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EQUITY: JAPAN HOUSING & REAL ESTATE

Office demand down for third straight month

Vacancy rate continues to improve on multiple demolitions, rent upside strengthens

Global Markets Research

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Research analysts

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Office demand falls m-m for third consecutive month, but we think it is too early to say that it is on a downtrend

According to major real estate brokerage Miki Shoji, the office vacancy rate in Tokyo's five central wards improved 4bp m-m to 3.90% in August 2016. Growth in advertised rents remained weak, up only 4.75% y-y, but this nevertheless represents a gradual improvement on 3.98% in January 2016, the weakest recent month. Office demand, a key indicator, fell 5,794 *tsubo* (3.3m²) m-m, thereby registering its third consecutive monthly decline. However, the vacancy rate improved because eight office buildings were demolished and therefore removed from the survey/statistics, which are now based on 2,591 office buildings, with the result that leasable office floor space fell 9,430 *tsubo* m-m to 7.28mn *tsubo* while vacant space fell 3,636 *tsubo* to 283,896 *tsubo*. While three straight months of falling demand for office space will warrant ongoing attention as it constitutes the first such move since end-2009/early 2010, the summer is not a particularly strong season for office demand to start with, and we therefore think it would be premature to say that demand has moved into a sustained downtrend along the lines of 2008, when the global financial crisis occurred. We think it would be prudent to maintain a wait-and-see attitude for now. We continue to recommend Mitsui Fudosan [8801] and Tokyo Tatemono [8804] for rising rents and low P/NAV ratios.

Little new office supply, fluctuations in demand and number of demolitions are key

Barring any major decline in office demand as a result of an economic downturn, we still think that the office vacancy rate is highly likely to improve through end-2017 as not much new supply is scheduled to come onto the market through 2017 and large numbers of office buildings are scheduled for demolition ahead of redevelopment from 2020 onwards. For example, the Marubeni head office building (floor area of 58,000m²) in Otemachi is scheduled for demolition from September 2016 and the former Mizuho Bank head office building (76,000m²) in Marunouchi 1-3 from October 2016, followed by several office buildings in the Yaesu area from 2017 onwards. Although buildings scheduled for redevelopment become vacant several months before they are demolished as former tenants move out, they are normally excluded from office supply-demand surveys/statistics as it is the owners that are canceling the tenancies. Assuming that office demand improves slightly, as was the case prior to April 2016, this will help the office vacancy rate to improve. Major new office buildings scheduled to come onto the market include the Kyobashi Edogrand in October 2016, a development in Otemachi 1-1B that Mitsubishi Estate [8802] is aiming to complete in January 2017, the former Shinsei Bank head office building in Hibiya, scheduled for completion in June 2017, and Akasaka Intercity Air, scheduled for completion in August 2017. NTT Urban Development [8933] has already found tenants for the office building it is developing in Otemachi 2-2, which is scheduled for completion in 2018 and is the largest development currently underway. It will be interesting to see how successful Mitsui Fudosan is in finding tenants for the Hibiya Mitsui Building, the second largest development currently underway, which is also scheduled for completion in 2018.

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Appendix A-1

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Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Mitsui Fudosan	8801 JP	JPY 2,273.5	07-Sep-2016	Buy	N/A	A4,A5,A6,A7,A11
Tokyo Tatemono	8804 JP	JPY 1,253	07-Sep-2016	Buy	N/A	A6,A11

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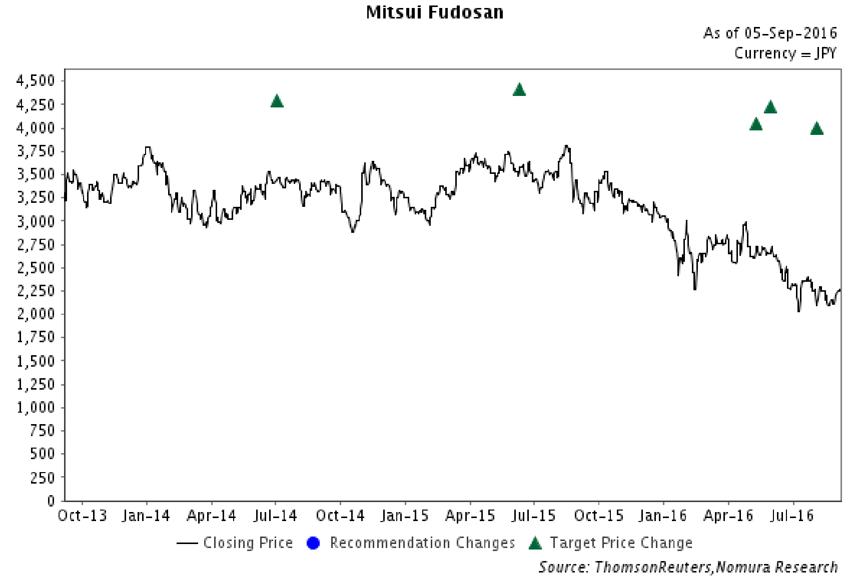
Mitsui Fudosan (8801 JP) **JPY 2,273.5 (07-Sep-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
04-Aug-16		4,000.0	2,116.5
30-May-16		4,220.0	2,673.5
10-May-16		4,040.0	2,728.5
11-Jun-15		4,410.0	3,569.0
03-Jul-14		4,280	3,431

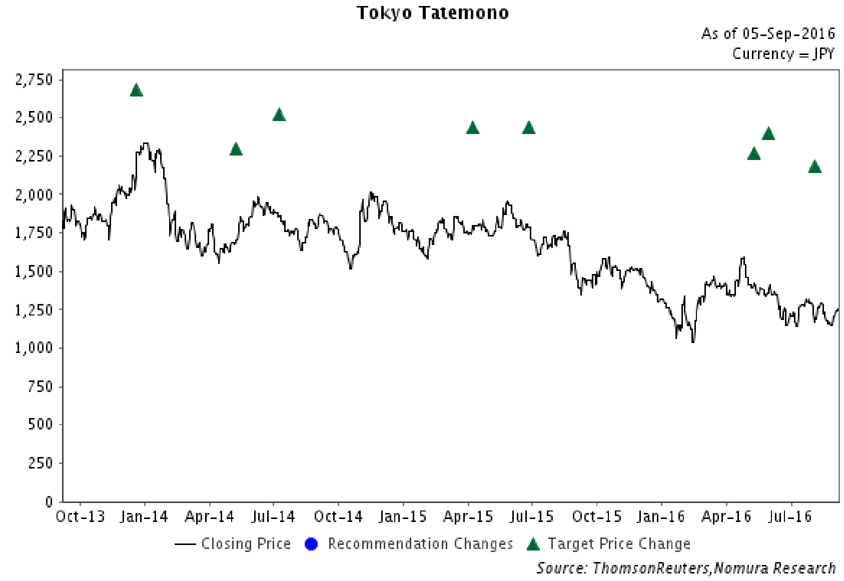
For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We set our target price at estimated NAV per share of ¥4,000, using a corporation tax rate of 29% and applying a cap rate of 3.5% to annualized cash flows from rental real estate.

Risks that may impede the achievement of the target price Improved economic conditions could result in stronger-than-expected office demand and rising rents, with potentially positive implications for valuations. Downside risks include higher construction costs and, although we do not see this as very likely, higher interest rates could also put a damper on the real estate investment market.

Tokyo Tatemono (8804 JP) **JPY 1,253 (07-Sep-2016)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
04-Aug-16		2,180	1,198
30-May-16		2,400	1,388
09-May-16		2,270	1,417
26-Jun-15		2,440	1,784
08-Apr-15		2,440	1,794
08-Jul-14		2,520	1,854
09-May-14		2,300	1,704
18-Dec-13		2,680	2,118

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We obtain our target price of ¥2,180 from NAV per share, calculated using a cap rate of 4.3% and a corporation tax rate of 29%.

Risks that may impede the achievement of the target price Interest-bearing liabilities stood at ¥701.0bn at end-15/12, giving a D/E ratio of 2.3x. Rises in interest rates would therefore pose a risk for Tokyo Tatemono unless it can generate considerably higher cash flow. However, we do not expect interest rates to rise substantially. We also think the company's limited real estate development pipeline could hamper profit growth through 2020.

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Investment trusts invest mainly in securities such as Japanese and foreign equities and bonds, whose prices fluctuate. Investment trust unit prices fluctuate owing to price fluctuations in the underlying assets and to foreign exchange rate fluctuations. As such, investment trusts carry the risk of losses. Fees and risks vary by investment trust. Maximum applicable fees are subject to change; please thoroughly read the written materials provided, such as prospectuses or documents delivered before making a contract.

In interest rate swap transactions and USD/JPY basis swap transactions ("interest rate swap transactions, etc."), only the agreed transaction payments shall be made on the settlement dates. Some interest rate swap transactions, etc. may require pledging of margin collateral. In some of these cases, transaction payments may exceed the amount of collateral. There shall be no advance notification of required collateral value or collateral ratios as they vary depending on the transaction. Interest rate swap transactions, etc. carry the risk of losses owing to fluctuations in market prices in the interest rate, currency and other markets, as well as reference indices. Losses incurred as such may exceed the value of margin collateral, in which case margin calls may be triggered. In the event that both parties agree to enter a replacement (or termination) transaction, the interest rates received (paid) under the new arrangement may differ from those in the original arrangement, even if terms other than the interest rates are identical to those in the original transaction. Risks vary by transaction. Please thoroughly read the written materials provided, such as documents delivered before making a contract and disclosure statements.
In OTC transactions of credit default swaps (CDS), no sales commission will be charged. When entering into CDS transactions, the protection buyer will be required to pledge or entrust an agreed amount of margin collateral. In some of these cases, the transaction payments may exceed the amount of margin collateral. There shall be no advance notification of required collateral value or collateral ratios as they vary depending on the financial position of the protection buyer. CDS transactions carry the risk of losses owing to changes in the credit position of some or all of the referenced entities, and/or fluctuations of the interest rate market. The amount the protection buyer receives in the event that the CDS is triggered by a credit event may undercut the total amount of premiums that he/she has paid in the course of the transaction. Similarly, the amount the protection seller pays in the event of a credit event may exceed the total amount of premiums that he/she has received in the transaction. All other conditions being equal, the amount of premiums that the protection buyer pays and that received by the protection seller shall differ. In principle, CDS transactions will be limited to financial instruments business operators and qualified institutional investors.
No account fee will be charged for marketable securities or monies deposited. Transfers of equities to another securities company via the Japan Securities Depository Center are subject to a transfer fee of up to ¥10,800 per issue transferred depending on volume.

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