Introduction
Despite historically high office supply in 2018, the Japanese real estate market showed resilience, supported by sound fundamentals with a stable government and a competitive yield gap. Although there is concern about the extended upward phase of the current cycle, GDP growth is steady, helped by rising corporate profits. Tourism is also energising local economies; Osaka especially is well positioned for further growth as the 2019 Rugby World Cup, the 2020 Tokyo Olympics, and now the World Expo 2025 are expected to add to the city’s dynamism.

Interest rates should remain relatively low due to weak capital demand from cash-rich Japanese corporations and households, though the Bank of Japan (BOJ) has begun skillful stealth tapering. The low interest environment offers attractive spreads compared to other countries, even with the Japanese real estate market’s tight cap rates. As dry powder for real estate is increasing globally and other developed markets face larger uncertainty, Japan remains an attractive market with prospects of steady yields.

Office market performance generally reflects trends in the overall Japanese real estate market. Graph 2 demonstrates that the office market has remained in the upswing phase since 2014. Supported by strong demand, the majority of office supply that will enter the market by 2020 has already been pre-leased and there is little sign of a loosening in the near term. Rents should grow moderately even as vacancy ticks up slightly. In previous cycles, rents have not declined until vacancy has risen above 4%, which suggests there may be additional room for the current property upswing to extend through this period of heightened supply, barring an exogenous shock.

The favourable environment for Japanese real estate is supported by sound corporate performance and increasing investment. According to the Development Bank of Japan, capital expenditure in FY2018 is expected to increase by 21.6% across all industries. Over 45% of surveyed companies named capacity expansion as a reason for investment.

While the domestic market is showing few signs of a correction, rising global economic uncertainty now overshadows Japan’s good prospects. According to the Cabinet Office, Japan’s economy is now more correlated to the global economy: whereas in 2006, 1% growth in global GDP was matched by 0.08% growth in Japan’s GDP, that figure has grown to 0.31% as of 2016. As the nation
Spotlight | 2018 review and 2019 prospects

Dec 2018

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Dec 2018

has pulled out of a multi-decade economic malaise and entered a steady growth track, investors would be justified in taking a more cautious stance given the current global environment. Indeed, the resiliency of this revitalised Japanese economy might soon be tested.

Cap rates and investment volumes

Cap rates stayed largely flat across all sectors in 2018 as sellers have remained bullish in light of improved NOI, while investors have become more cautious of the resulting high price tags and already-compressed yields. Prime Tokyo office cap rates appear to keep testing a bottom of around 2.9%, though regional office markets may still offer pickups and have a more favourable market balance.

According to Real Capital Analytics (RCA), YTD investment in Japanese real estate totalled 2.6 trillion yen through Q3/2018, 27% less than over the same period last year. Demand for Japanese real estate is strong, but a lack of opportunities in decent locations and core asset markets, as well as high price tags, is moderating transaction volumes.

Cross-border investments accounted for 20% of volumes through Q3/2018. J-REITs remain active among domestic players, though in the logistics sector there were concerns of exuberant purchasing activity after a raft of equity fundraisings in Q1.

The market may face some headwinds in 2019, most notably the consumption tax hike scheduled for October. Planned countermeasures should mitigate at least some of the fallout, however.Externally, rising U.S. interest rates or the China-U.S. trade war could potentially reduce global growth, but some countries could benefit by filling the gaps created in supply chains. According to Nomura’s assessment, Japan placed second, following Malaysia, out of those countries which might benefit from import substitution by the U.S. and China. While the negative impact of rising tensions should not be underestimated, the Japanese economy might be less vulnerable to it.

Overall, domestic fundamentals are robust and should remain stable over the medium term. Considering the somewhat bearish outlook for China, Japan should offer better value than Asia Pacific peers who have a greater dependence on the region’s largest economy. Although relatively insulated from current global issues, Japan is by no means immune to global economic ripples. With an already-extended upward cycle, which may in fact be peaking, a global correction could very well put an abrupt end to this bull market.

**Office**

Cap rates and investment volumes

In-house Tokyo office cap rates have held steady at 2.9% since the end of 2017, reflecting buyers’ still bullish but cautionary attitudes. The October 2018 survey by Japan Real Estate Institute (JREI)\(^1\) puts expected cap rate premiums in Osaka, Nagoya, and Fukuoka at roughly 120 basis points (bps), 150bps, and 150bps, a tightening of between 20bps and 40bps from last year, as investor interest in regional assets has grown.

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\(^1\) Expected cap rates reported by JREI tend to be looser than market cap rates.

**GRAPH 3**

Investment volumes and cross-border share, 2007—Q3/2018

**GRAPH 4**

JREI expected prime office cap rates by city, 2003—2018

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savills.co.jp/research 03
Spotlight | 2018 review and 2019 prospects

YTD investment in the Japan office market totalled 1.3 trillion yen as of Q3/2018, down 23% from the same period last year, likely as a result of limited investment opportunities. Tokyo’s share of office transaction volumes up to Q3/2018 was greater than the previous period; however, interest in regional office markets is increasing.

Review and prospects

Tokyo’s office market has extended 2017’s strong performance through 2018. Exceptionally strong pre-leasing is keeping vacancy low and rents are steady. Although Grade A office supply volumes are expected to remain elevated until 2020, a decline in rents over the short term seems unlikely while fundamentals remain strong. Landlords are adopting a conservative long-term strategy, keeping a lid on growth rates as they focus on securing high-credit tenants.

Regional high-grade offices are performing well, with vacancy below 1% in all three major markets and rents rising over 10% YoY on average as of Q3/2018. Regional demand is strong and supply is limited, providing a favourable environment for rent appreciation.

Co-working exploded onto the Tokyo office market in 2018, securing a significant portion of supply. Although WeWork, the most prominent new entrant, is currently lossmaking, its major shareholder SoftBank continues to supply more capital. The company looks set to open an eleventh location in Tokyo by early 2019, bringing total leased area to approximately 47,500 sq m. Competitors are following suit with expansion plans.

It is estimated that co-working providers took up almost 20% of new C5W supply that came online through the first half of 2018. Client demand appears to be strong, with reports of strong occupancy at all of WeWork’s sites in Tokyo and commitments for probably the next one to two years.

That being said, firms are still evaluating the efficacy of co-working.

There do not appear to be any catalysts for a significant correction in the office market. With a large number of firms relocating to new high-grade offices, there could be a delayed emergence of secondary vacancy in lower-grade properties, for instance, as fixed-term leasing contracts expire. The Grade A market, however, should continue to perform well. So long as the economy remains sound, rents should inch up while cap rates remain flat-ish. If an exogenous shock does occur, cap rates could wobble temporarily, but strong fundamentals should contain the effects.

Bearing WeWork’s mismatched leasing structures and rapid expansion plans in mind, if it were to prove relatively unpopular after a few years, the effect on the office market could be sizeable. Furthermore, this office leasing strategy may not be as appealing to companies in Japan, and especially Tokyo, where already-flexible leasing terms with much smaller down payments and plenty of affordable grade B and C space somewhat dilute co-working’s main economic selling points. More broadly, revisions in lease accounting treatment could have a large negative impact on the industry’s business model.
Residential

Cap rates and investment volumes

Based on our in-house survey, cap rates for mid-market residential property in the 23 wards have compressed 10bps to 3.6% from a year ago. According to JREI, expected cap rates for residential property in Jonan and Joto have compressed 20bps to 4.4% and 4.7%.

YTD investment in residential property has decreased by about 65% from a year ago and totals 182 billion yen. A significant drop in cross-border investment is due to a lack of large portfolio sales such as Anbang Insurance’s US$2.3 billion acquisition in 2017. According to RCA, TH Real Estate’s 19.5 billion yen acquisition of six properties through a partnership with Kenedix was the largest residential transaction of the year. TH Real Estate aims to expand the venture’s AUM to 100 billion yen.

Review and prospects

Tokyo’s residential market is and should remain stable as urbanisation drives residential demand and steady rental growth in central areas. While mid-market rental apartments are of major interest, the luxury condo market, which is considered historically underserved, is growing its presence among high net worth individuals (HNWI). In 2017, Park Mansion Hinokicho Koen was completed just east of Tokyo Midtown in Akasaka. Based on various reports, the most expensive unit was sold for an astonishing 5.5 billion yen, or 31 million yen per tsubo. It is rumoured that this ultra-luxury penthouse was snapped up by a Hong Kong national.

Even the most expensive dwellings in Japan are still somewhat reasonable compared with global peers. According to JREI, luxury condos in Hong Kong are almost twice as expensive as in Japan. The Rating and Valuation Department of Hong Kong reports residential property yields of 2.0% to 2.6% in Q3/2018 while JREI’s investor survey showed that of the Jonan area in Tokyo was 4.4% in October 2018.

Populations in prime residential areas have been growing. Between 1995 and 2015, the number of households in the Akasaka, Azabu, and Takanawa districts increased by about 33,600, or 80%, though growth temporarily stalled after the Crisis. Examining by residence type, households living in condos more than doubled between 1995 and 2016, while the number of detached house dwellers remained virtually unchanged. Concurrently, the number of households that rent homes doubled from 15,400 in 1995 to 30,800 in 2015, in proportion to increases in condo dwellers, indicating a large portion of condos in the area were purchased for investment purposes and placed in the rental pool.

Mitsui Fudosan and Mori Building, two major developers of luxury condos, continue to build new high-rise residences. Park Court Aoyama The Tower and Park Court Akasaka Hinokicho The Tower were among those completed in 2018, with the most expensive units rumoured to be between 1.5 and 3 billion yen, or 20 to 30 million yen per tsubo. Mori Building’s Toranomon Residential Tower planned for 2021 may even feature an ultra-luxury unit that exceeds 10 billion yen.

As Tokyo offers more residences with increasing levels of opulence, ultra luxury could be the next trend. With growth in tourism and many catalysts such as integrated resorts and the Linear Chuo Shinkansen (Maglev), Tokyo is building more high-end hotels with global standards, enhancing its appeal to ultra HNWI. Redevelopment of various areas in Tokyo should also continue to enhance the city’s attractiveness for wealthy buyers.

On the other hand, there are signs of a softening in mid-market condo sales. According to the Real Estate Economic Institute, with the exception of one month, contract rates of new condo units in Greater Tokyo were below 70% between January and October 2018. Additionally, the media has reported that contract rates were lower in some areas, though not fully reflected in published statistics. When demand feels soft, developers keep more units on their balance sheets and control the amount of units available for sale, creating “latent supply” that is not accounted for as unsold units. Although major developers are cash rich and can wait for demand to return using this strategy, current high prices may need to lower at some point. If this were to happen, the extent to which prices would slip is unclear.

Graph 7
JREI expected residential cap rates by city, 2003—2018

Graph 8
Residential investment volumes, 2007—Q3/2018

Graph 9
Household by dwelling types and renters in Azabu, Akasaka, and Takanawa, 1995—2015
Retail

Cap rate and investment volumes
Based on our in-house survey, cap rates for high street retail in Tokyo have held at 2.9% since the end of last year. According to JREI, expected cap rates for prime retail property in Ginza and Omotesando have compressed 20bps to 3.4% and 3.5%, while those in Osaka registered at 4.6%.

YTD investment in retail property has decreased by about 30% from a year ago and totals 329 billion yen. Considering sound acquisition interest, especially in urban retail, investment volume could increase in 2019. Some J-REITs may continue to shuffle their assets, depending on unit prices.

Review and prospects
Japan’s retail market is going through a steady growth period driven by somewhat improving domestic demand and robust inbound tourism demand. Based on the Current Survey of Commerce, overall retail sales² between Q1/2018 and Q3/2018 have improved by 0.9% from the same period in 2017. During the same time, duty-free sales increased by over 30% YoY according to Japan Department Stores Association. Expendable items in particular saw strong growth, increasing sales by over 40% YoY, reflecting the popularity of Japanese cosmetics products.

In terms of land price, inbound tourism is likely the key to a winning market. Based on the July land value survey, commercial land prices in second tier regional cities are on the rise. While land prices have strengthened in the top three metropolitan areas (Tokyo, Osaka, and Nagoya), growth in Sendai, Sapporo, Hiroshima, and Fukuoka outperformed them. With the population decreasing, polarisation of winning and losing retail markets is expected to deepen.

According to Japan Council of Shopping Centers, sales per tsubo per year in large cities and medium cities³ have improved in recent years. The figure is about 4.2 million yen in large cities and about 2.6 million yen in medium cities, up 15% and 13%, respectively, from 2016. As discussed in our “Japan Retail October 2018” report, general merchandise store (GMS) brands also appear to be seeing positive results, which show that improvement is being felt across a wide range of markets and retail categories.

Consolidation of regional shopping centres is likely to continue as underperforming stores are forced to exit the market. This creates opportunities for winning stores to reap larger shares. AEON, for instance, is actively renovating and expanding existing facilities to enhance its presence in certain markets. Large supply is also limited as, in principle, the City Planning Act (revised in 2007) prohibits the opening of over-10,000 sq m retail stores in suburbs.

The outlook for Japan’s retail market largely depends on economic conditions and inbound tourism. Although consumer confidence has been improving somewhat since mid-2016, supported by increasing cash earnings and stock rallies, rising global economic uncertainty appears to be putting a damper on general sentiment. The planned tax hike in 2019 will be a true test of resiliency, especially for the retail market. On the other hand, inbound tourism is expected to continue to expand and contribute to retail sales. Cosmetics are still popular among overseas tourists and should continue to perform well for a while, given its expendable nature.
Spotlight | 2018 review and 2019 prospects

December 2018

Hotel
Cap rate and investment volumes
According to JREI, as of October, expected cap rates for limited-service hotels in Tokyo have held steady at 4.5%, while those of all regional markets have compressed, with a notable drop of 30bps in Sapporo since April. Actual cap rates tend to be 50-100bps lower than these expected rates.

YTD hotel transaction volumes reached 229 billion yen as of Q3/2018, an increase of over 70% on the same period last year, but 25% less than the 2017 annual total, as overseas investors more than doubled their investment volumes. Indeed, Japanese assets are now among the most sought after in the Asia Pacific hospitality market. Even so, relatively modest supply in the past has limited acquisitions, particularly in Tokyo. The current development boom leading into the 2020 Olympics should open up more investment opportunities, though this may weigh on individual hotel performance. In this environment, some investors may be turning to less crowded regional markets.

Review and prospects
Inbound tourism is expected to keep growing and Japan has the capacity to accommodate. As the hotel market develops and diversifies, operators new and old are employing various strategies to capitalise on this unprecedented tourism boom. Some are expanding their geographic scope to capture growing demand for lodging outside of major metropolitan areas, while others are moving into specialist roles, designing boutique hotels that meet a specific niche of the market.

According to the Japan Tourism Agency (JTA), stays by foreign visitors outside of Japan’s top three metro areas accounted for over 40% of all foreign stays for the first time in 2017. Developers have taken note of this trend and are extending their reach into regional markets. Marriott and Sekisui House announced a collaboration in late 2018 to develop a portfolio of up to 50 hotels in rural areas near roadside rest stops.

Other traditional players, including APA Group and Japan Railway, are moving to develop limited-service hotels in cities such as Fukuoka and Sapporo. With regional areas expected to host significantly more foreign visitors in the future, development and investment activity should continue.

On the other hand, 2018 also offered a sharp reminder of an inherent risk to the hospitality industry: natural disasters. In September alone, Kansai International Airport, Osaka’s largest airport and Japan’s primary LCC hub, was closed down for ten days following typhoon Jebi, while an estimated 500,000 people cancelled their Hokkaido (Sapporo) lodging reservations in the week following the Eastern Iburi Earthquake. Hotel J-REIT unit prices have unsurprisingly dropped since the summer. Equity investors may have moved to rebalance their portfolios following this clear reminder of the sector’s risks. Large supply is also doing little to alleviate investor concerns.

More positively for traditional hoteliers, the implementation of the Minpaku Law in June 2018 led to the removal of nearly 80% of Airbnb listings and many small individual operators have since closed shop. However, a recent survey by the JTA suggests that other types of alternative lodging have for now filled some of the gap left by delisted minpaku. Most importantly, the large number of hotels opening in 2018 and 2019 might outweigh any reduction in competition caused by the new regulation. These added competitive pressures may weaken the performance of limited-service hotels in crowded markets.

Graphs:
GRAPH 13
Hotel investment volumes, 2007—Q3/2018

Source: RCA, Savills Research & Consultancy

GRAPH 14
Hotel guest room supply, 1982—2020

Source: Ministry of Health, Labour and Welfare, Savills Research & Consultancy

GRAPH 15
Change in reported lodging utilised by foreign travellers, Jul-Sep 2018 v. Apr-Jun 2018

Source: JTA, Savills Research & Consultancy
Logistics

Cap rates and investment volumes
According to JREI's October 2018 survey, expected cap rates have tightened somewhat in all markets since last year. Cap rates in Osaka, now at 5.1%, and Nagoya have continued to decline steadily, while those of Tokyo, now at 4.5%, and Fukuoka appear to be flattening. As with other sectors, actual transaction cap rates may be up to 100bps tighter than these values.

YTD investment in industrial property totalled 327 billion yen through Q3/2018, up 48% YoY, already exceeding the 2017 annual total. Overseas investment accounted for 48% of the total amount, though this is largely attributable to a single portfolio transfer related to the acquisition of GLP. Even so, 2018 has seen significant investment activity among a diverse set of foreign and domestic players, especially J-REITs.

Review and prospects
After a sharp increase in vacancy in the wake of historically large supply, the Greater Osaka market is steadily recovering as supply cools. According to Ichigo Real Estate Service, vacancy fell from 12.8% in January to 9.6% in October and rents rose 3.2% YoY. Greater Tokyo, on the other hand, saw over 2 million sq m of supply in 2018, though vacancy has risen only slightly so far as e-commerce and 3PL firms actively sweep up space. Further, rising e-commerce revenues and the expected influx of new high-spec facilities has turned expectations of rental growth positive for the first time since early 2016. As the overall market strengthens, however, large supply is being met with strong but uneven demand, leading to a divergence among submarkets as some new facilities require more time to fill space.

Against this backdrop, a slew of new players entered the field in 2018. Tokyo Tatemono, a major domestic developer, has made its first push into the sector by partnering with CRE to construct a built-to-suit facility in Saitama, with plans for additional developments in Greater Osaka. In August, U.S.-based investment manager Angelo Gordon made its own Japan industrial foray, purchasing a 100,000 sq m facility in the Osaka bay area, one of the largest logistics facilities transacted this year. This may even be an opportunistic buy as the facility, which was developed in 2016 at an estimated cost of 20 billion yen, is rumoured to have had low occupancy at purchase.

Existing players are also strengthening their positions. Nomura Real Estate, for example, intends to develop at least nine facilities in the Greater Tokyo area from 2018 to 2020, adding over 600,000 sq m to the market. 2018 has also seen robust REIT activity, including the IPO of two new logistics J-REITs. Capital markets appear to have had a mixed response to this large financing, however, with logistics J-REIT unit prices underperforming the TSE REIT index by 14% YTD. Concerns regarding large supply, in addition to significant capital raising by J-REITs in particular, may be weighing on equity investors. Nevertheless, prospects for hard assets remain sound, supported by strong demand. With limited acquisition opportunities in other sectors, increased supply may even provide much-needed flexibility to prospective buyers.

To be sure, large supply to Greater Tokyo will likely increase vacancy in the near term, particularly for the inland areas where new supply is concentrated. Bayside vacancy remains low as the submarket enjoys excellent access to transportation infrastructure and limited supply. Greater Osaka has seen a similar divergence, as bayside locations have been struggling to fill spaces, while well-located inland facilities are seeing tighter vacancy. However, 2019's supply is expected to be around 40% of 2018's, which should give more breathing room for new facilities to secure tenants.

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4 Based on the simple average of unit price movements from 4 January to 30 November for seven pure logistics REITs and two mixed-sector REITs with logistics exposure.
Alternative assets

As core asset yields continue to tighten, some investors are exploring new asset classes in search of higher returns. Alternative asset classes such as healthcare, student housing, self-storage, and data centres have become more prominent over the past several years. Investor interest is steadily picking up as some large players enter the arena and new opportunities emerge. That said, current opportunities are still relatively small and markets are fragmented, possibly requiring more time to scale up.

Healthcare

Japan’s over-75 population is forecast to increase from 16 million in 2015 to 22 million in 2025. Current projections suggest that senior housing supply will not keep up with demand over the medium term, despite a 160% increase in private stock since 2011.

Volumes since 2007 have typically not exceeded 30 billion yen per annum, demonstrating a lack of investment opportunities, though they are steadily increasing over time. For example, Hoosiers, a developer of retirement homes, is ramping up development plans and aims to launch a REIT in 2020. Sector cap rates have compressed rapidly since the emergence of healthcare J-REITs in 2013. While REITs have mainly focused on private senior housing so far, 2017 and 2018 saw further expansion into other healthcare asset types.

Concerns of a labour shortage pose risks to operator profitability. Possible changes in government policy also cloud the industry outlook somewhat. On the other hand, consolidations, business transfers, and major shifts in healthcare demand may lead to a wave of new investment opportunities.

Although the healthcare market is still in its infancy and lot sizes are relatively small, more opportunities for institutional players should emerge over time as the sector matures. Please see our November 2018 “Japan Healthcare” report for a more in-depth analysis of the market.

Student housing

Student housing offers stable revenues as education demand is relatively insulated from the economic cycle. End-users of upscale student housing tend to be from affluent backgrounds, and in some cases, student housing is master leased to specialised operators or universities, providing a layer of protection for investors.

The number of international students coming to Japan has expanded in recent years, fuelled by growing demand from nearby countries for high-quality tertiary education that offers good value for money, a safe environment, and the possibility of gainful employment after graduation. A government-set target of 300,000 international students by 2020 as well as recent relaxations in immigration restrictions is also aiding growth. Foreign students, who often struggle to rent private accommodation in Japan, represent a significant proportion of the growing number of students. Current stock is forecast to fall below strong demand, providing a positive outlook for the sector.

In March 2017, Global Student Accommodation announced a partnership with Star Asia Group, targeting 20,000 student beds. Also in 2017, Mizuho launched a 10 billion yen fund, planning to lease land from national universities and develop dormitories, while in April this year Mitsui Fudosan opened the Waseda International Dormitory, boasting 500 rooms at a premium location just five minutes from the Waseda Campus.

Cap rates on student housing transactions reported by J-REITs have compressed from the mid-6% to the low-4% level. As with senior housing, the market is still small, keeping assets under the radar of larger investors. Consolidation of operators and build-out of complexes should create more opportunities for institutional investors in the future.

Self-storage

Quraz, one of the largest self-storage providers in Japan, forecasts annual market growth of nearly 9% up until 2020. Japan’s population continues to congregate towards smaller abodes in urban centres, perhaps raising needs for personal storage, while e-commerce and small business sales growth should fuel needs for business storage solutions.

Storage facilities tend to have stable occupancy and low customer turnover. Units are typically installed in lower grade office buildings, with low setup and acquisition costs. As a result, they offer attractive yields compared to office and residential assets, possibly surpassing 6% in Tokyo.

The Japanese market for self-storage facilities was estimated to be about 65...
Investor interest appears to be growing. Arealink, a Tokyo-based operator, sold 15 blocks of units in 2017 and plans to sell about 40 blocks in 2018, growing to 60 in 2019. According to the Nikkei, in 2017, developer Palma was approached by an overseas investor for facilities worth 5 billion yen, and in January 2018, it established a joint venture to launch self-storage REITs and eventually list on the stock market. Ichigo also plans to create private REITs.

Given estimated market penetration of just 0.3% versus 10% in the U.S., this sector may have large growth potential for many years to come. Investors who target the sector now could still benefit from an early-mover advantage, but competition for land has been fierce and it is not easy to outbid residential developers.

**Data centres**

Japan comes second in terms of the number of data centres throughout the Asia Pacific region, according to Cloudscene, a data centre directory service provider. The Japanese data service provider market is expected to exceed 2 trillion yen in the near future. According to figures by Colt, a data centre provider, the Japanese multi-tenant data center market is set to grow faster than the global average in 2018, at a rate of 16%.

In 2016, Google launched its first Japanese cloud region in Tokyo, with plans to launch another in Osaka in 2019. In 2017, Digital Realty opened its first Japanese data centre in Osaka and announced a joint venture with Mitsubishi Corporation through which it plans to manage more than 200 billion yen in assets by 2022. Other corporations such as Salesforce, Oracle, NEC and Colt have also announced plans to expand in Japan.

Japanese firms are not well incentivised to cannibalise existing business with attractive profit margins. As such, rapid growth in the market has largely been driven by international players, as in the logistics sector.

The asset-heavy nature of the business places high financial demands on providers, making tax efficient schemes such as REITs ideal for expanding the data center business. Limited available land, however, somewhat restricts the rollout of such products. Long lead times, particularly with respect to energy infrastructure installation which can take as long as seven years, is also holding back expansion efforts. There may be latent opportunities, however, as large Japanese firms own vast amounts of underutilised assets.

**Opportunities and risks**

**Opportunities**

An increasing amount of capital is chasing global real estate, and the Japanese market continues to attract interest due to its sound prospects. GPIF is slowly but steadily formulating its investment strategy, while J-REITs, which have seen unit prices rise modestly through the year, may increase investment activity in 2019 as demand for hard assets is strong. Some investors are making forays into different asset categories and markets in pursuit of higher yields. New investment strategies are also being tested to take advantage of shifting underlying trends. Below are some of our investment ideas for Japan.

**Core and Core-plus**

Although Core and Core-plus continues to attract probably the strongest interest, ticket prices are high and acquisition opportunities that meet investors’ target yields are rather limited. Grade B offices in Tokyo, as well as regional offices, are expected to see increasing interest from investors who are priced out of Tokyo’s Grade A market. Residential properties are the most sought after given their defensive nature, though cap rates are highly compressed.

**Value add**

With inbound tourism growing, hotel guests’ preferences are diversifying, and demand for different product types, service levels, and locations are increasing. Against this backdrop, boutique hotels are growing in popularity and companies like Marriott and Sekisui House are developing hotels in rural areas where global hotel brands have traditionally shied away. Investors who are willing to venture into these new hotel categories could earn premiums above typical hotel acquisitions.

**Opportunistic**

Although the logistics market in general is stable, some logistics facilities in areas where supply concentrates are struggling to fill vacancy. Opportunistic investors could snatch up those underutilised properties, secure tenants, and exit at better prices. Opportunistic investors could also renovate ageing office properties.
Spotlight | 2018 review and 2019 prospects

Savills plc

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and ratchet up values. For instance, GreenOak Real Estate relaunched the Aoyama Building in September after a large-scale renovation. There should be more opportunities left for long-term investors with well-thought-out strategies and strong intuitions.

Risks

Overseas risks
Bolstered by a stable government and consistent economic policy, Japan’s prospects are good; however, the global economic and political climate is becoming more uncertain. Though Japan is relatively insulated from current global issues, the U.S.-China trade war is disturbing supply chains and posing a risk to the global economy. The impact will be felt unevenly among countries, based upon their dependence on the U.S. and China in trade. Japan’s dependence on trade is relatively small, but the discord between the world’s two largest economies is likely to have a negative effect on global markets, which could impact Japan specifically. Political uncertainty in Europe presents another risk for global prospects in 2019.

Interest rates
The prospect of higher interest rates is somewhat contributing to buyers’ cautionary stances. The Fed continues to taper, and the European Central Bank is expected to follow suit in 2019. The BOJ relaxed its 10-year yield target to 0.2% as the side effect of its monetary policy is being echoed. However, capital demand in Japan is limited for cash-rich corporations and households, and Japan’s relatively wide spreads have some room to narrow while remaining attractive. Additionally, investment appetite for Japanese real estate continues to grow. We expect only mild increases in interest rates in the near future, which should not have an observable impact on property prices. That said, a sharp rise in overseas interest rates, particularly in the U.S., could have a significant impact on interest rates in Japan and, ultimately, property investment.

Consumption tax hike
The consumption tax hike planned in October 2019 could weaken household spending and dampen the current upswing of the domestic economy. Learning from the fallout in 2014, the government plans a number of countermeasures to mitigate the immediate impact on consumption. Some have even argued that the government is going further than necessary: measures include a 5% rebate on cashless purchases, premium shopping vouchers, and free early childhood education. As long as sound economic conditions hold, the negative effects from tax increases are likely to be manageable.