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Japan

Spotlight
Japan negative interest rates

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The Bank of Japan's negative interest rate policy (NIRP) is buoying real estate markets in general, especially for sellers, individual and retail buyers, and J-REITs. Counterintuitively, NIRP appears to be decreasing transaction volumes and repelling some investors. An eventual slowdown in credit growth could lead to a change in market direction.

Transaction volumes

Attractive funding costs may have initially spurred greater investment, but the opposite may now be true. Sellers need to divest properties if attractive funding is not available. However, current funding conditions make refinancing more attractive than selling in some cases. Many sellers have therefore cancelled disposals when buyers have proven unwilling to meet sellers' ambitious price targets. YTD transaction volumes have significantly decreased, down 34% January through September against the same period last year. This is partially due to exceptionally high volumes in 2014 and 2015, however, when total transactions excluding land almost matched 2007 figures. We have witnessed the cancellation of several US$ billion transactions this year, partly due to the availability of extremely attractive refinancing.

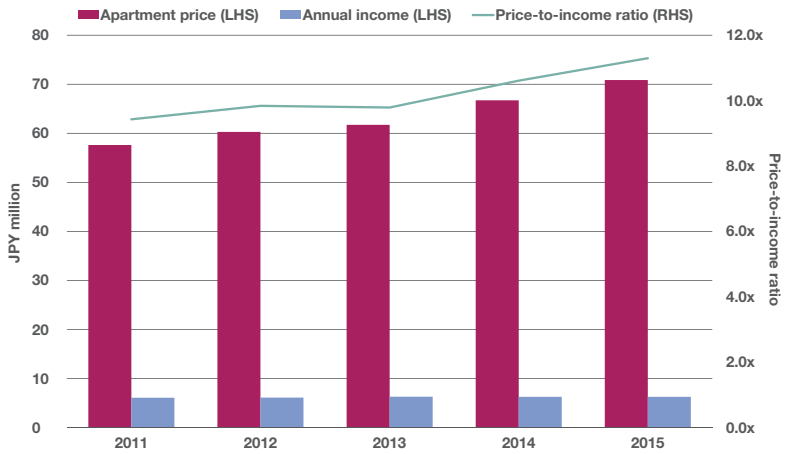
Individual investors

Individual investors have aggressively invested in residential properties by leveraging attractive loans. Prices have significantly increased as a result. According to Tokyo Kantei, a Japanese real estate data provider, the ratio of newly built condominium prices to average annual income currently stands at 11.3x in Tokyo, up from 10.6x the previous year. A ratio of over 10x is considered high. The ratio for Tokyo condominiums over 10 years old stands at 6.7x, up from 6.3x in the previous year, and looks more reasonable. There are several other reasons for higher prices – rising construction costs, land prices, purchases to manage inheritance taxes, a softer yen and robust demand from emerging Asia all play roles as well.

Some individual investors have extremely high leverage at over 90-100%, which may cause problems when markets soften. Regional banks,

GRAPH 1

Tokyo incomes and housing prices, 2011–2015



Source: Tokyo Kantei, Savills Research & Consultancy

SUMMARY

- In 2016, many large transactions have been cancelled partly because sellers could enjoy higher returns through lower refinancing costs. This is one major driver of 2016's significant decrease in transaction volumes.
- Individual investors have taken advantage of negative interest rates and higher leverage, leading to higher prices especially in residential property such as condominiums.
- On the other hand, institutional buyers have not significantly increased leverage and look to be on firm footing in the event of a possible downturn.
- Bank exposure to the property market has been edging up from an already high level. This may become an issue especially for retail lending.
- Increases in land prices are partly driven by attractive funding.
- J-REIT unit prices have risen on the back of lower funding costs, which free up more capital for dividends and also grant more firepower for acquisitions.
- Considering new initiatives announced by the Bank of Japan (BOJ), this low-funding-cost environment appears likely to continue though it may slowly taper over the medium term.

lacking the diversified businesses of large banks, tend to favour loans to such investors because it is one of the easiest ways to seek returns.

Institutional investors

Institutional investors are keeping disciplined control of their balance sheets and are generally maintaining sound leverage. Since cap rates have compressed, mainly core investors have been active and are acquiring stable properties at moderate leverage. Such transactions should survive even during a downturn, although price corrections may drag investment returns down to a nominal level. Institutional investors therefore appear positioned to survive a possible downturn even after acquiring properties at historically high prices.

J-REITs

J-REITs have benefited from NIRP. Low funding costs have enabled them to increase dividends per unit despite a lack of accretive acquisitions. This has gradually pushed up unit prices – the Tokyo Stock Exchange's J-REIT index has increased 47% from January 2013 through September 2016. J-REITs have also been supported by the BOJ's quantitative and qualitative easing programme, which is pumping JPY90 billion into J-REITs annually as of 2016. The programme only targets J-REITs that satisfy certain criteria, however, raising concerns that some J-REITs are benefitting more than others.

Loan exposure to the property sector

The BOJ announced in October that the financial sector's outstanding credit balance has reached a 14.5 year high of JPY500 trillion. This loan balance has been increasing for the past 60 consecutive months. The credit growth speed is different from bank to bank, subject to each bank's appetite. Outstanding credit in large banks has increased 0.8% over the past twelve months, while credit in regional banks grew 3.4% and loans from credit unions grew 2.3%. Total outstanding loans to the property sector from domestic banks and credit unions as a percentage of all loans outstanding has also increased 1.4ppts since the beginning of 2015 to 16.7%, the sharpest rise since 2009.

Land price increases

According to the Ministry of the Economy, Trade, and Industry's (METI) July 1st Kijun Chika report, commercial land prices in Japan's three major metropolitan areas – Tokyo, Osaka, and Nagoya – have seen four consecutive annual increases over the past four years. Residential land prices have increased for the past three years. The Bank of Japan's ultra loose monetary policy, including NIRP, has stimulated demand for real estate investment among financial institutions. Recent price increases have even propagated to mid-tier cities such as Sapporo and Sendai.

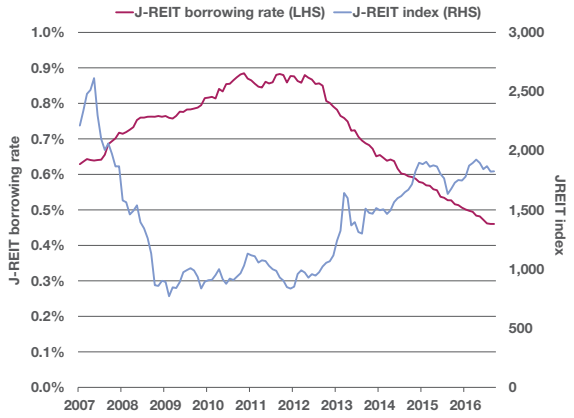
The METI report indicates that commercial land prices in Japan's three largest cities have increased 2.9% YTD on top of a 2.3% increase in 2015. Under the Abe administration, land prices have increased rapidly since 2013. Residential prices increased 0.4% over the same period in 2015. 40% of all residential locations and 70% of all commercial locations surveyed have increased in price. Commercial land prices in the four major cities of Sapporo, Sendai, Hiroshima, and Fukuoka rose 6.7% over the period.

BOJ policy actions

The BOJ is reaching deeper into its playbook to try and stimulate additional inflation in a more sustainable way. Rather than push rates deeper into negative territory or intensify its asset purchases, the bank instead on September 20 began targeting a yield of zero on 10 year government bonds. The bank also relaxed its timeframe for achieving 2% core inflation and its hard commitment to purchase an explicit 80 trillion yen of assets, although it indicates that asset purchases should continue at the same level for the time being. This could be the beginning of stealth tapering by the BOJ, as well as an attempt to make its "bazooka"-style QQE more sustainable, which may allow it more room to fight this sticky issue on a long-term basis.

GRAPH 2

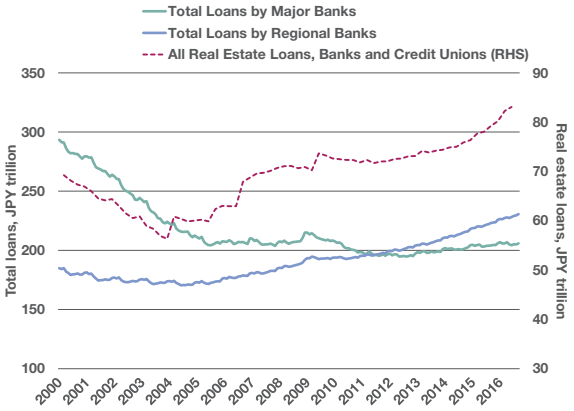
Average J-REIT borrowing rate and J-REIT Index, 2007–Q3/2016



Source: Jefferies, Bloomberg, Savills Research & Consultancy

GRAPH 3

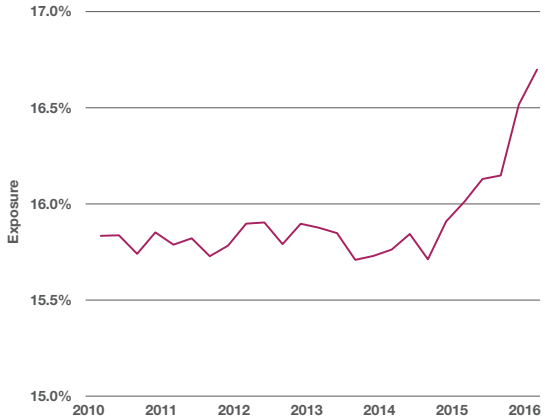
Japanese bank and credit union loans outstanding, 2000–Q2/2016



Source: Bank of Japan, Savills Research & Consultancy

GRAPH 4

Bank loans to property sector as % of all bank and credit union loans outstanding, 2010–Q2/2016



Source: Bank of Japan, Savills Research & Consultancy

OUTLOOK

The prospects for the market

The BOJ's extended policy of low interest rates has stimulated activity in the real estate market, especially for retail investors. Smaller institutions and individuals have taken advantage of attractive and widely available funding to lever up and seek out opportunities in this relatively high-yield asset class. Regional banks, struggling to find borrowers, have readily financed this activity.

As the financial system's outstanding loan balance approaches a 15-year high, however, lenders, especially big banks, appear to be exercising more caution and may slow down origination. The BOJ has stated that it intends to monitor the property market more closely due to this abundant build-up of capital. Institutional investors have by contrast not significantly modified their behaviour under NIRP. These investors appear to be focusing more defensively on core properties with moderate leverage which should survive even during downturns.

Though the BOJ – now in possession of 40% of all outstanding JGBs – has opened the door for future tapering, it appears that Japanese as well as global interest rates will stay very low for the foreseeable future.

Active investment through 2014 and 2015 has pushed transaction prices higher, and buyers have not aggressively negotiated down prices. Sellers have little incentive to lower prices or dispose of assets while refinancing is so attractive. This has resulted in a decline in transaction volumes in 2016. However, activity will remain strong in strategic sectors such as hospitality, where Japan's story of burgeoning inbound tourism continues to sustain investor interest. Operational assets such as hotels should stay relatively popular due to higher potential earnings growth under skilful management.

Continued low global interest rates should keep capital values in the property sector high. Yield spreads vs the 10 year JGB are still higher in Japan than in almost every other Asian market, offering investors relatively juicy returns even as cap rates compress further. Property price corrections, if any, should not be significant because naturally low growth should keep global interest rates low for the foreseeable future. Even in the case of a downturn, institutional players appear well-capitalised and should not suffer any major setbacks. An eventual slowdown in credit growth could offer an early sign of a change in direction.

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