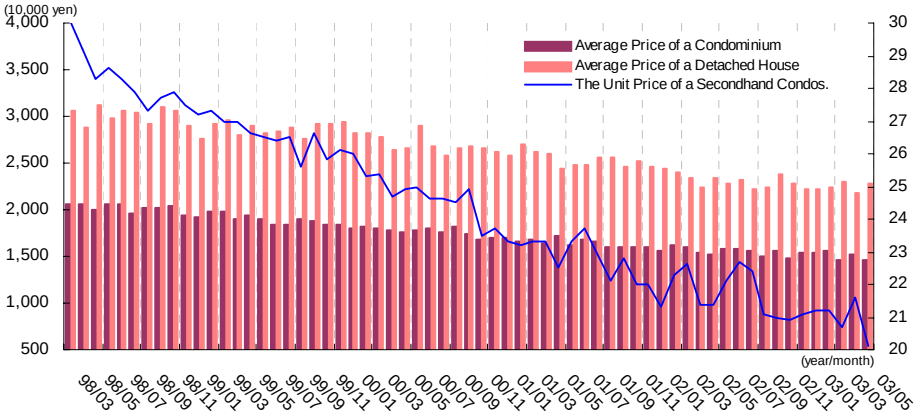
① Trends in Average Contract Price

Tokyo Metropolitan Area



Source: Real Estate Information Network

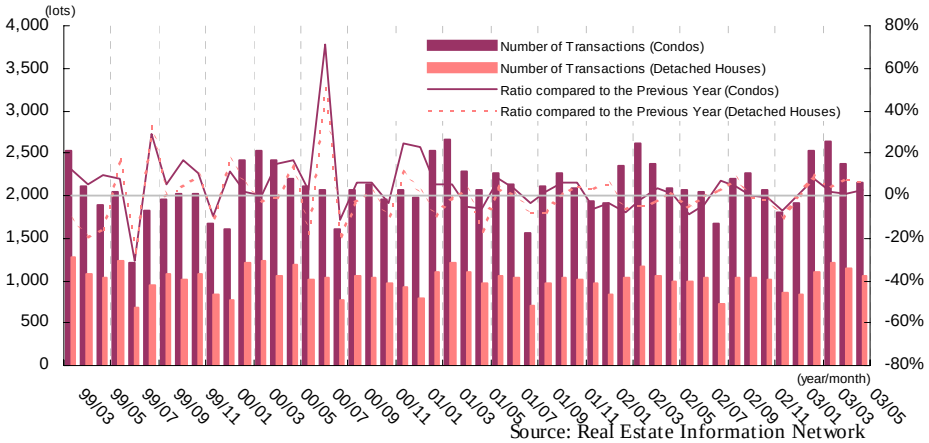
Keihanshin Area



Source: Real Estate Information Network

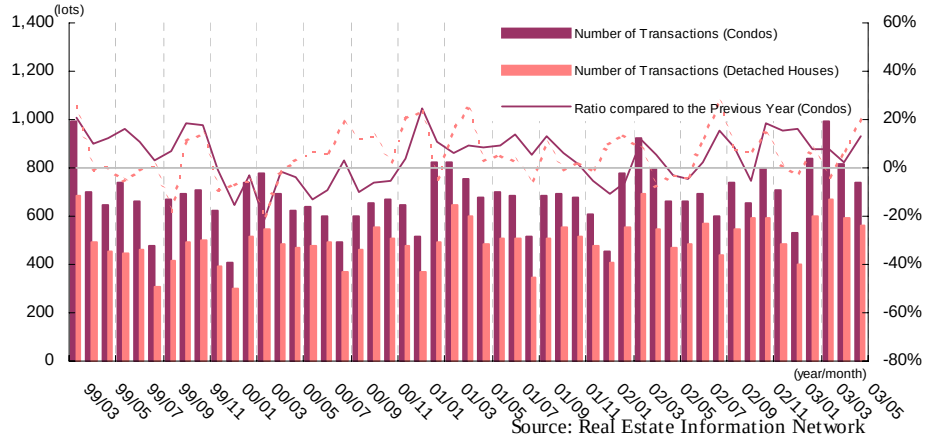
② Trends in Number of Contracts

Tokyo Metropolitan Area



Source: Real Estate Information Network

Keihanshin Area

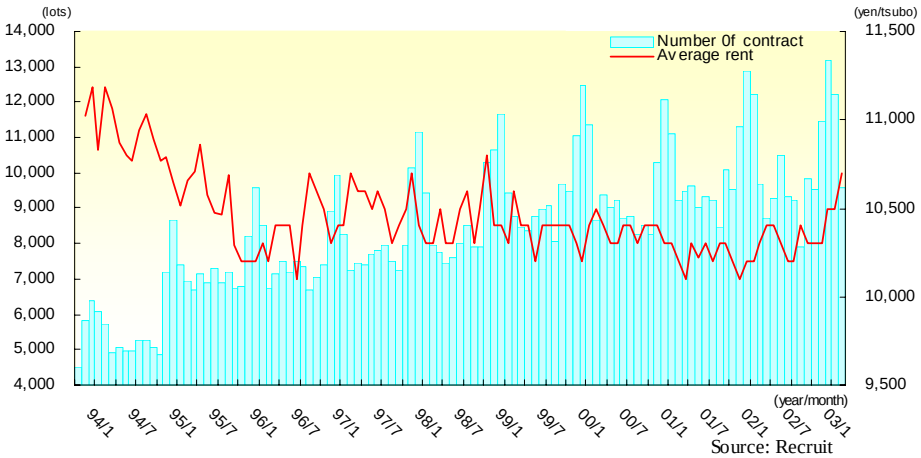


Source: Real Estate Information Network

3. Trends in the Rental Condominium Market

Trends in Average Rent and Number of Contracts Concluded

Tokyo

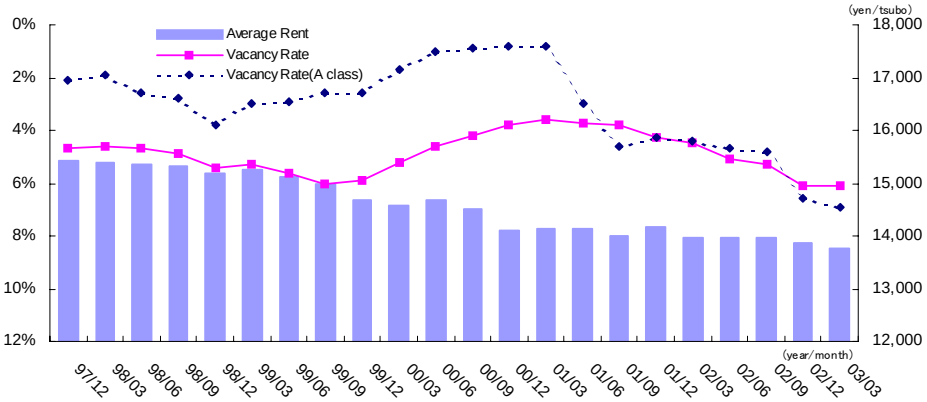


Source: Recruit

4. Trends in the Office Market

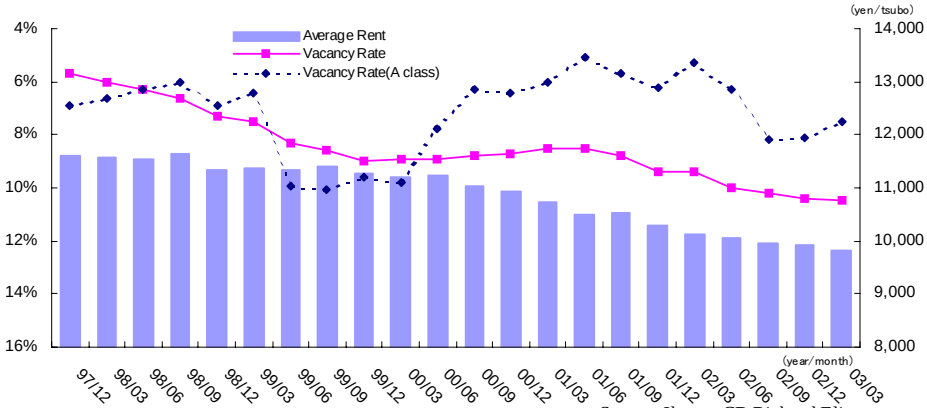
Trend in Asking Rents and Vacancy Rates

Tokyo 23 wards



Source: Ikoma CB Richard Ellis

Osaka City

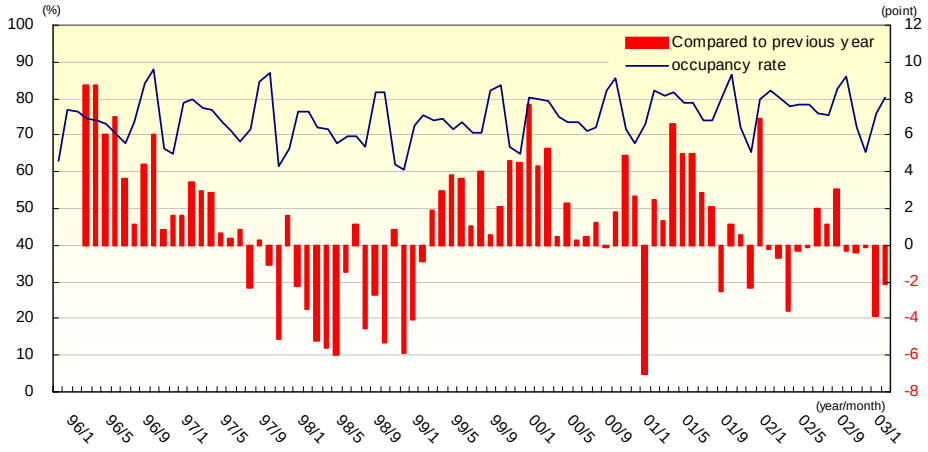


Source: Ikoma CB Richard Eliss

5. Trends in the Hotel Market

Trends in Occupancy Rates

Tokyo and Osaka Areas

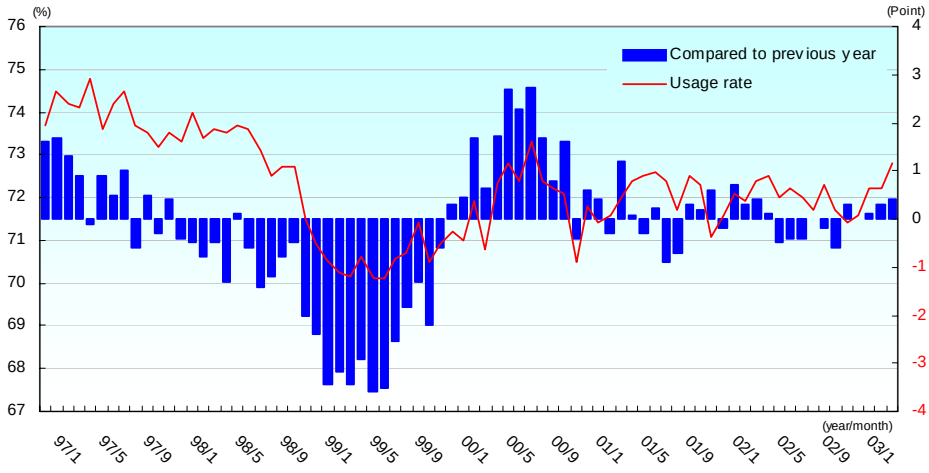


Source: Ministry of Land, Infrastructure and Trasportation

6. Trends in the Industrial Market

Trends in Warehouse Usage Rates

Major 21 Companies



Source: Japan Warehouse Association