

AMB Property Corp (AMB) and ProLogis (PLD) **The Sun is Still Rising in Japan for U.S. Industrial REITs**

June 23, 2008 ■ AMB Recent Price \$51.64 ■ PLD Recent Price \$56.49 ■ DJIA 11,842 ■ RMZ 845

I. Overview

We recently toured the Tokyo industrial market with AMB Property Corp. (AMB) and ProLogis (PLD). AMB and PLD have made Tokyo the nucleus of their strategies in Japan. The country represents 9% of AMB's and 13% of PLD's controlled asset bases, making it the largest investment outside of the U.S. for each company. AMB controls six million s.f. in Tokyo and Osaka (the two main industrial markets in Japan) and is establishing a base in Fukuoka and Sendai (see Exhibit 1 for a map), representing a solid growth pace for a company only in the market for five years. With 23 million s.f. of properties under management, PLD is the largest industrial landlord in Japan. The global giant has a presence in every major Japanese industrial market and continues to add scale through a mix of development and sale-leaseback transactions.

The core investment and development thesis for industrial players in Japan has been the same for a number of years. Japanese companies are shedding legacy real estate holdings and outsourcing management of their supply chains to third-party logistics providers (3PLs), thus creating development and sale-leaseback opportunities. Despite the slow pace of economic growth, the need for modern distribution space remains strong throughout Japan due largely to low investments during the previous two decades. Replacing obsolete stock is a theme that appears to have substantially longer to go. With capable teams in place, AMB and PLD should further capitalize on the sustained demand for new distribution space to grow their Japanese development platforms.

II. Japanese Economy

Japan is the second largest economy in the world with a per capita GDP of \$38,000, which is comparable to that of major European countries and slightly below that of the U.S. The country has gone through numerous economic reforms in recent years as it still reels from the "lost decade" – more than 15 years of lackluster growth and deflation following the

bursting of a major economic and asset value bubble in '89. While reforms and the rebound of the global economy propelled Japan to 2-3% GDP growth since '03, the economy is expected to grow by a mere 1.1% in '08. Inflation, which had been essentially non-existent in recent years, has now crept up above 1%, which is paltry compared to inflation rates in most developed or emerging economies. Short- and long-term interest rates also remain low (10 yr bond = 1.8%, Central bank rate = 0.5%).

Japan is a large consumer market with a relatively wealthy population. The country is an active importer and exporter of goods. Those are all ingredients of a buoyant industrial distribution network. However, the Japanese population has started to shrink, while the moribund GDP growth suggests that future growth in spending power could be limited.

III. Japanese Industrial Market

A. Key Markets and Features

The Japanese industrial landscape is divided into five main geographic regions: Tokyo (1.3 billion s.f. or 25% larger than Chicago, the largest U.S. market), Osaka/Kobe (540 million s.f.; roughly the size of Atlanta), Nagoya, Fukuoka, and Sendai/Tohoku. Tokyo is the largest industrial market in the world and is driven by local distribution to its 35-million strong population as well as port activity. Osaka/Kobe is an industrial production center and boasts one of the leading Japanese ports. Despite the size of the markets in Tokyo and Osaka, there is a scarcity of functional product. According to PLD, 83% of the industrial properties built in the last quarter century encompass fewer than 100,000 s.f. and likely fail to meet the requirements of third-party logistics providers. The small buildings generally stand only one-story tall. Modern facilities, by contrast, typically span six or seven levels and exceed one million s.f. Most of these large buildings use freight elevators, although truck ramps have become more commonplace, especially in AMB and PLD buildings. Roughly 80-85% of industrial space in Japan remains in the hands of owner-occupiers versus 65% in the U.S.

Exhibit 1: Map of Japan

Japan has a population that is about half the size of the United States. In physical terms, it is about the size of California. Roughly 70-80% of the country is mountainous and unsuitable for development. As a result, land is very expensive. Tokyo, the capital, is the center of commerce in the country. Nearly 35 million people live in the Greater Tokyo area, making it the most populated MSA in the world. In addition to a strong consumer market, Tokyo has three of the largest seaports in the world (Chiba, Tokyo, and Yokohama).



Source: Wordtravels.com

B. Investment Drivers

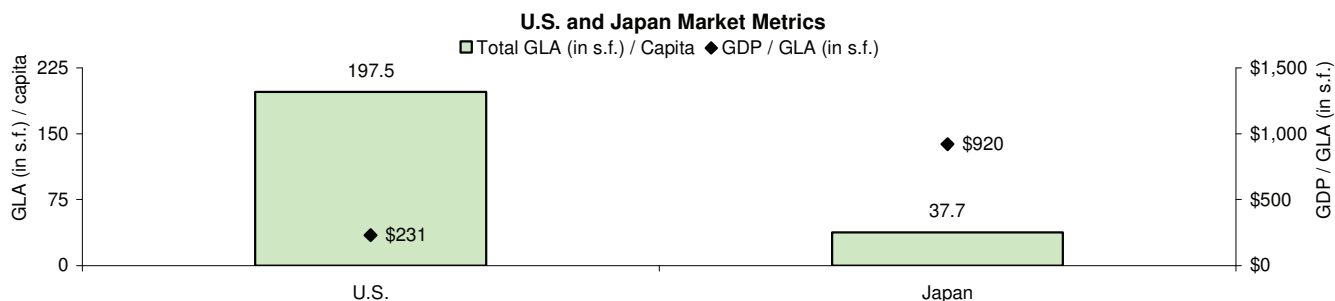
There are two main pillars of capital deployment in the Japanese third-party leasing industrial market. One is the transition from “own” to “lease” as **many Japanese companies have been divesting their real estate holdings to focus on operating their core businesses. This process is likely no more than 50% complete and will continue to feed a vibrant sale-leaseback market.** While the acquired customer relationships are meaningful, the quality of real estate is often mixed.

The other investment driver is the need for modern distribution space. The country’s stock of industrial real estate appears ill-equipped to handle the demands of a modern logistics distribution network, thus opening the door to developers. Assessing such demand is difficult, but it appears elevated versus the amount of comparable space for the near future. As shown in Exhibit 2, the floor space per

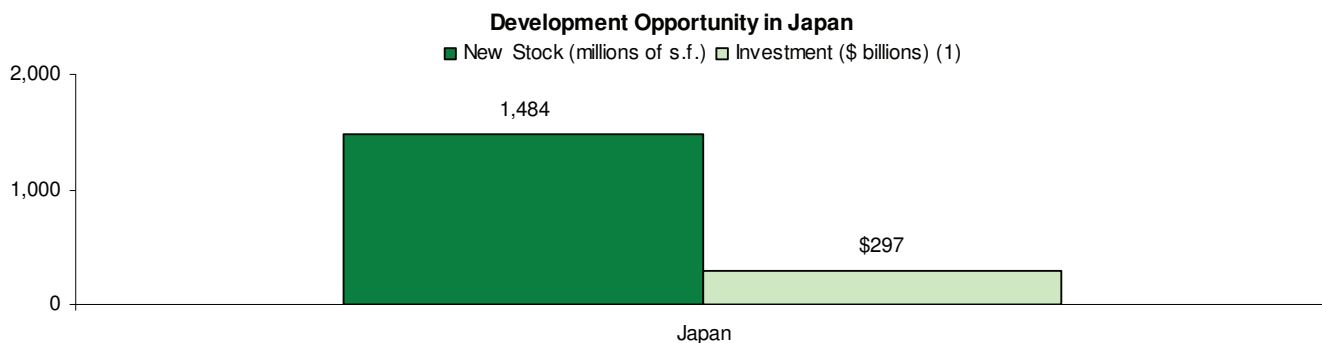
capita in Japan is roughly one-fifth that of the U.S. While the high population density of the country likely leads to less distribution space needs than in the U.S., the consumption patterns between the two countries are similar. As a result, one would expect the amount of modern space to greatly rise in coming years. This has sparked increased demand for speculative and build-to-suit space, which bodes well for merchant-builders such as AMB and PLD. **This process must continue for investors to believe that AMB and PLD can expand their development pipelines in the face of lackluster economic growth in the country.** With the average state-of-the-art industrial development costing about \$200 million (versus \$30-50 million in the U.S.), it only takes a few projects for the REITs to fill the development bucket in Japan.

Exhibit 2: Assessing the Japanese Development Opportunity

The Japanese economy has been stuck in neutral for several years. Yet, modern warehouse space has been growing at a rapid pace. This is due to the high level of obsolescence in the existing stock. In addition, the Japanese market appears relatively undersupplied versus the U.S. The leasable space per capita is only one-fifth of the U.S. However, population density in the country likely explains in part why there is such a large gap.

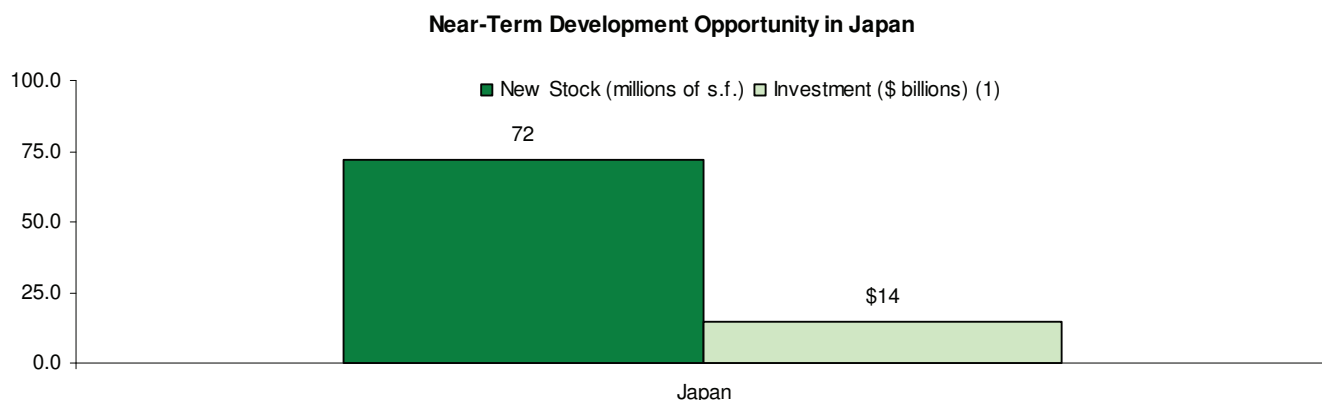


If stock / capita in Japan were to rise to one-quarter of the current level in the U.S., development volume would be sizable. Nearly 1.5 billion s.f. of space could be developed in Japan. Assuming that it takes place over 20 years, a developer with a 10% market share could capture about \$1.5 billion in development volume annually.



(1) Assumes development cost in Japan is about \$200/s.f.
Source: World Fact Book, ProLogis (Ikoma Data Service), and Green Street Advisors.

Obsolescence is an important driver of new supply in Japan. In the U.S., new stock expands the inventory by roughly 1.0-1.2% annually. Assuming that greater obsolescence in Japan pushes the development pace to 1.5% per year, the development opportunity in Japan would amount to roughly \$14 billion annually. If the U.S. REITs could capture 5% to 10% of this opportunity, they could start \$700 million to



(1) Assumes development cost in Japan is about \$200/s.f.
Source: ProLogis (Ikoma Data Service) and Green Street Advisors.

C. Transparency is Lacking

Although the Japanese industrial market is large, transparency is scanty. This is mostly due to the high percentage of assets in the hands of owner-operators and the relatively low use of brokers in leasing transactions. Basic market statistics are difficult to find, which gives an advantage to local players with well-heelled networks and customer relationships. As if to complicate matters, the main industrial broker in Japan (J-Rep who also runs a development arm) was recently acquired by a consortium led by Goodman Group, an Australian industrial REIT that runs a business model roughly similar to that of AMB and PLD. The U.S. REITs have a deep presence in Tokyo, which helps them compete in an environment where information comes at a premium.

D. Land Costs Are High

A lack of available land serves as a sizable barrier to entry in most Japanese markets. Land in Tokyo costs roughly \$100/buildable s.f. (versus \$40/s.f. in prime Inland Empire locations in the U.S.) and comprises about 50% of a project's total development cost. Given land's high cost, buildings are vertical (some developments have nine floors). A typical multi-story facility can exceed 1 million s.f. Assembling adjacent parcels needed to build a large distribution center is a long and tedious process, which limits new supply. In theory, land reclamation (creating new land by filling in wetlands) could increase the availability of land; however, the process takes a long time and its large expense prices out most industrial development projects.

E. Lease Structure

The type of leases signed by tenants has evolved in recent years from a "perpetual" structure to fixed-terms. Most leases range from three to ten years in length and do not typically include pre-negotiated rental rate increases. Signing fixed-term leases and aggressively seeking higher rents had historically been considered a cultural taboo in Japan. During the "lost decade," tenants paid rates that were likely above the "true market value" of the space to not inflict pain on financially strapped landlords. As the economy rebounded, landlords repaid tenants by not marking leases to what should have been a higher market rent. As more foreign companies have entered the Japanese real estate market, this landlord-tenant dynamic has been challenged. One of the key mechanisms used by AMB and PLD (and many other foreign property operators) to push for higher rents has been to change the typical lease structure

from perpetual to fixed-term. By requiring fixed-term leases, the REITs can command market rents and push out tenants unwilling to pay. While both changes were initially opposed, they have become accepted market practices.

F. Leasing Conditions

Tokyo's overall occupancy level is unknown. Occupancy in what the U.S. REITs deem as competitive product is estimated at 95%. AMB's and PLD's stabilized portfolio occupancies are 95% and 100%, respectively (Exhibit 3). Market rents in Tokyo vary by submarket but average about \$21/s.f. in Ohta, a prime Tokyo submarket. Near Narita Airport, rents are closer to \$10/s.f. Despite relatively tight leasing conditions and strong demand for modern space, rents in Tokyo have been flat for the last seven years. This might have been due to the considerable supply of new properties provided by many new market entrants or the fact that the country as a whole has experienced bouts of deflation and roughly flat inflation over the same time period. Paradoxically, market rents for the U.S. as a whole have been flat over the past seven years, except that in this case rental rate volatility was high due to a period of significant rate decreases followed by considerable increases in recent years. As a result, rents in the U.S. did not keep pace with inflation. London market rents averaged 2% growth over the same time period, which was roughly in line with inflation.

It is surprising that despite the high population density and low land availability in London and Tokyo, the industrial markets in both cities have registered rental growth only approximating CPI. The primary culprits in Japan appear to be low economic growth and indexing rents to CPI changes upon renewal. Since inflation in Japan will probably remain low for some time, it is unlikely that the market will register markedly improved rental growth unless the supply/demand equation changes dramatically.

New facilities also do not command a rent premium, although they do have the advantage of a very short lease-up period (averaging less than 2 months for PLD's entire portfolio) and likely higher occupancy. Leasing commissions and tenant improvements are low as a percentage of NOI. Japan is one of the least expensive global markets in terms of lease incentives as a percentage of NOI.

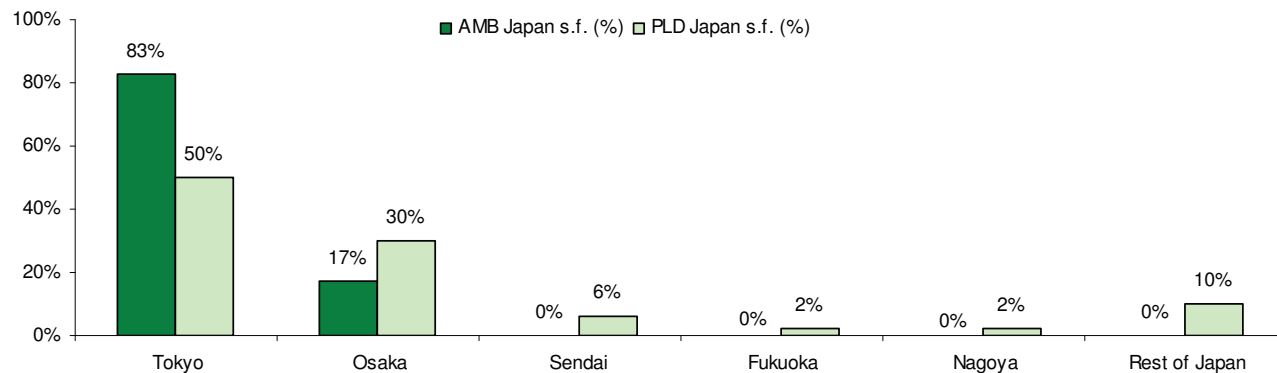
Exhibit 3: Portfolio Scorecard

While PLD is the largest industrial developer in Japan, AMB's efforts are gaining steam and its portfolio is generally of a high quality. AMB's properties are mostly located in seaport markets and, on a per s.f. basis, are valued slightly higher than PLD's assets.

Category	AMB	PLD
S.F. Controlled (millions)	5.9	23.4
Nominal Cap Rate	5.2%	5.3%
Current Approximate Value (\$ millions)	\$1,205	\$4,374
Pro-Rata Share (\$ millions)	\$334	\$875
As a % of Total Pro-Rata Assets	5.0%	4.4%
Value/s.f.	\$203	\$187
Occupancy	95%	100%
Development In Process (\$ millions)	\$641	\$936
Development as a % of Total Development Pipeline	36%	23%
Ownership Structure	Development is on balance sheet. Operating properties are mostly owned through AMB Japan Fund I (AMB with 20% ownership). Some assets are held on balance sheet.	Development is on balance sheet. Operating properties are owned by ProLogis Japan Funds I and II. PLD has a 20% ownership interest in the Funds (GIC is the 80% partner).

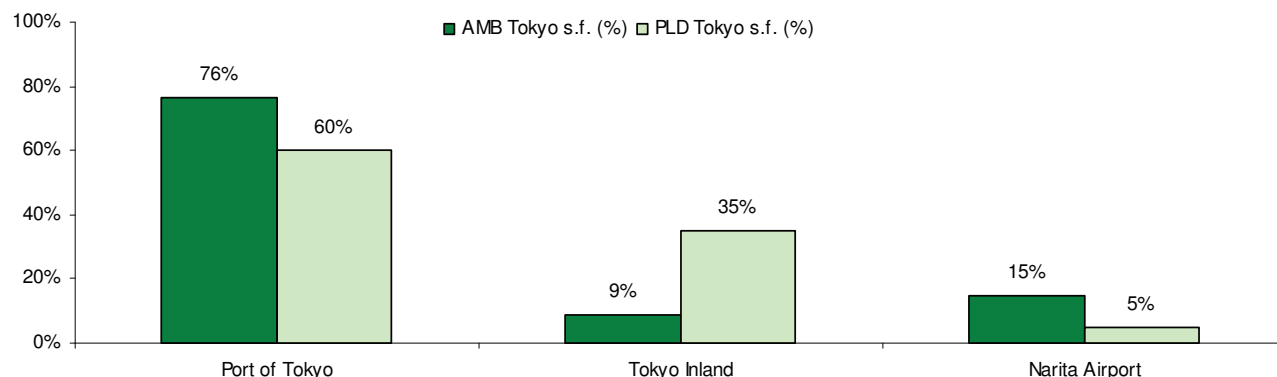
Source: Company disclosure and Green Street Advisors.

While PLD's assets are located in several markets across Japan, AMB's portfolio is concentrated in Tokyo. AMB is building a presence in Osaka and is in the process of establishing bases in Fukuoka and Nagoya.



Source: Company disclosure and Green Street Advisors.

AMB's Tokyo portfolio is concentrated in port submarkets, which fits well with its global strategy of focusing on submarkets tied to global trade. Although PLD also focuses on the port of Tokyo, a large portion of its portfolio is concentrated in the Tokyo Inland area, a less desirable submarket.



Source: Company disclosure and Green Street Advisors.

G. Cap Rates

Japanese cap rates have declined by roughly 300 basis points since '02 as global real estate firms and Japanese institutional investors have taken an interest in the market (cap rates also decreased by 260 basis points in the U.S.). Nominal cap rates are currently in the 5.0-5.5% range (5.0% for prime Tokyo assets). While there would seem to be an opportunity for cap rates to compress further, given that real estate loans are priced in the 2% range, and other property types have cap rates of approximately 3%, there has so far proven to be very few transactions below 5% cap rates.

The equity return expectations (IRR) of private-market industrial investors in Tokyo appear to be roughly 6.0% on an unlevered basis. Compared to the 7.1% IRR expectations in the U.S., Japan appears pricey. **However, debt is priced well-below the U.S. and the gap between expected equity returns and debt costs is the widest of any markets in which the U.S. industrial REITs currently invest. The levered IRR expectation (~8.25%) in Japan is roughly 25 basis points superior to the U.S., thus providing AMB and PLD (and their fund partners) with a slight premium for investing in a developed market that may not have more intrinsic risks than the U.S. or Western Europe.**

H. PLD and AMB Dominate the “Modern Market”

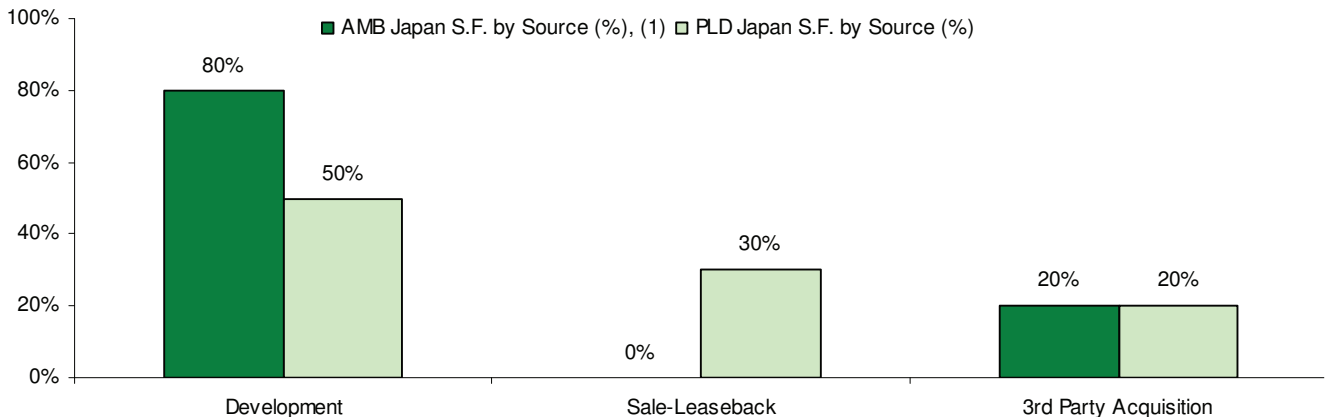
According to data collected by PLD, the Denver-based REIT is the dominant owner of “modern” distribution facilities in Japan with close to a 30% market share. AMB lands in second place, followed by a plethora of smaller Japanese rivals. J-Rep has the number four market share but at its core is more of a broker than developer and has yet to demonstrate that it can effectively compete with AMB or PLD. With the Goodman Group now at the helm (and able to bring along its capital raising abilities), it is likely that J-Rep will become a more aggressive competitor. That being said, Goodman currently seems more interested in shoring up its balance sheet and it will likely take some time for the Australian firm to establish the same foundation in Japan as its American rivals. AMB and PLD have been able to carve up an impressive niche in the Japanese market without being overly challenged by local players. The two companies seem to benefit from their global capabilities and have established an enviable position for some time to come.

IV. AMB and PLD in Japan

PLD entered Japan in '98 and has become the largest industrial developer in the country. AMB followed suit five years later. **Whereas AMB’s portfolio has been assembled primarily through ground-up development, PLD’s asset base has been gathered through a variety of means in-**

Exhibit 4: Portfolio Source

PLD has developed the majority of its controlled assets in Japan. Sale-leasebacks have also helped to establish a large footprint in the country. In contrast, AMB’s portfolio has been primarily assembled through ground-up development.



(1) AMB does not breakout non-development s.f. between sale-leaseback and third-party acquisitions. However, it appears that AMB has not yet engaged in a sale-leaseback transaction.

Source: Company disclosure and Green Street Advisors.

cluding large sale-leaseback transactions. Both companies' portfolios are of high quality with a slight edge given to AMB. Exhibits 3 to 5 highlight the key differences between the REITs' portfolios.

The strategy employed in Japan by AMB and PLD is similar to that used by each company in other parts of the world. The emphasis is placed on development, and stabilized assets are generally contributed to co-investment funds in which the REITs own minority stakes. Japan is the largest development market for AMB and PLD; accounting for 35% and 25% of their global totals, respectively. The profit margins expected on the current Japanese development pipeline remain high due to cap rate compression early in the projects' lives as well as continuously good execution. We estimate that the Japanese pipelines have embedded profit margins in a range of 20-25%, which surpasses the averages in other regions. The REITs' development pipelines differ slightly in terms of product and geographic mix. While AMB's pipeline was entirely begun on a speculative basis, PLD's include a significant number of build-to-suits (Exhibit 5).

AMB's assets are held through AMB Japan Fund I, a \$2.4 billion closed-end fund with \$1.4 billion of investment capacity remaining representing over three years of expected development completions. AMB owns a 20% stake in the fund. PLD controls two property funds in Japan, totaling \$4.4 billion of assets. The 20/80 joint ventures are partnerships with GIC, a Singapore sovereign wealth fund. PLD has roughly \$1.1 billion of investment capacity remaining in the active fund, or enough dry powder to absorb another year of development activity.

V. Recommendation

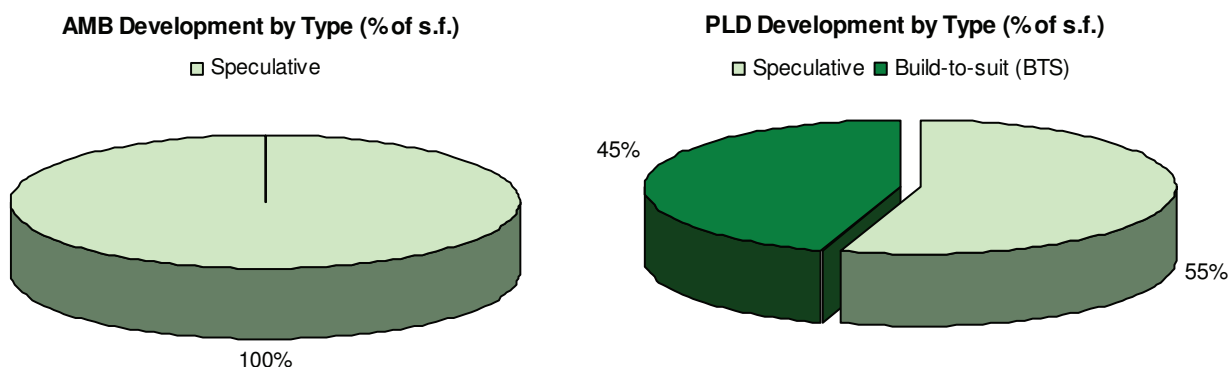
The Japanese industrial market is still in the middle stages of transitioning from an owner-user to a third-party leasing market. While the process has been occurring for about five years, owner-occupiers are continuing to shed real estate holdings to focus on their core businesses. There is also substantial pent-up demand for modern institutional quality stock, which should enable development activity to grow further. AMB and PLD are well-situated to capitalize on these trends and have made substantial progress in the country. Despite the rosy picture, challenges abound. The Japanese economy is showing signs of strain, population is shrinking, and development profit margins will likely be on par with other developed economies by '09.

At current prices, we maintain our BUY recommendation on the shares of AMB and HOLD recommendation on the shares of PLD.

Cedrik Lachance
Steven Frankel

Exhibit 5: Development Pipeline Composition

Build-to-suit projects comprise a significant portion of PLD's development pipeline in Japan. AMB's entire development pipeline centers on speculative projects.



Source: Company disclosure and Green Street Advisors.

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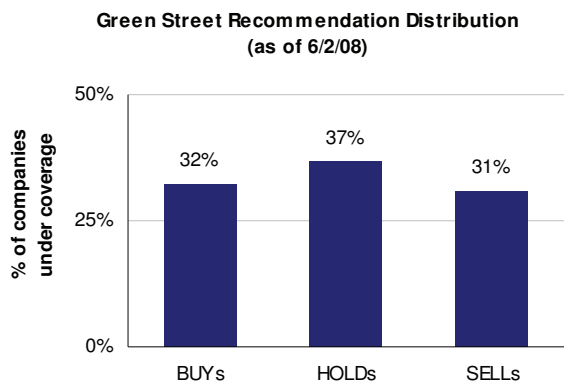
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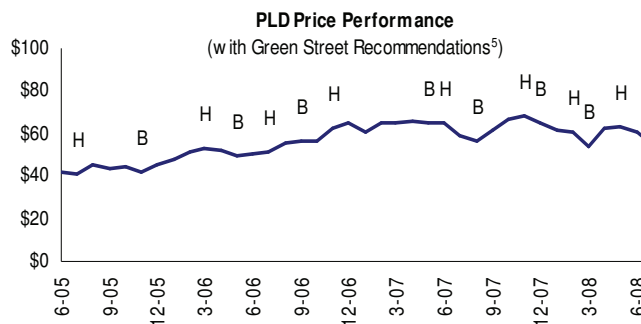
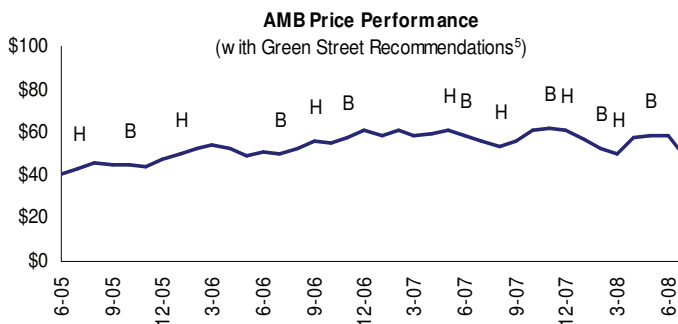
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Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".^{1, 2}

Year	Buy	Hold	Sell	NAREIT Eqty ⁴
2008 YTD ³	11.1%	10.4%	3.3%	8.2%
2007	-6.5%	-22.3%	-27.6%	-15.7%
2006	45.4%	29.9%	18.4%	35.1%
2005	26.3%	18.3%	-1.9%	12.2%
2004	42.3%	28.4%	15.6%	31.6%
2003	42.7%	37.2%	20.9%	37.1%
2002	17.7%	2.6%	1.9%	3.8%
2001	35.7%	19.1%	11.9%	13.9%
2000	53.6%	29.3%	4.4%	26.4%
1999	14.2%	-9.2%	-20.2%	-4.6%
1998	-0.6%	-15.1%	-16.4%	-17.5%
1997	37.1%	14.2%	5.8%	20.3%
1996	47.3%	30.2%	17.5%	35.3%
1995	23.6%	14.3%	-0.4%	15.3%
1994	20.5%	-0.7%	-9.3%	3.2%
1993 ³	29.4%	5.4%	6.7%	12.4%
Total Return³ Annualized	4091.7%	402.4%	15.3%	537.7%
	27.6%	11.1%	0.9%	12.8%

The chart below shows AMB and PLD's price performance over the last three years, along with Green Street's recommendations during that time.



1) Historical results through January 3, 2005 were independently verified by Ernst & Young, LLP. E&Y did not verify stated results subsequent to January 3, 2005. Past performance results cannot be used to predict future performance. For a complete explanation of study, see 5/9/03 report "How are We Doing?".
 2) Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly", pg. 13-16. Beginning with May 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, are not included in the primary exhibit and therefore not included in the calculation of total return. Beginning with March 2003, all Hotel companies are excluded.
 3) Study uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 29, 1993 through June 2, 2008.
 4) Not directly comparable to Green Street's performance indices because NAREIT includes more companies and uses market-cap weightings. Green Street's returns are equally-weighted averages.
 5) Green Street has only three recommendations: BUY ("B"), HOLD ("H") and SELL ("S"). The firm does not consistently publish price targets and therefore price targets are not included in this graph.