
Osaka Renaissance News

No 11 December 2004

Welcome to “Osaka Renaissance News” - the email newsletter of Osaka City Government’s “Urban Revitalization Task Force”.

The Osaka Urban Revitalization Task Force

We are the first *City Task Force* established in Japan to address urban regeneration and revitalization at the same time. For this we are also collaborating with the central government’s “Urban Renaissance Program”. The role of the task force is to coordinate and promote the set of initiatives that taken together form the Osaka Revitalization Plan.

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This Issue: The Osaka Property Market Recovery

This month’s issue explains trends in the Osaka property market and the potential for a full-blown recovery.

“Osaka Renaissance News” is distributed through multiple email channels to spread the word about important initiatives taking place in Osaka.

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The Osaka City Blue Print for Urban Revitalization covers:

- Urban regeneration
 - Business stimulation (notably in knowledge industries)
 - Tourism and life-style services
 - Education – especially professional and life-time learning
 - Foreign direct investment
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THE OSAKA PROPERTY MARKET

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AUTHOR'S INTRODUCTION

Upward property prices are really a vote of confidence in a city. In the case of Osaka we are now seeing an improvement in property prices in some prime areas for the first time since the Bubble. Remarkably, overall commercial property prices are standing around the same level as 1982. The Japanese economy of course has changed substantially over this time, and in effect has been "re-priced" to reflect new realities, such as a lower demographic trend. Even so, prices now look very attractive, especially in downtown city centres, which is where demand for land is most concentrated.

Land prices are strengthening because of: 1) the improvement in the bad loan situation at banks which is removing the overhang of properties coming on to the market at steeply discounted prices; 2) central government initiatives to support city regeneration, notably through the introduction of special deregulation zones; 3) promotion of tourism coupled with the gradual integration of Kansai into the Asian economy, notably China and Korea.

Indicators that the economy is recovering are all positive, which is providing support to the current market. However, the long-term reason to be positive about property lies in the integration of Kansai into Asia. If this happens, as I expect, then the future of Osaka as a major trade and information hub, as well as a visitor centre, is assured, and the current efforts of the city government to make Osaka more pleasant to visit, live and work in will make a vital difference to the city's success.

Several major foreign funds seem to agree with this assessment. Their purchases of properties have helped to prime the market. Now domestic property funds and real estate developers in turn are becoming more active. In my view therefore the property market has turned the corner, at least in downtown Osaka. If so, the era of bargain hunting is over.

Alex Stewart

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The Osaka City Revitalization Task Force has commissioned Alex Stewart to author this series of newsletters. He is the president of Alexander Capital Access Co., Ltd., an investment catalyst and PR communications company based in Osaka. He is also an Executive Adviser to the Osaka City Revitalization Task Force. Questions about these articles can be directed to him at: alex@ac-access.com

THE OSAKA PROPERTY MARKET

In this issue we look at how the property market is recovering in Osaka.

(1) Economic Factors

A clear trend is emerging in Osaka whereby property prices in prime downtown centres are holding steady, or increasing, but land further away is continuing to decline. On a more positive note, the rate of decline is falling each year, and the feeling is taking hold that the market is bottoming.

The improvement in the bad debt situation at banks is the most important factor for the property market. Leading banks in Osaka, like Resona Bank and UFJ, have written off the worst of their non-performing loans. This means that the deflationary effects of land sales, at deeply discounted prices to foreign financial institutions and their partners, is now passing out of the system.

Another positive factor is the growth of the REIT market. Investors are attracted by their higher returns versus conventional savings instruments and are pouring money into them. The result is that the market in Tokyo is beginning to overheat with a spill over to Osaka as funds look for good value.

Strengthened corporate profitability after restructuring is also having a

positive effect on confidence. Companies in Osaka generally restructured faster than other companies in Japan, with the result that almost all listed companies are showing much better profit performance. This is feeding into new investment, assisted by eased rules on zoning for industrial development in the waterfront area in particular.

(2) Morgan Stanley's Buying Stance

The sharp growth in trade with China is helping the economy as well. The Japanese refer to it as a "kamikaze" wind, or wind of good fortune. The managing director of Morgan Stanley Real Estate, Sonny Kalsi, explained at a presentation in September to the American, Canadian and Osaka Chambers of Commerce, that his fund's aggressive investment in Osaka and the Kansai region is linked to a view they took in 2002 that China will be growth region, and have knock on benefits for Japan, and the Kansai region in particular, because of its much higher gearing to trade with China. Additionally, there was a double gearing opportunity because the property market looked oversold, especially in Kansai. Since then Morgan Stanley has invested around

25% of the over \$6 billion allocated for investment in Japan in the Kansai region. This is significantly higher than the fund's investments in central Tokyo. And, according to Kalsi, the fund is only half way through its investment cycle.

Morgan Stanley has seen rental rates improve 10% in the last year in Osaka and the Kansai region, and occupancy rates rise as high as 95%, from 80%. However, the market may now be reaching a turning point, as the investment risk to invest in property starts to reduce. Carlos Ramirez, a Canadian, who is one of the few non-Japanese active in the Kansai real estate market, notes that sellers are starting to set conditions when they look for buyers. For any one lot of land downtown there may be several funds from Tokyo bidding. Accordingly, foreign funds may have to re-evaluate their yield expectations, which until recently were net yield levels of 6% or over. More competition from domestic funds may mean the era of bargain hunting is coming to a close.

(3) Urban Renaissance Projects

There is however longer-term support for the property market provided by the central government's promotion of large-scale downtown redevelopment, under the Urban Renaissance Special Measures Act, announced in August 2002. In Osaka, there are several key areas that are benefiting from this program. The most important is the redevelopment of the Umeda Station Freight Yard, which was announced in 2002 [Osaka Renaissance News, June 2004].

The freight yard is described as the largest urban redevelopment project in Japan. It covers a 24-hectare area, equivalent to 78% of the area of the Shiodome re-development in Tokyo

(also the site of a former JR freight yard). Its impact on the economy will be much greater, however, because of its strategic location next to the city's main railway and subway connections. The sale of a 7-hectare portion of the site is due to be announced by the middle of next year. Redevelopment will begin by 2006 with completion of this first phase due in 2011.

The first major property development in the vicinity of the freight yard took place in 2002 when a large outlet of Yodobashi Camera opened next to the freight yard. It has been immensely successful, attracting a new younger customer especially into the area. Its success is certain to provide more confidence for prospective developers. Last year, in the government's annual land survey Yodobashi store topped the list of most expensive land in Osaka. In the government's land survey this year, land prices in several parts of Umeda rose Year On Year, for the first time since the Bubble.

(4) The Kita Yard Effect

Expectation around the redevelopment is beginning to produce a "Kita Yard effect". The first move came in February 2004 when the JR West group announced plans to undertake the total redevelopment of the JR Osaka-Umeda station area, including the development of a new office and shopping complex, with completion set for 2011. Mitsukoshi Department Store has signed to be the first anchor tenant. In May, Hankyu Department Store announced plans to redevelop its flagship store nearby, with completion set for 2011. After the Mitsukoshi store opens there will be a total of five department stores in the immediate area, which will ensure that Umeda retains its position as an upmarket retail centre, not only in Osaka, but in the whole of Kansai, as well as a major

attraction for tourists in the future who will be visiting from Asia especially.

Around Umeda other upmarket developments are going forward, supported by the knowledge that the whole area will eventually be transformed into a major shopping and business hub. The most advanced redevelopment is on the southern side of the JR tracks, opposite the freight yard, called Hanshin West, which is owned by the Hanshin Railway group. Redevelopment started in the late 1980s, when the plan to move the freight yard first surfaced. The final stage of development occurred in October 2004 with the opening of two Grade A buildings, Herbis Ent and the Daini Yoshimoto Building. The interiors of both buildings are especially stunning, incorporating a large theatre, shops and restaurants. Alongside them is the upmarket Ritz-Carlton Hotel, which opened its doors in 1997 under a management contract with the Hanshin group.

To the east of the freight yard is an area of land owned mainly by the other major private railway group, Hankyu. Redevelopment here has taken longer because of difficulties in consolidating land lots. Now construction is moving forward with a major office and commercial complex due for completion in 2006. The high-class Hankyu International Hotel and a theatre are already occupying part of the site.

(5) The Midosuji Bloc

A 4.4 km boulevard links Umeda with its southern counterpart, Namba, which is a major rail hub and retail centre. Development within this 4.4 km "Midosuji Bloc" is being driven forward by a number of factors. The first is the easing of building zone regulations, which the city government

applied for under the central government's special zone deregulation measures. This reduces the planning approval process to six months, and eases the Volume to Plot ratio, allowing developers to build taller buildings. Sogo Department Store was the first company to secure permission to expand its Floor Area Ratio for the redevelopment of its flagship store on Midosuji Boulevard, which will reopen in 2005.

A second factor helping to stimulate development is the city government's plans to change Midosuji Boulevard into a stroll area for shoppers and visitors. This has encouraged many shops and restaurants to open along the street, with similar results to the Marunouchi area of Tokyo, where the ground floors of drab office buildings have become populated with trendy new shops and restaurants.

The Shinsaibashi area, at the southern end of Midosuji Boulevard where the Sogo Department store is located, is a major beneficiary of these changes. Here like Umeda land prices are actually rising. The reason is that many major brand retail outlets have been attracted to the area over the last six years. This in turn has stimulated many independent labels, design shops, and creative studios to open in the streets around it, especially on the western side, in an area called Kita Horie, where real estate were much lower, but now are rising.

A short walk south of Shinsaibashi is the entertainment area and transport hub of Namba. The Takashimaya department store is next to the station, which connects directly to the Kansai International Airport. The Swissotel group is managing the main railway hotel. A landowning consortium, headed by Nankai Electric Railway,

developed the land immediately south of the station into a suburban style version of Roppongi Hills, called Namba Parks. The US architect has created a feeling of nature by using warm materials, curving lines, and generous green plantings. Linked to it is a 30-storey office tower. Both opened at the end of 2003. The success of Namba Parks is helping to serve as a counterweight to the redevelopment of Umeda at the northern end of the Midosuji bloc.

The other key area, for office property development especially, is Nakanoshima. This is an urban island formed where the main river through the centre of Osaka divides. It has always been a major head office area, but at the same time has suffered from the problem of poor public transport links to its western end. Keihan Electric Railway is now building an extension of its line, which stops at the Midosuji Boulevard, which will connect the western end of Nakanoshima, with completion scheduled for 2008. In anticipation the government has been developing part of the island as a cultural zone, including two new museums. It also built the city's main business convention centre at the western end of the island, which opened in 2000, next to the Rihga Royal's flagship hotel. It will be joined in 2005 by one of the largest new office developments undertaken in Osaka, the Shin Kanden Building.

(6) Office Market

There was a higher than average supply of new office buildings in 2003 and 2004, according to Ikoma CB Richard Ellis. This year Ikoma projects total supply of 108,392m², which represents about 1% of the total office building stock. In the five central wards of Tokyo for reference the

comparable ratio is 1.9%, according to Ikoma (down from 4.4% in 2003). Next year Ikoma projects new office supply to fall back to 81,985m² (or 0.8% of total office stock). In central Tokyo the comparable figures are 392,789m², representing 1.5% of total office stock. Nagoya, with which Osaka is often compared these days, will have a slight increase in office stock next year, helped by the effect of Aichi Expo 2005 and Toyota's increased investment in the region. Even so, the total supply of new offices will only be 61% the level of Osaka. Comparing the construction of Grade A office buildings in the two cities, between October 2004 and August 2005 a total of eight are due to be completed in Osaka and three in Nagoya, all of which are smaller than the top three in Osaka (nb. Ikoma's definition of "Grade A" buildings outside Tokyo includes a minimum of 16,500m² floor area in a prime office location).

The vacancy ratio at the 35 Grade A office buildings tracked by Ikoma in Osaka is around 7.0%. The average vacancy rate for all office buildings in Osaka is just under 10%. The comparable figures in central Tokyo are 4% for Grade A buildings and 6% for all office buildings. In Nagoya, the vacancy rate at Grade A buildings is under 4% and the general vacancy ratio is slightly under 9%. The vacancy ratio in Osaka however has been declining faster than in Nagoya.

Demand is mainly from companies who are already based in Osaka and looking for space to expand their operations or to consolidate offices into one location, according to Ikoma. Although property prices are showing a firmer trend, tenants still have strong negotiating power to secure rents at favourable rates. This is one sign that

the market is not yet in a full-blown recovery. One trend is that building rentals are tending to widen between newer buildings and older ones which offer less space. There is strong demand especially from companies which need to accommodate walk-in customer enquiries, such as temporary staffing agencies and educational institutions. In response to the government's program to help people acquire new skills at a time of economic transition many schools and universities have opened city centre campuses in the last two years. Another trend is that 20-30% of new office buildings now include space for commercial use, such as shops and restaurants.

An emerging factor in demand for commercial space is the development of tourism. A few years ago several financially troubled business hotels were forced to close, which left a relative shortage of accommodation in central Osaka. The promotion of tourism, coinciding with the shortage of beds in certain categories, and the potential demand from Asian visitors, seems to be a prime reason for investment in the sector. Morgan Stanley, for example, which has linked the expansion of China with its investments in the Kansai region, has bought at least four hotels in Kansai this year, two of which are in Osaka - one in Umeda and the other next to Shin-Osaka station.

(7) Condo Market

As the city puts more emphasis on the quality of life, the attraction of living downtown is growing as well, which is having the secondary benefits of stimulating demand for eating out, convenience stores, education and health services. Falling prices is

another factor in luring people back to the city. The downtown population has increased by an average of 2% from 1995 through to April 2004. Even so, the ratio of daytime to night-time population is still the highest in Japan, at 1.4x compared to 1.38x in central Tokyo. This suggests there is room to increase the number of residential units.

The condo market is viewed as a lower investment risk than the office market because buyers are easier to secure. The relaxation of building regulations in the special zones has led to a surge in condo development. There are now over a dozen high-rise blocks standing or nearing completion, whereas only two years ago there were none. According to a report by Merrill Lynch, entitled "Naniwa Renaissance" (Naniwa is the old name for Osaka), the supply of condos increased 8.9% Year On Year in 2003, to 9,812 units, or 31.3% of the total annual supply of condos in the Kinki area. This compares with a ratio of 23% the year before. Contributing to demand for condos is the fact that prices are only slightly higher than in the most popular commuter areas, typically around Y30 million (\$270,000) for a typical 3 LDK (Living, Dining, Kitchen) family size unit.

Demand for condos is providing a new market for sellers of surplus office buildings, which is helping to stimulate the recovery of the downtown office market. Combined with the other long-term drivers mentioned in this report, such as urban regeneration measures, tourism, and the strengthening of trade ties with Asia, it suggests the outlook for the property market is healthy, and even rosy.

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