Linking Japan

Winter 2013
Volume 5

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Quarterly Investment Insights

Daiwa House Residential

Cultivating Residential Investment to Deliver a Product Investors Understand and Recognize

Japanese Economy Outlook Fiscal 2012~2013

Offering PEACE of Mind
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The Japanese Real Estate Investment Market: 2012 Overview and 2013 Outlook

Publisher's Note

The year 2013 arrives with many in the foreign financial press talking about the weak yen policy of Prime Minister Shinzo Abe and I am forced to yell at my computer screen. What policy? This is just inevitability. It is not a policy. Nearly all of the programs the former government eliminated in a great big public spectacle maddingly egged on by the press, are now being quietly returned. In other words, business as usual with a side order of stimulus.

So where does this put us? Heck if I know. Prime Minister Abe was inept before, what makes this time any different? This is why I am forced to focus on the Japanese business world and hope that they have remembered how to do business without government interference – at least that Sharp and Panasonic can revive themselves in a weak yen state, despite more and more of their production already having been moved overseas.

Leading the rah, rah charge presently is real estate. We are seeing waves of core, value plus, and other capital entering the market from overseas. The Germans who sprinted out of Japan during the earthquake are back buying in Tokyo and Osaka along with other Europeans. Japanese REITs are seeing a recovery in their stock prices unseen in the past three to four years, and there seem to be more smiles to go around. As this issue gives a look on the economy this year and specifically on real estate, I hope that the economy finds some answers to its new paradigms, a slow growth economy and what is sure to be another inept government. And of course, just for continuity's sake that Prime Minister Abe doesn't have another stomach ache.

J. Michael Owen
President
Transpacific Enterprises

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Winter 2013

On the Cover
From Left: Masaru Okada – CIO & Managing Director
Yuji Yamada – CEO & President
Hirotaka Uruma – CFO & Director

Japanese Economy Outlook Fiscal 2012~2013

Economy to be Supported by a Recovery in Overseas Demand and Long-Term Post-Earthquake Reconstruction But is Not Self-Sustaining

Both current internal and external demand is deteriorating in the Japanese economy due to the end of the eco-friendly car subsidy program and a deceleration in overseas economies among other factors. This in despite of support from reconstruction demand related to the Great East Japan Earthquake of 2011. The indices of economic trends used to judge the condition of the economy have continued to decline since April 2012 and there is a very strong possibility that the Japanese economy entered a recessionary phase as of April. Furthermore, the dispute between Japan and China over the Senkaku Islands is a new risk that can potentially push the economy downward. In particular, the negative impact of this friction on import machinery with strong local sales in China is quite evident.

Under these conditions, the three key factors for analyzing the Japanese economy going forward are 1) the export environment including the impact of Japan-China friction, 2) the effects of the reconstruction demand on supporting the economy, and 3) the impact of the increase in the consumption tax rate that will be a huge factor in shifting domestic demand. This report will give an outlook on the Japanese economy from fiscal 2012 through fiscal 2013 by focusing on these three areas and provide a discussion as to the timing and momentum of the economic recovery.

Exports to Recover Gradually from Spring of 2013

First, let's take a look at overseas demand. Overseas economies are expected to begin a gradual recovery after entering 2013. In the U.S., the fiscal cliff may lead to a temporary slump in the economy, but the clear recovery in the housing market means that the economy centering on the household sector should show solid growth from the spring and after when the negative impacts of financial tightening subside. In China, the impact from the government implementing economic stimulation measures beginning in the spring of 2012 is expected to take shape and the growth, though gradually, will increase.

Moreover, as for the yen exchange rate which has continued to suppress exports, the risk of yen appreciation progressing one-sidedly is significantly reduced due to excessive concern over the U.S. economy, deterioration of the trade balance of Japan and other factors. Based on this, Japan's exports are likely to gradually recover after spring 2013.

As for concerns over the growing friction between Japan and China, we believe the respective changes in political leadership of each country create a great opportunity to improve relations since the depth of the Japan-China relationship is based on mutual economic dependence. Restoration of the relationship upon entering 2013 is expected to gradually occur. However, the risk of the issue continuing and having a serious negative impact on Japan cannot be eliminated. For information sake, in addition to transport equipment being heavily and negatively impacted, production of transport equipment, TVs and other equipment by local Chinese corporations is down year-on-year by 50%, 40% and 20% respectively and production is not expected to return to the previous year's levels for another nine months. The impact of the decrease in exports to China on real GDP of Japan is projected to be minus 0.6% through fiscal 2013 (Figure 1). Thus this area requires continued caution.

Figure 1: Impact on Japanese Economy Caused by Decrease in Production at Local Chinese Entities of Japanese Corporations (through Fiscal 2013, estimate)

(compared to fiscal 2011 performance)

	Real GDP	Domestic Corporate Earnings
Scenario (1) (settles down in 6 months)	-2.1 trillion yen (-0.4%)	-1.7 trillion yen (-3.7%)
Scenario (2) (settles down in 9 months)	-3.0 trillion yen (-0.6%)	-2.5 trillion yen (-5.5%)
Scenario (3) (settles down in 1 year)	-3.9 trillion yen (-0.8%)	-3.3 trillion yen (-7.2%)

Source: Macro-model simulation based on materials from the Ministry of Finance, Cabinet Office, etc.
Note 1: Assumes a drop in exports to China with the decrease in production of local Chinese entities of Japanese corporations.
Note 2: Simulated by the period it takes to settle down with the following paths of decrease assumed on a year-on-year production basis: Transport equipment: -50% → -25% → 0%, TVs (visual equipment and components): -40% → -20% → 0%, and Other: -20% → 10% → 0%.
Note 3: Accumulation of downward swing from the base line.

Consumption Tax Increase Driving up the Economy in Fiscal 2013, But Reactionary Downward Push in Fiscal 2014

As for domestic demand, automobile sales will see an expected reactionary downward push after entering 2013 due to the end of the eco-friendly car subsidy program. Simultaneously, governmental policies are expected to continue pushing the economy up. Post-earthquake reconstruction activities have become gradually pronounced since entering 2012 and are helping to support the economy. On the other hand, execution of the budget has been delayed in parts of the disaster stricken areas due to emerging bottlenecks of products and people. This has led to public investment falling behind the pace initially assumed at the beginning of 2012 and having an overall smaller scale. If we consider this delay in implementing the budget and the budgetary demands for fiscal 2013, we can expect public investment in fiscal 2013 to fall behind the levels of fiscal 2012 but to continue at a relatively high level and to support the economy for a prolonged period.

Governmental policy having a positive impact is not limited to reconstruction demand. With the consumption tax hike approaching in April 2014, there will be widespread "last minute" demand in the latter half of fiscal 2013 that is expected to push up the economic figures. In particular, personal consumption for durable and semi-durable goods that are expensive or can be stocked up are expected to experience significant last minute demand. In the case of housing investment, the last minute demand is expected to happen at an earlier date than general consumption due to the long time between actual completion and hand over of a finished property. An example from

Figure 2: Outlook of Japanese Economy and Product Prices

(Year-on-year comparison, %)

	2012				2013				2014	FY2011	FY2012	FY2013
	Jan.-Mar.	Apr.-Jun.	Jul.-Sep.	Oct.-Dec.	Jan.-Mar.	Apr.-Jun.	Jul.-Sep.	Oct.-Dec.	Jan.-Mar.			
	Actual			Forecast						Actual	Forecast	
Real GDP	5.7	- 0.1	- 3.5	- 0.7	1.2	1.5	1.7	3.3	4.3	0.3	1.0	1.3
Personal consumption	4.7	0.3	- 1.7	- 0.8	0.6	0.7	0.9	3.8	6.8	1.6	1.2	1.1
Housing investment	- 4.3	6.3	3.7	4.1	1.8	7.6	15.3	11.5	- 8.3	3.7	3.0	6.7
Capital investment	- 9.3	0.5	- 11.3	0.2	3.0	3.1	3.3	3.4	4.3	4.1	0.1	2.0
Inventory investment (contribution)	(- 1.4)	(- 1.2)	(- 1.0)	(- 0.0)	(- 0.1)	(- 0.1)	(- 0.0)	(- 0.0)	(- 0.1)	(- 0.5)	(- 0.0)	(- 0.1)
Government consumption	5.7	1.9	2.4	0.8	0.5	0.3	0.2	0.5	0.7	1.5	2.4	0.5
Public investment	34.9	23.6	6.1	1.9	5.8	1.0	0.4	- 1.2	- 6.2	- 2.3	12.4	1.2
Public inventory (contribution)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)	(- 0.0)
Exports	13.9	3.3	- 18.9	- 3.9	0.9	4.3	4.5	4.8	4.8	- 1.7	- 1.0	1.1
Imports	9.7	7.4	- 1.8	0.2	1.6	2.1	2.9	3.8	5.1	5.2	4.7	2.1
Domestic private demand (contribution)	(- 2.7)	(- 0.8)	(- 1.5)	(- 0.3)	(- 0.8)	(- 1.1)	(- 1.4)	(- 3.1)	(- 4.5)	(- 1.1)	(- 0.8)	(- 1.2)
Government and public demand (contribution)	(- 2.4)	(- 1.4)	(- 0.8)	(- 0.3)	(- 0.4)	(- 0.1)	(- 0.1)	(- 0.0)	(- 0.2)	(- 0.2)	(- 1.0)	(- 0.2)
Net exports (contribution)	(- 0.4)	(- 0.7)	(- 2.8)	(- 0.6)	(- 0.1)	(- 0.3	(- 0.2)	(- 0.1)	(- 0.1)	(- 1.0)	(- 0.9)	(- 0.2)

(Year-on-year comparison, %)

Nominal GDP	2.3	2.9	- 0.3	- 0.3	- 1.5	- 0.7	0.7	1.8	2.8	- 1.4	0.2	1.1
GDP deflator	- 1.1	- 1.0	- 0.8	- 0.5	- 0.8	- 0.3	- 0.4	- 0.1	0.1	- 1.7	- 0.8	- 0.2
Consumer prices (excluding fresh foodstuffs)	0.1	- 0.1	- 0.3	- 0.1	- 0.4	- 0.1	0.0	0.1	0.1	0.0	- 0.2	0.1

(Year-on-year comparison, %)

Total unemployment rate (%)	4.6	4.4	4.2	4.2	4.1	4.1	4.1	4.0	4.0	4.5	4.3	4.1
Yen/dollar exchange rate	79	80	79	81	82	82	83	83	84	79	81	83
Import crude oil price (dollars/barrel)	116	123	106	113	114	115	115	115	115	114	114	115

Source: Prepared by the Japan General Institute based on materials of the Cabinet Office and Ministry of Internal Affairs and Communications
Note: Assumes that the consumption tax rate is hiked form 5% to 8% in April 2014.

the past is April 1997 when the last consumption tax hike occurred, a significant level of last minute demand occurred in the July to September period two quarters before the actual tax hike, and personal consumption was driven up by 0.8% leading up to the tax hike. The same impact can be expected this time.

Weak Recovery in Domestic Demand

However, despite special factors like reconstruction demand and last minute demand from the increase in the consumption tax rate greatly driving up domestic demand in Japan throughout fiscal 2013, the true recovery strength of demand as represented in employment, income and capital investment is weak and the fact is it is difficult to expect any large improvement going forward.

In the corporate sector, earnings are expected to gradually improve thanks to the recovery among overseas economies and the temporary break in the excessive appreciation of the yen. However, the probability is very high that corporations will remain very cautious regarding increasing investment activities in Japan and increasing employment and income. This is because, 1) the implied growth rate in Japan is dropping significantly due to the decline in the population, etc. while high growth is expected overseas, and 2) there are no signs of movements to improve the difficult working environment in Japan that is said to struggle under "six immense weights" including the high corporate tax rate and utility costs. Since the distribution of income to households will remain low, compensation to employees – the source of consumption – will continue to struggle.

In this manner, within the large drop in the implied growth rate of Japan, the self-sustaining recovery mechanism in which investment, employment and income increase due to production increasing as a result of a recovery in overseas demand is finding it harder to function. Domestic demand is projected to continue on a weak note as long as there is no large change in this environment, such as an expansion in the growth expectations and elimination of the "six immense weights."

Recovery in Overseas Demand, But Domestic Demand will Remain Weak

The outlook for the Japanese economy after entering 2013 based on the above analyses are 1) a reactionary drop in automobile sales with the end of the eco-friendly car subsidy program, 2) shrinking of the downward pressure on exports caused by the impact of Japan-China friction, and 3) recovery in the U.S., China and other overseas economies. Comprehensively, these mean a quick recovery to positive growth (Figure 2). As a result, the economic recessionary phase that began from April 2012 will end in a comparatively short period of time. During the first half of 2013, the reconstruction demand will expand enough to support the economy and last minute demand prior to the raising of the consumption tax rate will emerge from the middle of the year and greatly push up the economy through an increase in acquisitions of durable goods and investments in housing. Consequently, growth in fiscal 2012 and fiscal 2013 is expected to be about +1%. Further, the Liberal Democratic Party of Japan, which was victorious in the House of Representatives election of December 2012, will issue economic stimulus measures immediately after the new government takes office in response to the recent deteriorating economy, and government and public demand centering on public works will probably further push up the growth rate. Real GDP will be driven up by about +1% points if, for example, the scope of the economic stimulus measures has 5 trillion yen allotted to truly effective measures not bogged down by politics that directly contributes to an expansion in the GDP.

Domestic Private Demand Growth Measures Essential with Raising of Consumption Tax Rate

Therefore, we can expect an acceleration of growth rate in fiscal 2013 but we cannot deny that a part of this is being driven by last minute demand before the hike in the consumption tax rate. After entering fiscal 2014, there will be a reactionary downward push from the last minute demand and a drop in the purchasing power of households caused by the rise in product prices caused by the hike in the consumption tax rate and these will lead to the negative impact of a drop in the level of real personal consumption. As an aside, according to a macro-model simulation and other approaches, in the event the consumption tax rate is hiked from 5% to 8% in April 2014, the impact from the reaction to the last minute demand and the drop in purchasing power caused by the rise in product prices is estimated to drive the real GDP down by 1.4% (Figure 3). The fiscal 2014 economy may suffer greatly unless countermeasures are promptly implemented to offset this negative impact. Therefore, it is imperative that the base of domestic demand be reinforced over the next year.

Figure 3: Impact on Fiscal Year caused by Consumption Tax Hike (5% → 8%, estimate)

	Real GDP	
		Real Personal Consumption
Downward Movement	- 1.4%	- 1.9%
Last minute demand factor	-0.6%	-0.8%
Product price hike factor	-0.8%	-1.1%

Source: Prepared by the Japan Research Institute based on materials from the Cabinet Office, etc.
Note: Divergence from the base line that exists if there wasn't a hike in the consumption tax rate.

A broad swath of concrete governmental measures are needed to achieve this, including tax support or benefits that improve corporate competitiveness, and develop and promote high value-added products and services, conclusion and promotion of a free trade treaty that aims to expand efforts to achieve greater overseas demand, and an enhancement of the reduction in home loan taxes and abolishment of automobile-related taxes to prevent fluctuations in demand immediately before and after the raising of the consumption tax rate, etc.

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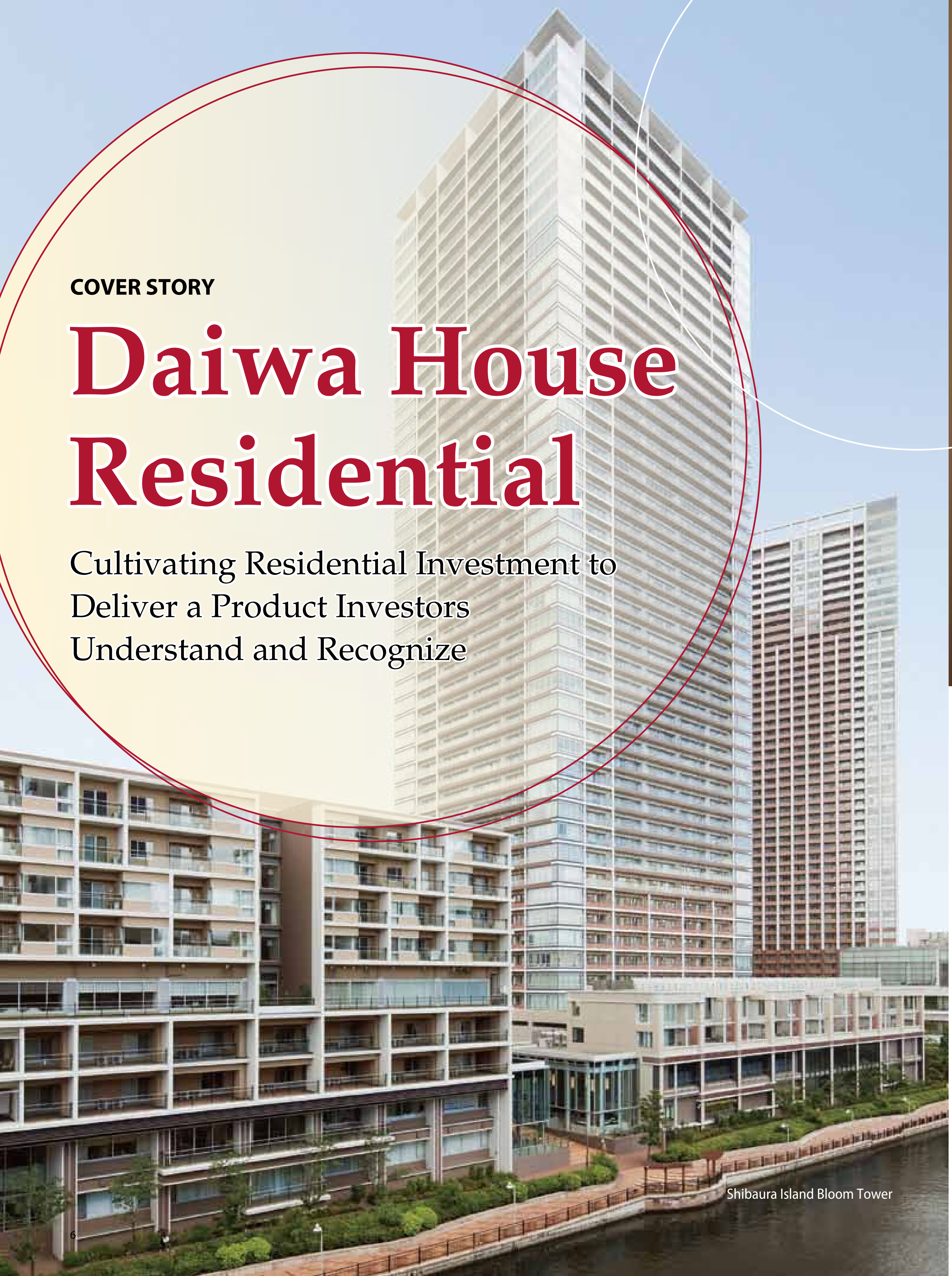
COVER STORY

Daiwa House Residential

Cultivating Residential Investment to Deliver a Product Investors Understand and Recognize



Shibaura Island Bloom Tower

Yuji Yamada
CEO & President
Daiwa House Asset Management Co., Ltd.

Daiwa House Asset Mgt.™
Daiwa House Group

Daiwa House Residential Investment Corporation (DHI) is a residential REIT specializing in rental housing centering on the Tokyo metropolitan area. As its name indicates, DHI is sponsored by Daiwa House Industry, Co., Ltd., a leading housing maker headquartered in western Japan that is particularly known for its residential offerings. DHI boasts a portfolio of 123 properties with a total acquisition price of 211 billion yen. DHI is able to leverage the comprehensive strength of the Daiwa House Group, which boasts strengths in developing, managing and leasing residential housing. The greatest feature of the REIT is that it is able to further demonstrate the stable rents Japanese residential units are renowned for through the reliable management capabilities of the sponsor group.

The Daiwa House Group is active nationwide developing rental houses, condominiums and commercial facilities. Its management firm is responsible for managing over 300,000 rental residential units.

With the support of the Daiwa House Group such as warehousing functions, DHI is able to acquire relatively new properties and, as a result, the average age of portfolio properties is 7.5 years as of the end of 2012. Furthermore, due to the high credibility of the Daiwa House Group, DHI is able to procure funds from financial institutions for acquiring properties at minute cost levels.

DHI merged with New City Residence Investment Corporation in April 2010 to achieve sudden growth from 51.1 billion yen to 190.5 billion yen in acquisitions, and since the merger has acquired 44 billion yen of properties while disposing of others to attain a total acquisition price of 211 billion yen. According to CEO & President Yuji Yamada of Daiwa House Asset Management, the asset manager of DHI, “It is our intent to achieve a portfolio value of 300 billion yen within the next four to five years while maintaining steady dividends for investors.”

Royal Parks Toyosu

Castalia Nakameguro

In addition, DHI is conscious of its responsibility to society as a product that is actively invested in by individuals. Therefore, both its assets manager, Daiwa House Asset Management, and its sponsor exercise care to avoid conflicts of interest via an internal Compliance Committee, and the appointment of an outside director who is actually a U.S. investor residing in Hong Kong. This is a feature unique to this REIT. In addition, properties acquired from the sponsor by DHI have been acquired at cap rates higher than the market.

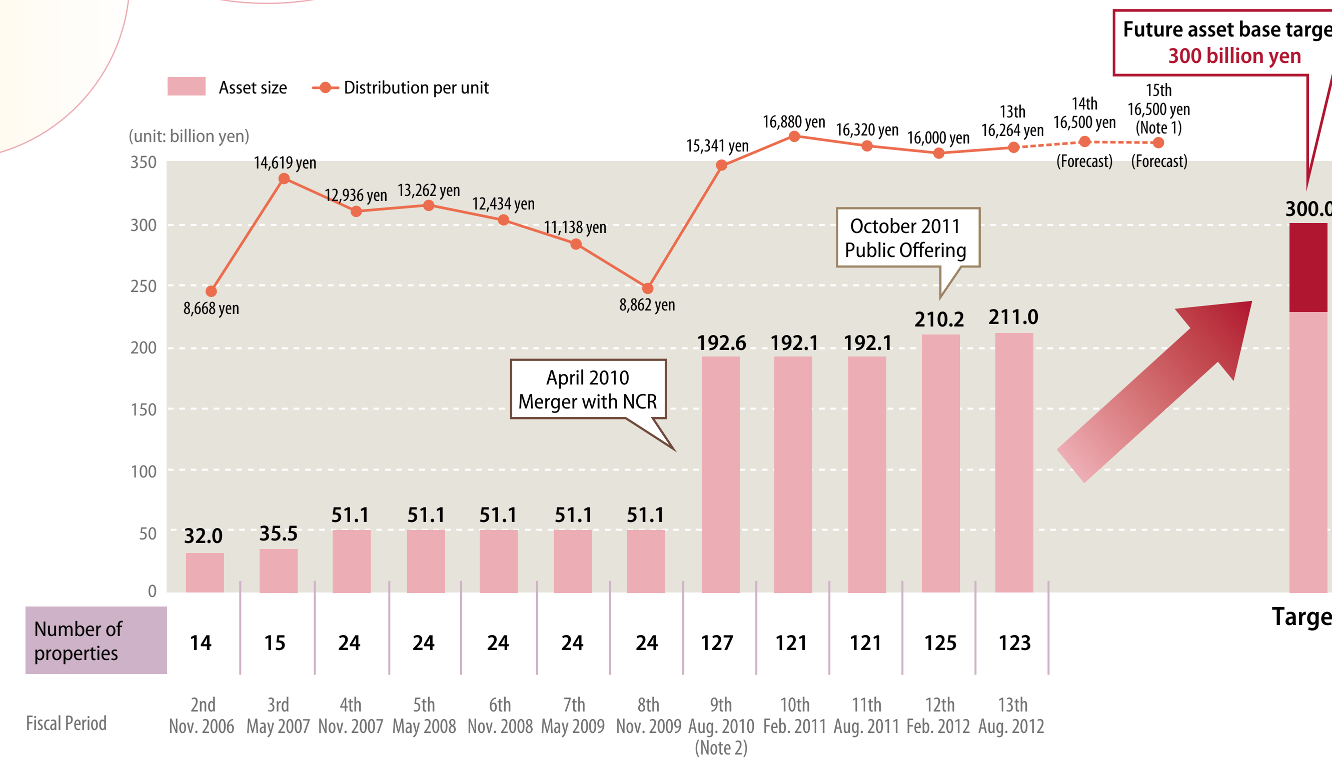
Investment Policy Calling for Stable Rents and Performance

DHI invests in residential properties for their comparatively stable rents and occupancy rates. The REIT primarily invests in the Tokyo metropolitan area where population increases are anticipated and plans to increase its share of investments in areas where the Daiwa House Group applies its network and regional knowledge to deliver strong development products. Simply put, areas where strong demographics are demonstrated are targets for investment as a means to reduce the risks of excessive concentration in a single area and include areas such as Osaka and Kyushu. This fact also points to the notion that though the Japanese population is widely reported to be shrinking, there are areas where robust growth is projected to continue.

DHI also primarily invests in compact type properties, which accounted for 84% of the portfolio as of August 31, 2012, as this type delivers the greatest stability among rental products. It is also noteworthy that the Japanese REIT product boasts a high quality found more often in for-sale products than rental products. DHI is also utilizing an exclusive site for residents to answer questions, earn points and receive discounts at various service providers such as fitness clubs. This system is being used to create an identity that tenants want to be a part of and do not want to leave.

Daiwa House Asset Mgt.

Figure 1: Growth History

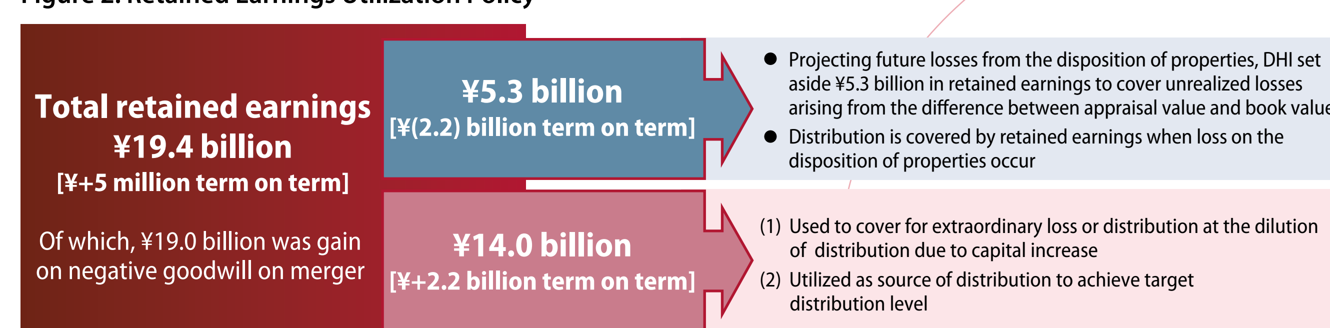


Note 1: The forecast distribution per unit for the 15th Fiscal Period will be revised in proportion to the investment unit split (half), resulting in a revision from ¥16,500 to half that of ¥8,250.
Note 2: The 9th fiscal period is the nine-month period from December 1, 2009 to August 31, 2010 due to a change in fiscal period-end.

Leveraging Retained Earnings for Greater Stability

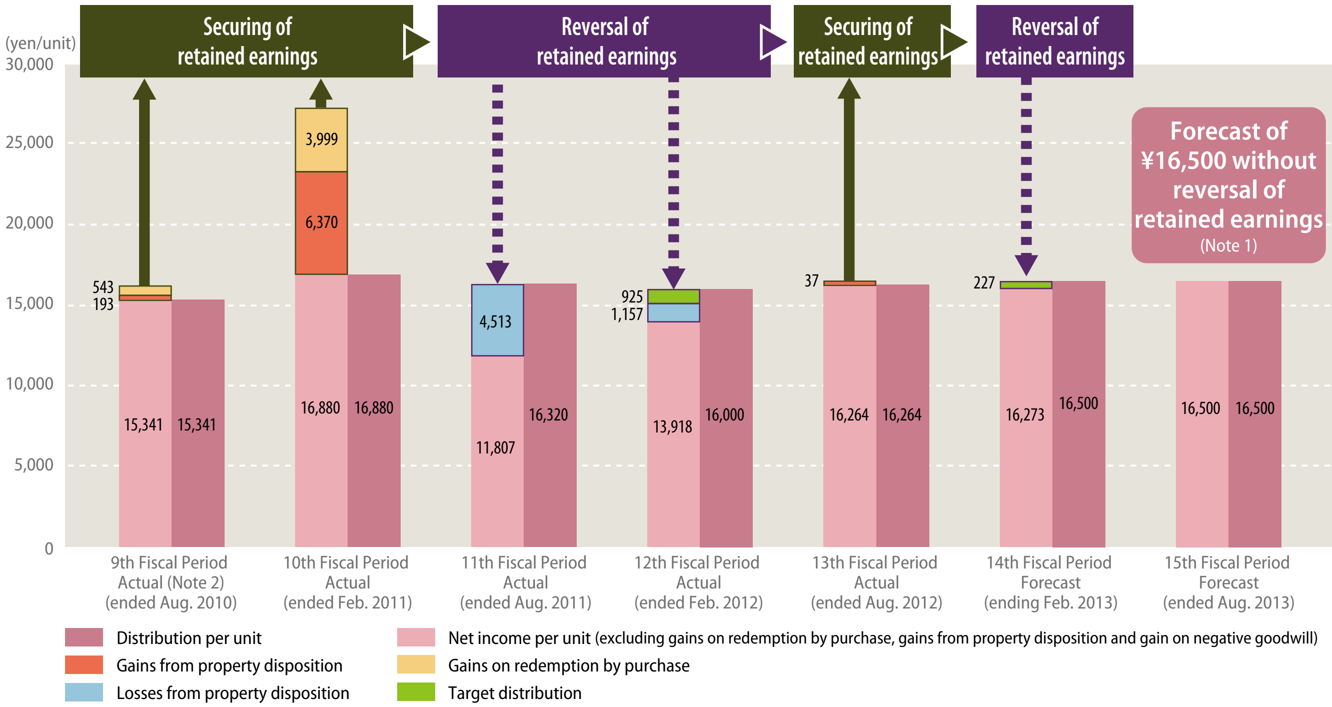
DHI has applied the earnings from negative goodwill that were gained from the merger, capital gains from selling real estate, and other earnings to retained earnings of 19,473 million yen as of August 2012. DHI proactively applies these earnings to fulfill its medium to long-term mission of stable dividends and stable growth of the REIT. The specifics of the DHI policy on retained earnings are illustrated in the figure below.

Figure 2: Retained Earnings Utilization Policy



Daiwa House Asset Mgt.
Daiwa House Group

Figure 3: Trend in Stabilization of Distribution through Securing and Reversal of Retained Earnings



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Retained earnings (reserve for distribution) increased by a total of ¥462 million

	9th Fiscal Period Actual (ended Aug. 2010)	10th Fiscal Period Actual (ended Feb. 2011)	11th Fiscal Period Actual (ended Aug. 2011)	12th Fiscal Period Actual (ended Feb. 2012)	13th Fiscal Period Actual (ended Aug. 2012)	14th Fiscal Period Forecast (ending Feb. 2013)	15th Fiscal Period Forecast (ending Aug. 2013)
Net income	¥1,909 million (Note 3)	¥3,245 million	¥1,401 million	¥2,234 million	¥2,616 million	¥2,612 million	¥2,648 million
Retained earnings (reversal)	¥87 million	¥1,241 million	¥(535 million)	¥(334 million)	¥5 million	¥(36 million)	—
Total distributions	¥1,821 million	¥2,004 million	¥1,937 million	¥2,568 million	¥2,610 million	¥2,648 million	¥2,648 million

Note 3: Net income for the 9th fiscal period (ended Aug. 2010) was ¥20,918 million. However, for the purpose of comparison, the figure of ¥1,909 million, which excludes ¥19,009 million gain on negative goodwill, is presented.

Achieving Social Significance

"REITs have actually played a large role in transforming the real estate industry of Japan. J-REITs have only existed for a little over 10 years but are responsible for entrenching the concept of discounted cash flows in real estate and also bringing a sizeable amount of transparency to the Japan market, which of course has made the market a destination for institutional investors," states Yamada. Adding that, accounting for 9 to 10 trillion yen of the 120 trillion yen of income-generating property that exists in Japan, REIT properties are fast becoming the central actors of the real estate market and are also poised to play a key role in eliminating deflation."

The key for Japan to be recognized as a global investment market is that it be accessible to foreign investors. There also must be an understanding that external management of REITs, as exists in Japan, is not a bad thing as there is an established strong commitment to compliance and conflicts of interest are not a concern. Yamada states, "Regardless of how the market is perceived, we are committed to becoming a REIT with a favorable atmosphere that investors feel is accessible."

Desiring to be the Choice of Tenants and Investors

As mentioned above, DHI is committed to tenants through enjoying fitness clubs that have benefits and other exclusive privileges so that they want to continue to live in one of their properties. Yamada states, "It is simple, tenant satisfaction leads to the satisfaction of all unitholders."

Likewise DHI seeks to be one of the top choices for investors.

Castalia Tower Shinagawa Seaside

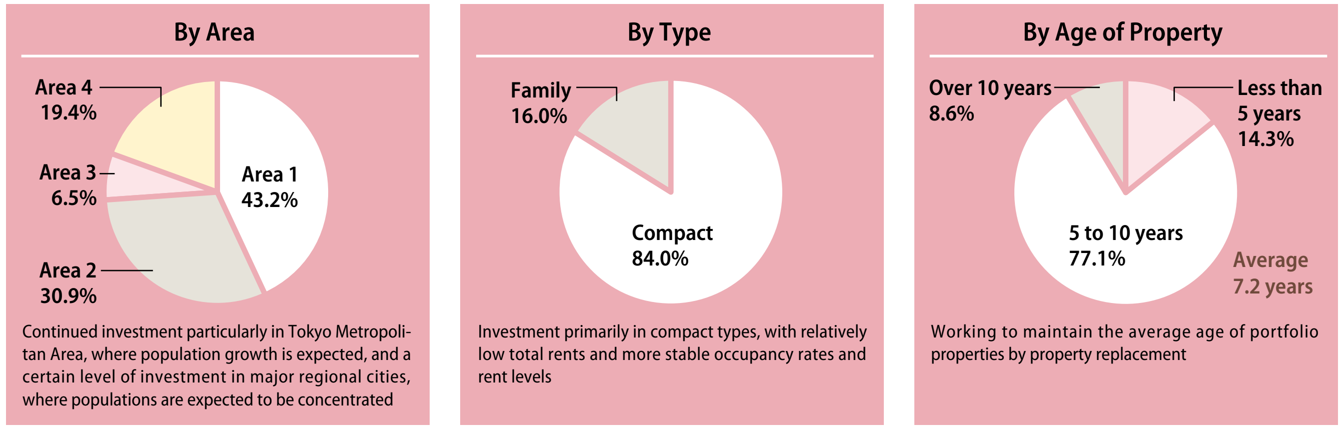
Qiz Ebisu

Since DHI is trading around 600,000 yen, the board of directors met and decided to split the investment units so that investors would feel that the units are more accessible.

DHI has been receiving requests from investors desiring the minimum investment amount be lowered as well as requests for investment unit liquidity enhancement measures. The split will help create greater volumes of trade as they are easier to buy and sell. The added volume and potential increased interest of foreign investors will invigorate the market, which is one of the key goals of the split.

The split itself will increase the number of units from 160,535 to 321,070 units on February 28, 2013, which will take the 15th Fiscal Period (six months ending August 2013) distribution from 16,500 yen to 8,250 yen. The increase in volume and accessibility is expected to contribute to improving DHI's position in the market and heighten the interest of foreign investors. Yamada states, "We need to be a REIT that values the interests of our investors and a REIT that is selected even in the event of a population decline. DHI is the residential REIT that can and will achieve our goal of being the REIT of choice."

Figure 4: Portfolio Distribution at end of 13th Fiscal Period (as of August 31, 2012)



Note 1: Value by area and by age of property is calculated based on acquisition prices. Value by type is calculated based on the number of residential units in each classification.
Note 2: (1) Area 1 (5 central wards): Chiyoda Ward, Chuo Ward, Minato Ward, Shibuya Ward and Shinjuku Ward
(2) Area 2 (Other 23 wards): 23 wards of Tokyo excluding Area 1
(3) Area 3 (Tokyo Metropolitan Area): Tokyo excluding Area 1 and Area 2, Kanagawa Prefecture, Saitama Prefecture and Chiba Prefecture
(4) Area 4 (Other): Other cities with populations of more than approx. 100,000.
Note 3: Types are defined as follows: Compact: leasable area of less than 60m² / Family: leasable area of over 60m².

FEATURE

Offering PEACE of Mind

Heiwa Real Estate REIT Provides More Than Just Rock-steady Earnings and Distributions

HEIWA REAL ESTATE REIT, Inc.

Crescendo Co., Ltd. was founded in March 2000, acquired its operational license a year later and in May 2001 changed its name to Canal Investment Trust Co., Ltd. In early 2002 it launched proceedings to establish an investment corporation, and the IPO for Crescendo Investment Corporation was conducted on the Tokyo Stock Exchange REIT market in March 2005.

In the fall of 2009, Canal Investment Trust Co., Ltd. became a wholly owned subsidiary of Heiwa Real Estate Co., Ltd., a developer established in 1947 and based in Tokyo with offices in Osaka, Nagoya, Fukuoka and Sapporo.

In July 2010, Canal Investment Trust became Heiwa Real Estate Asset Management Co., Ltd.

In October 2010, Heiwa Real Estate Asset Management Co., Ltd. executed an absorption-type merger with Japan Single-residence Asset Management Corp. (JSR), resulting in a significant increase in the size and depth of its portfolio by bringing together the properties of the two investment corporations – the new entity was renamed Heiwa Real Estate REIT. As of December 2012, the REIT had 91 properties at a value of nearly 140 billion yen under management. Further, the integration of accumulated knowhow in the operation of office and residential properties enabled a noteworthy improvement in occupancy rates.

Heiwa Real Estate REIT (8966) is a fund comprised mainly of office and residential properties, concentrated in the Tokyo Metropolitan area. Strong sponsorship, ambitious goals and a portfolio of newer, advantageously located properties makes this entity one that merits closer inspection.

Takaya Ichikawa
President & Representative Director
Heiwa Real Estate Asset Management Co., Ltd.

Heiwa Real Estate REIT

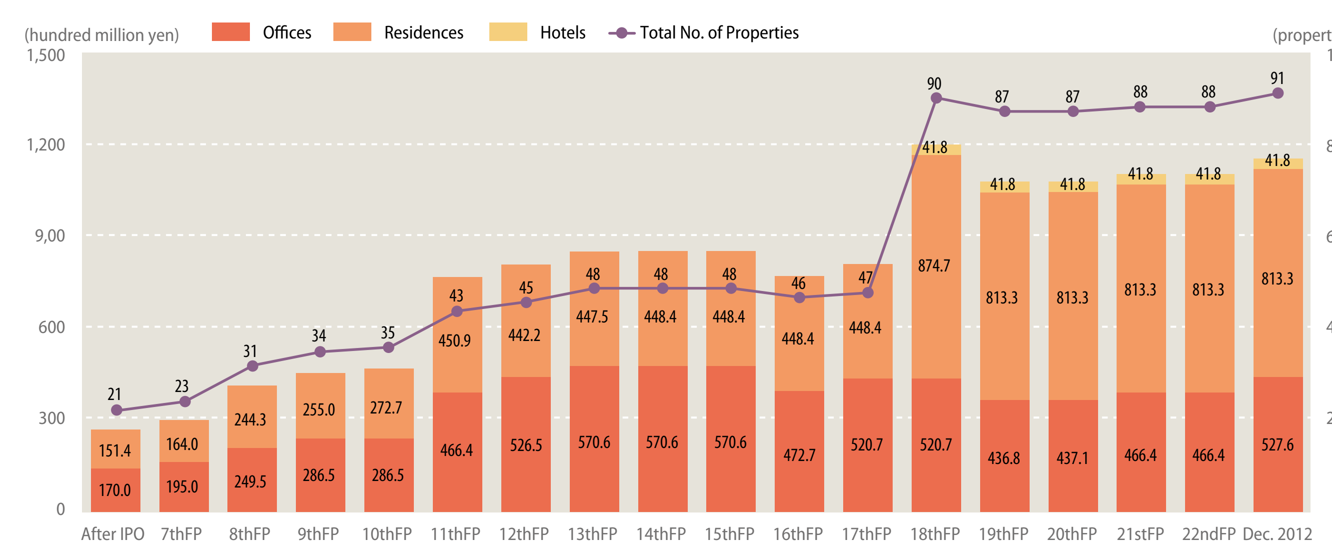
Heiwa Real Estate REIT (HRE REIT) is overseen by Executive Director Masaaki Higashihara who, until accepting this post in December 2009, spent his career primarily with one of Japan's more well-known financial institutions. HRE REIT looks to maintain a balance on a purchase price basis of 50% between its office and residential properties, with a major proportion of its assets located in Tokyo, the country's financial, industrial and cultural center. Heiwa Real Estate Co., Ltd. – HRE REIT's sponsor, and owner, operator and manager of such high-profile properties as the Tokyo Stock Exchange and Osaka Securities Exchange buildings – provides HRE REIT with greatly enhanced information and financial support, and combined with the professionalism and specialized expertise of Heiwa Real Estate Asset Management ensures steady external and internal growth going forward.

Portfolio

Since its listing on the Tokyo Stock Exchange in 2005, HRE REIT has grown its portfolio from 21 properties at a value of around 32 billion yen to an AUM (as of December 2012) of just under 140 billion yen, with 91 office, residential and hotel properties in and around Tokyo.

In the 12 months from November 2011 through November 2012, HRE REIT improved its overall occupancy rate from 95.1% to 96.6% through successful rent adjustments at its residential properties. Occupancy at its office properties started and ended the 12 months at over 97% thanks to locations in the Central 5 Wards of Tokyo. Office properties are vulnerable to economic swings, and during periods of growth performance

Growth Of Heiwa Real Estate REIT Since IPO



Note: FP stands for Fiscal Period.

HIROKOJI AQUA PLACE

- Completed May 2008
- Purchased March 2012
- Four-minute walk from Shinsakae Station on the Nagoya City Subway Higashiyama Line; seven-minute walk from Takaoka Station on the Nagoya City Subway Sakura-Dori Line
- Faces major thoroughfare and high visibility
- Few office buildings in area despite superior access

can be expected to improve. Conversely, residential properties remain relatively steady, not dramatically affected by fluctuations in economic conditions. In this regard, HRE REIT's portfolio is well balanced in terms of profitability and stability. The merger with JSR enabled capitalization on its specialized experience in residential real estate, and HRE REIT enjoys formidable support on the office side from its sponsor, Heiwa Real Estate.

For the 22nd Fiscal Period (six months ended November 2012), HRE REIT announced 4,295 million yen in operating revenues, 1,794 million yen in operating income, 1,049 million yen in ordinary income, and 1,049 million yen in net income.

Since being appointed Representative Director of Canal Investment Trust in January 2010, Takaya Ichikawa has steered the management of the REIT's assets through a strategic merger executed amidst one of the most grueling economic environments in modern history. This included overseeing comprehensive structural change within the asset manager, which adopted a two-division configuration to enhance operational efficiency and transparency, while at the same time bolstering its risk management capability.

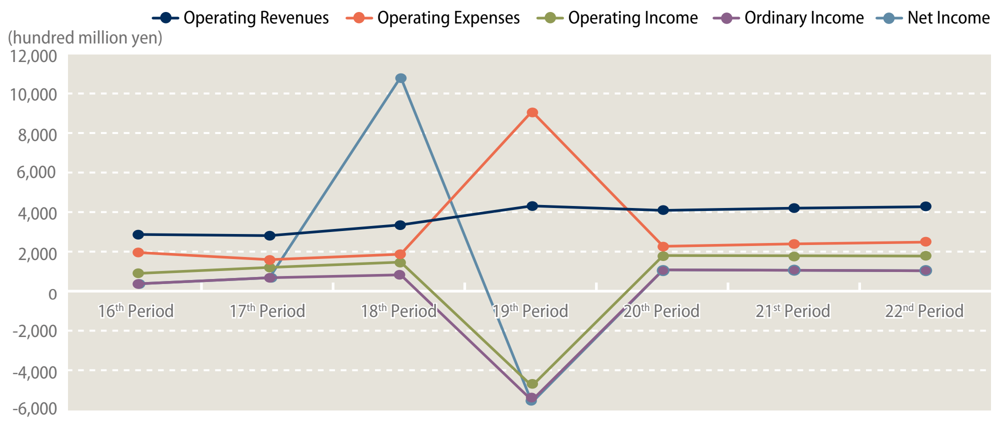
Sponsorship

From its sponsor, Heiwa Real Estate Co., Ltd., HRE REIT enjoys benefits such as first refusal rights on owned or developed properties; rapid sharing of information on brokered properties it handles; 'pre-emptive' acquisition of properties that may strengthen the REIT's portfolio long term (warehousing); acquisition of assets no longer beneficial to the REIT's portfolio; and co-ownership or sectional ownership of the REIT's existing assets or properties it plans to acquire. Heiwa Real Estate also provides property management services, access to considerable financial resources and support, and the purchase of additional investment units when issued by the REIT.

HRE REIT aims to ensure long-term growth through the formation of a value chain incorporating the operational processes of the Heiwa Real Estate Group.

Heiwa Real Estate Asset Management's aggressive measures to restructure debt; to streamline and maximize the efficiency of the portfolio through cooperation with the sponsor; and to effectively and consistently manage HRE REIT's LTV (nominally between 40 and 50% with a ceiling of 65% — as of May 2012 it was at 45.7%) have earned HRE REIT praise from credit rating agencies. In September 2012 Rating and Investment Information, Inc. (R&I) upgraded the REIT's rating to BBB+ with a stable outlook, and the following month the Japan Credit Rating Agency, Ltd. (JCR) assigned the REIT an A- rating with a stable outlook.

Historical Performance of Heiwa Real Estate REIT



Note: The 16th through 22nd Fiscal Periods run from June 2009 through November 2012.

FISCAL PERIOD	ENDING	DISTRIBUTIONS PER UNIT (yen)
16th	November 2009	734
17th	May 2010	1,317
18th	November 2010	1,375
19th	May 2011	1,550
20th	November 2011	1,574
21st	May 2012	1,550
22nd	November 2012	1,560
23rd (forecast)	May 2013	1,640
24th (forecast)	November 2013	1,600

SAKAE MINAMI HEIWA BUILDING

- Completed July 2002
- Purchased December 2012
- Eight-minute walk from Yabacho Station on the Nagoya Municipal Subway Meijo Line and Sakae Station on the Nagoya City Municipal Subway Meijo and Higashiyama Lines
- Located in busy commercial area that is recognized as being a center for art and design

Market

Office building vacancy in the Central 5 Wards of Tokyo was at 9.4% (Miki Shoji Co., Ltd.) as of May 2012 due to new supply becoming available, but rates at existing properties had fallen from 8.72% to 8.42% since the end of 2011, a clear indicator of improving conditions. While average rents in Tokyo were down against the end of the previous period, the rate of decrease has slowed noticeably. Looking at residential real estate, though new housing starts have failed to gain substantial traction, the rental housing market continues to flourish with a steady population influx into the metropolis and growing demand for space in smaller, seismically superior properties.

Sponsor Value Chain

Note: ML stands for Master Lease and PM stands for Property Management. In certain instances, Heiwa Real Estate Co., Ltd. may recommission partial property management duties to Heiwa Service Co., Ltd.

"Mission PEACE"

At Heiwa Real Estate Asset Management, our mission is to apply our passion and high aspirations to our efforts toward the long-term development of the J-REIT market, as well as to continued social and economic development.

PRIORITY
Nothing is more important to us than maximizing value for our shareholders.

EARNING TRUST
We constantly endeavor to earn and maintain the trust of all stakeholders – from unitholders to tenants and financial institutions.

AGGRESSIVENESS
Our goal as a highly specialized professional organization is to perform proactive, high-quality fund management conducive to enhancing the profitability and stability of assets under management.

COMFORT
Through investment in and management of superior income properties, we work to provide comfortable urban living environments and services.

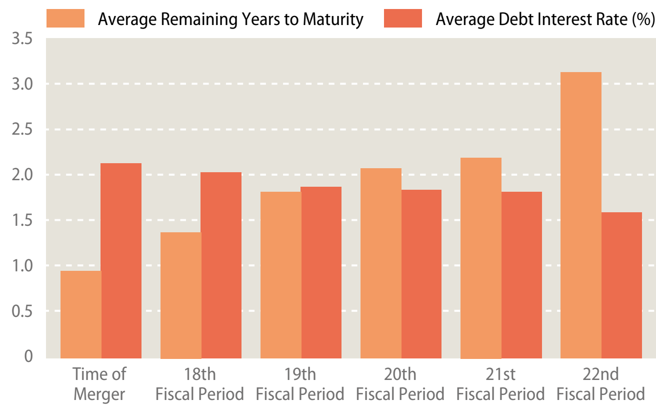
ETHICS
We deliver a high standard of corporate ethics through our thoroughly compliant and highly transparent management structure.

Left: **Takaya Ichikawa** Right: **Masaaki Higashihara**, Executive Director, Heiwa Real Estate REIT, Inc.

MITA HEIWA BUILDING (leasehold land)

- 21 floors
- Purchased December 2012
- Located at intersection of major thoroughfares
- Superior access to public transportation, with two subway lines and one surface train line within walking distance

Improvement in Financial Position



At the beginning of 2012, land price data showed a decline for the 4th straight year, but the rate of decline is slowing and aggressive monetary easing and large-scale public works projects promised by the new administration may contribute to gradual economic and then market recovery.

Medium-term Management Plan

In September 2009, HRE REIT issued its medium-term management plan and launched Stage 1 – Restructuring Foundation for Growth. From inception through the end of the 19th Fiscal Period (May 2011), the REIT successfully executed its absorption of JSR, and using the negative goodwill resulting from the merger disposed of some of the less attractive properties in the newly formed portfolio. It welcomed Heiwa Real Estate Co., Ltd. as its sponsor, which immediately strengthened its financial base.

Entering the 20th Fiscal Period, the REIT launched the next phase of the plan, Stage 2 – Towards the Phase of Re-Growth. The goals in this phase are decidedly more focused – the REIT has made strategic property acquisitions, placed the sponsor in charge of property management operations, and restructured loans while also succeeding in welcoming aboard new lenders. It has achieved a reduction in financial costs of two basis points and lengthened loans by 5.4%. Further significant improvements were achieved in the 22nd Fiscal Period – the average time to maturity has been lengthened to 3.1 years, and the average interest rate of debt has been lowered to 1.61%.

In December 2012 Heiwa Real Estate REIT launched its first public offering since the merger, and succeeded in raising about 5 billion yen. Using the funds procured, the REIT acquired three properties (Kobe Kyukyoryuchi Heiwa Building, Mita Heiwa Building, Sakae Minami Heiwa Building) from its sponsor, Heiwa Real Estate. Through the prudent selection of superior office properties utilizing its sponsor pipeline, it enhanced not only the scale but also the quality and profitability of its portfolio. Furthermore, in addition to reducing its LTV and greatly bolstering the stability of its financial foundation, the REIT has succeeded in putting itself in an advantageous position in terms of property acquisition.

A Look Ahead

For the 23rd Fiscal Period (ending May 2013), HRE REIT forecasts operating revenue of 4,553 million yen (+7.3%) against operating expenses of 2,732 million yen (+9.0%), operating income of 1,821 million yen (+4.8%), ordinary income of 1,132 million yen (+14.2%) and net income of 1,132 million yen (+14.2%). The REIT's forecast for the 24th Fiscal Period (ending November 2013) is for operating revenue of 4,535 million yen (-0.4%) against operating expenses of 2,579 million yen (-5.6%), operating income of 1,955 million yen (+7.4%), ordinary income of 1,273 million yen (+12.5%) and net income of 1,273 million yen (+12.5%).

Heiwa Real Estate Asset Management Co., Ltd.
From Left: **Yuji Tomiyasu** – Managing Director; General Manager, Business Planning Division **Satoru Yamanaka** – Executive Managing Director **Takaya Ichikawa** – President & Representative Director **Masanori Hirano** – Managing Director; General Manager, Investment Management Division; General Manager, Real Estate Investment Department

The Japanese Real Estate Investment Market: 2012 Overview and 2013 Outlook

The regionally-unrivalled depth of Japan's real estate market was highlighted in 2012 as deal flow shifted away from an office sector constrained by a lack of purchasing opportunities to alternative asset classes, most notably retail and logistics. Increased liquidity in the capital markets was demonstrated by the structuring of four new listed J-REITs - the first in as many years - as well as new private placement REITs affiliated with blue-chip names such as Goldman Sachs and Mitsubishi Corporation. In addition to expansion in the REIT market, overseas funds seeking stable, long-term returns refocused their attention on Tokyo and the country's key regional cities. The resulting broad-based competition for quality assets maintained downward pressure on cap rates across the core market sectors.

Investment volume

Preliminary figures compiled by Real Capital Analytics (RCA) suggest that approximately JPY2.07 trillion (US$26.1 billion) of property was transacted in publically reported deals in Japan during 2012, of which an estimated 77% comprised asset purchases in Greater Tokyo (Note 1). Proportionally, the office sector accounted for about 43% of Japan's total acquisition value, followed by retail at around 20% and residential at just over 16%. The share attributed to logistics properties was close to 13% – stable from the previous year but twice that of 2010 on the back of heightened investor interest in this sector (Note 2).

The indicative total investment volume for 2012 across all sectors was approximately 10% lower than that of 2011, led by a decline in the office sector equivalent to around 25% year-on-year (YoY). The total value of property purchases conducted by J-REITs, however, rose by about 8% YoY. With acquisitions totalling approximately JPY736 billion (US$9.2 billion), the J-REIT market accounted for around 36% of total real estate investment in Japan in 2012, based on reported transaction pricing (Note 3). This share is up from 30% in 2011 and approximately 12% in both 2010 and 2009.

Mirroring the market as a whole, the volume of office acquisitions by J-REITs fell approximately 26% YoY in terms of purchase price, with the retail and logistics sectors rising to fill the gap. The share of J-REIT acquisitions occupied by the retail sector rose to approximately 27% from 13% in 2011, while logistics accounted for a 19% share, up from less than 2% the previous year.

Drivers of investment

Investment activity in 2012 was supported by heightened liquidity in the capital and debt markets.

New REIT offerings – listed

Backstopped by the Bank of Japan's (BOJ) Asset Purchase Programme, which invested some JPY40.6 billion (US$509 million) in domestic REITs during 2012, expansion of the J-REIT market provided major developers and blue-chip corporations with a natural exit point for stable properties held on their balance sheets.

Investment volumes, particularly in the commercial and logistics sectors, were bolstered by willingness in the capital markets to finance new REIT offerings. Four J-REITs were listed through the year on the Tokyo Stock Exchange, with Kenedix Residential Investment Corporation's successful initial public offering (IPO) in April marking the first new J-REIT in approximately 4.5 years. The Kenedix-sponsored investment trust started trading with an initial portfolio of 20 residential assets located across Japan, acquired for a total of JPY30.4 billion (US$360 million).

The listing of Tokyu Land's Activia Properties REIT followed in June, with 18 seed assets acquired from its sponsor for approximately JPY170 billion (US$2.1 billion). Its opening assets under management comprised a mix of high-street and suburban retail facilities, offices and a lease-land asset, located predominantly in the Greater Tokyo region. With a price tag of JPY45 billion (US$564 million), the trophy asset of the portfolio is Tokyu Plaza Omotesando Harajuku, a prime high-street retail property that opened in central Tokyo in April.

In the third J-REIT listing of the year, Daiwa House REIT used the proceeds of its November IPO to part-fund the acquisition of 19 logistics facilities and a shopping centre from its sponsor, Daiwa House Industry and related companies for JPY95.05 billion (US$1.2 billion). The listing had previously been scheduled for June 2008 but was abandoned due to weakening market conditions. Japan's second biggest IPO to date followed in December with the listing of GLP Reit. Singapore-based Global Logistics Properties will initially contribute 30 logistics properties to the REIT in January 2013 with a transfer price of JPY208.7 billion (US$2.6 billion).

New REIT offerings – private

Illustrative of growth in the burgeoning non-listed REIT sector, Goldman Sachs Asset Management acquired three core properties in Tokyo to incorporate into its newly-structured private REIT for approximately JPY25 billion (US$312.5 million). The REIT is the first private trust set up by an overseas financial institution in Japan and there are plans to eventually increase its asset size to about JPY300 billion (US$3.75 billion).

Separately, DREAM Private REIT was structured by Diamond Realty Management, a Mitsubishi Corporation subsidiary, with an initial JPY31.7 billion (US$402.0 million) investment in three Tokyo assets. A first of its kind affiliated to a trading company, the private placement REIT focuses largely on top-grade properties in the retail and logistics sectors and targets an asset volume of JPY250 billion (US$3.1 billion) in five years.

Improved access to debt finance

Coinciding with increased liquidity in the capital markets for real estate investment, a gradual easing of lending criteria in the debt market was noted by property investors – as illustrated by the BOJ's benchmark Tankan survey (Figure 2). This is considered to be a contributing factor behind the noticeable increase in purchases of traditionally alternative asset types through the year by blue-chip domestic and overseas players.

Overseas investors becoming more active

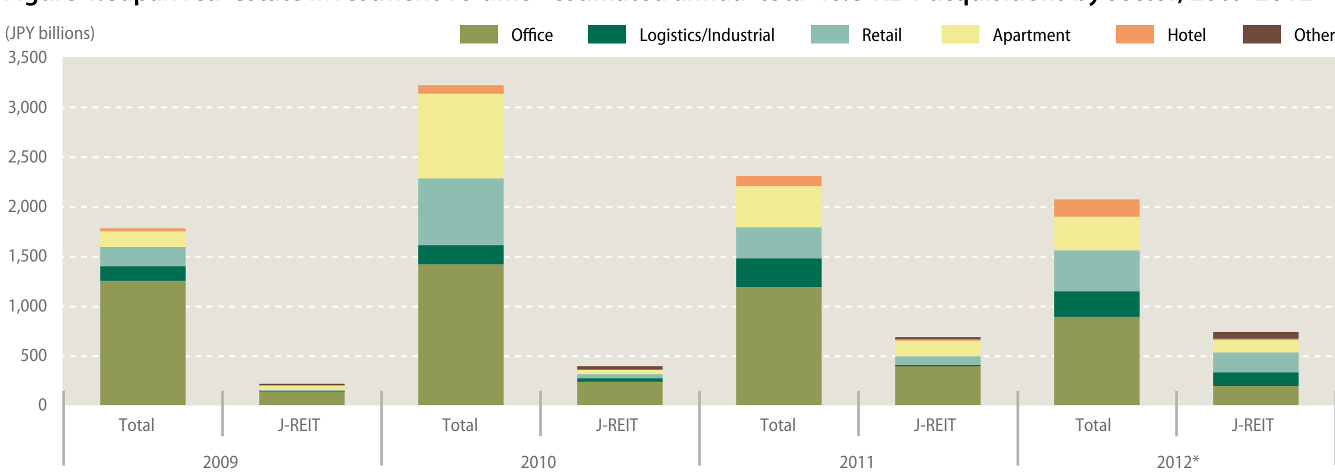
Domestic investors have driven Japan's real estate market after credit tightening in the wake of the global financial crisis led to an exodus of their generally higher-leveraged overseas counterparts. It is nonetheless important to note that transaction data indicates increased activity by overseas investors in recent years, with a number of well-known global names completing sizable property acquisitions in locations nationwide in 2012.

Significant deals involving overseas players included Angelo Gordon and minority partner Orix Real Estate Capital's purchase of ownership in the Kioicho Building, an office property in central Tokyo, for an estimated JPY24.2 billion (US$293.7 million). Secured Capital Investment Management and Aviva Investors' jointly-managed Tokyo Recovery Fund also targeted the office sector, acquiring its first two assets for an unconfirmed price tag of around JPY15 billion (US$186 million).

Property transactions exceeding JPY5 billion (US$63 million) were also concluded across the office, retail, hospitality and logistics sectors by international groups such as MGPA, RREEF, CapitaMalls Asia, Credit Suisse, SEB Asset Management, S-REIT Ascendas Hospitality Trust, US-REIT W. P. Carey and CBRE Global Investors.

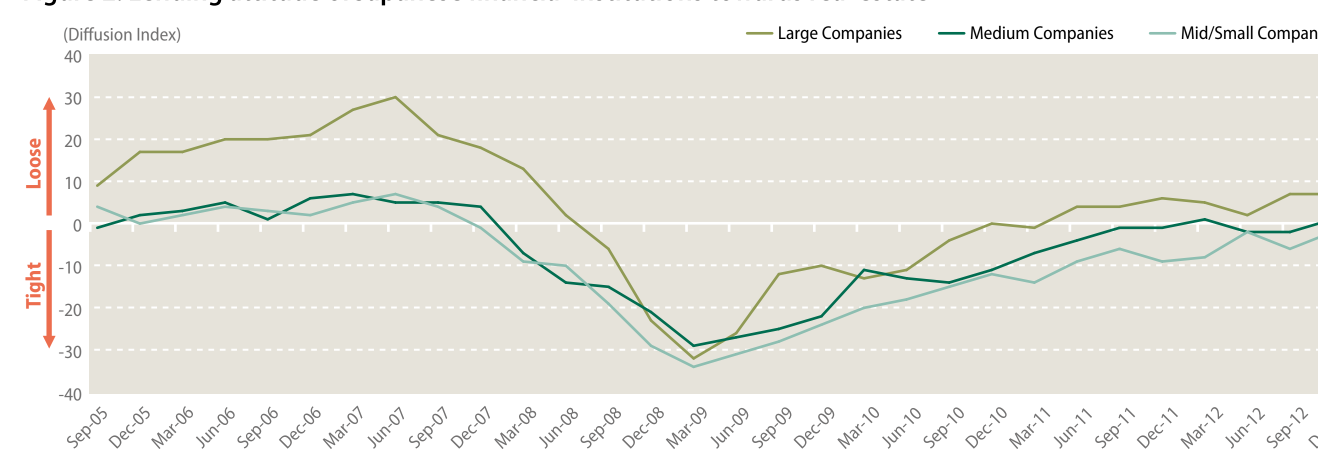
Increased liquidity is one aspect behind this apparent refocus of global capital on the Japanese real estate market. Another driving factor is the perception that current pricing is at a cyclical low and that capital growth, led by a recovery in the office sector, may occur in the short- to medium-term.

Figure 1: Japan real estate investment volume - estimated annual total vs. J-REIT acquisitions by sector, 2009-2012



Source: Compiled by Savills Research & Consultancy based on RCA and publicly disclosed J-REIT data
*Preliminary figures

Figure 2: Lending attitude of Japanese financial institutions towards real estate



Source: BOJ Tankan Survey, Savills Research & Consultancy

Anticipation of a recovery in the office sector failed to bring increased investment volume

As a result of sharp rental reductions in 2008 and 2009, and softened cap rate expectations, current pricing in Tokyo's office market looks comparatively cheap from a historical perspective. In fact, indicative capital values for Grade A space in 2012 were down as much as 60% from their 2007 peak based on mark-to-market NOI assumptions.

Complementing the view that the Tokyo market has become 'good value', investment appetite has been spurred by growing anticipation of a recovery in office rents – sentiment that 2012 leasing data appears to support. After a bulge in speculative Grade A supply, stable tenant demand saw prime vacancy fall back from 7.0% in Q2 to approximately 5.9% in Q4. Declining availability in certain submarkets enabled landlords to firm-up rental expectations for well-positioned properties, while the addition of new high-specification buildings helped to pull prime market rents up through the year. The combined effect was that average Grade A office passing rents in 2012 rose 1.3% over average 2011 rental pricing.

Improved sentiment towards the Tokyo office sector saw investors actively looking for core and core-plus purchasing opportunities. Nonetheless, as reported above, the office sector failed to see an increase in investment volume. This is principally attributable to the limited availability of investment-grade properties on offer, a trend that in part stems from domestic vendors' disinclination to sell on the open market given the lack of investment alternatives and their generally conservative gearing.

Outlook for 2013

Investment volume across all real estate sectors is expected to increase in 2013, driven by continued growth in the REIT market and improved investor sentiment. Currently as many as four new J-REIT listings are earmarked to take place in the short term, including Nippon Prologis REIT and Comforia Residential REIT, which are set to IPO in February, and those planned by retail giant Aeon and property company Hulic. The private REIT market is also expected to see further expansion, exemplified by the anticipated launch of Japan's first open-ended unlisted residential REIT by Daiwa Real Estate Asset Management in March 2013.

The recovery in Tokyo's prime office leasing market is expected to see modest rental growth continue through 2013, driven by strengthened economic fundamentals and a significant reduction in new office supply. New opportunities to acquire large-scale Tokyo office properties may present themselves as several Japanese corporations consider selling-off non-core assets in an effort to free-up capital. Such assets are reported to include the headquarters facilities of major electronics groups Sony, Panasonic and Sharp, and leading beverage manufacturer Kirin.

The weight of capital chasing investment opportunities should increase slightly from 2012. Additionally, 2013 may see a return of the European open-ended funds, as they hunt for durable yield in the region and reallocate away from certain markets which enjoyed significant attention over the past three years, namely Singapore and Australia. This may result in: 1) moderate cap rate compression across sectors for core assets throughout 2013; and 2) increased appetite for certain asset classes outside Greater Tokyo, as investors expand their geographical sphere in order to secure required returns. Aside from well-positioned residential and logistics assets located in and around Japan's major regional cities, high street retail in Kansai and Fukuoka appears to generate significant interest.

Will Johnson
Head of Research & Consultancy
Savills Japan Co., Ltd.

Note 1: RCA based on independent reports of properties and portfolios of US$10 million and greater.
Note 2: Logistics includes distribution and other industrial-type units.
Note 3: Savills Research & Consultancy based on J-REIT press releases and scheduled acquisition dates.