Tokyo – Q1/2019

MARKET IN MINUTES
Savills Research

Residential Leasing

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Rents are rising across the 23W

One year has elapsed since C5W rents surpassed their Q3/2008 level, and 23W rents are now approaching their own high water mark.

- Average mid-market asking rents in Tokyo's 23 wards (23W) stood at JPY3,927 per sq m at the end of Q1/2019, up 2.7% QoQ and 3.6% YoY.
- Average asking rents in the central five wards (C5W) were JPY4,674 per sq m at the end of Q1/2019, up 2.6% QoQ and 3.2% YoY.
- The C5W's premium over the 23W average has dipped by 0.1ppts to 19%, but is still 2.3ppts higher than the five-year average.
- The Inner North once again recorded the strongest annual growth as its proximity to the centre, coupled with a healthy discount to the C5W, attracts demand.
- The Inner East rents are steadily approaching the 23W average as new supply comes online.
- Smaller size band rents once again command a premium after a strong 2018 for larger size bands. The small sample sizes of larger size bands have been contributing to volatility.
- Occupancy rates remained high in Q1/2019, at 97.0% in the 23W, though small pockets of vacancy generated some volatility.
- High condo prices could tempt prospective buyers to rent for the time being, supporting leasing demand, though wealthy residents still appear interested in luxury properties.

"Tokyo rents continue to rise steadily as positive net migration bolsters the urban population, average incomes rise, and a steady supply of new stock comes online. Outer wards are posting above-average growth."

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MAP 1: Tokyo's 23 Wards By Survey Area

Source Savills Research & Consultancy

SURVEY GEOGRAPHY

In order to illustrate trends in the central Tokyo residential market, Savills has segmented Tokyo's 23 wards into seven distinct geographical areas: Central (or "central five wards"), South, West, North (Inner and Outer) and East (Inner and Outer).

RENTAL INDEX DATA CHARACTERISTICS

Savills collates thousands of leasing comparables each quarter in order to analyse trends affecting "mid-market" rental apartment units in Tokyo. Our benchmark rental data is based on average advertised monthly rents for units which fit the following criteria:

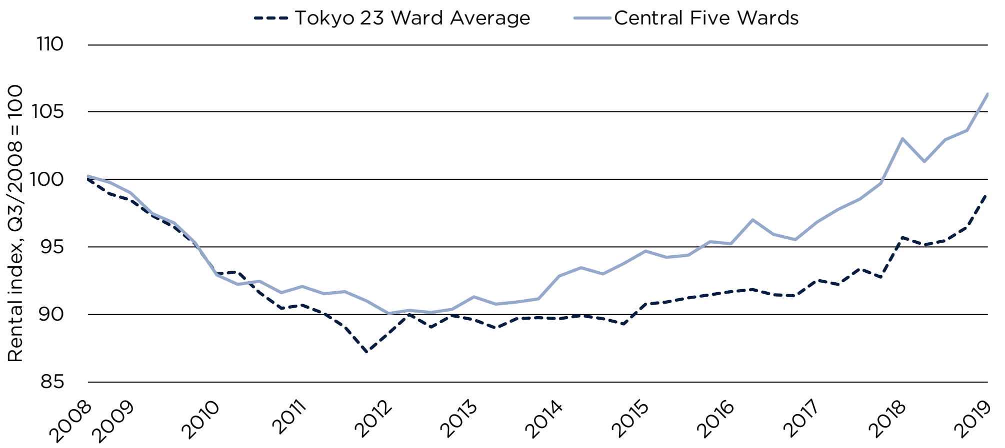
1) studio and one- or two-bedroom rental apartments of up to 100 sq m in size,

2) reinforced concrete structures built within the last ten years, and

3) properties located in Tokyo's 23 wards and situated within a ten-minute walk of the nearest station.

In contrast to the luxury residential market, advertised or "asking" rents for mid-market units fitting the above criteria are typically non-negotiable and are not subject to incentives such as rent-free periods. Savills mid-market rental indices are therefore considered to closely reflect movement in contract rents for the Tokyo market.

GRAPH 1: Mid-market Apartment Rental Index, Q3/2008 to Q1/2019



Source Savills Research & Consultancy

OVERALL RESULTS

C5W rents rose by 2.6% quarter-on-quarter (QoQ) and 3.2% year-on-year (YoY) to reach JPY4,674 per sq m[1] in Q1/2019. 23W average rents were up by 2.7% QoQ and 3.6% YoY to JPY3,927 per sq m. One year has now elapsed since the C5W surpassed its Q3/2008 level, and 23W rents are now steadily approaching their own high water mark.

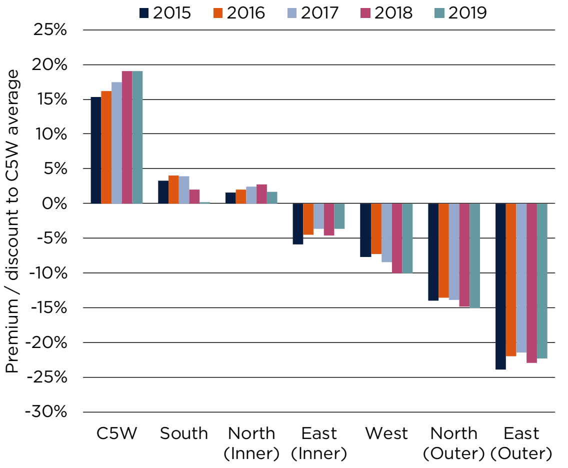
The C5W's premium over the 23W dipped by 0.1 percentage points (ppts) to 19.0% in Q1/2019, slightly below the 2018 average, but still 2.3ppts above the five-year average, while the South and North submarkets still cling to their premiums of 0.2% and 1.9%, respectively. The East submarkets saw strong growth this quarter, narrowing their discounts somewhat. While it seems unlikely that the Inner East will move to a premium over the short term, its position as the submarket with the smallest discount looks tenable.

As urban migration appears to be driven by young, single adults, smaller apartments have tended to be more popular and command a premium. After sitting below larger size bands for two quarters, the popular 15-30 sq m size band has returned to the top spot, growing 3.9% QoQ as the 45-60 sq m size band fell 5.0%. The average age of larger apartments was slightly greater than last quarter, and the small sample sizes of larger size bands may partly explain recent volatility. Indeed, over the last year, the greatest fluctuation in the number of listings in the large size band appears to have occurred in Minato and Chiyoda, where rents are typically at the higher end of the range.

The relatively high cost of purchasing a new condo could be a source of demand for the rental market over the short term, as price-to-income multiples now exceed 13x in the 23W, and initial costs, most of which vary with the purchase price, are similarly elevated, making it difficult for the average resident to make a purchase.

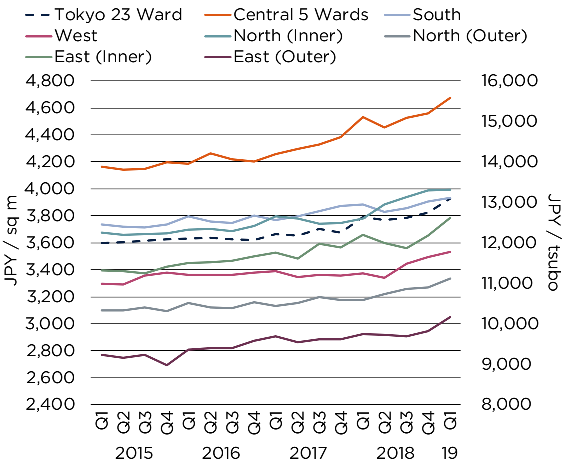
1 Throughout the report, "per sq m" means "per square metre per month".

GRAPH 2: Rental Premiums/Discounts vs 23W Average, 2015 to 2019



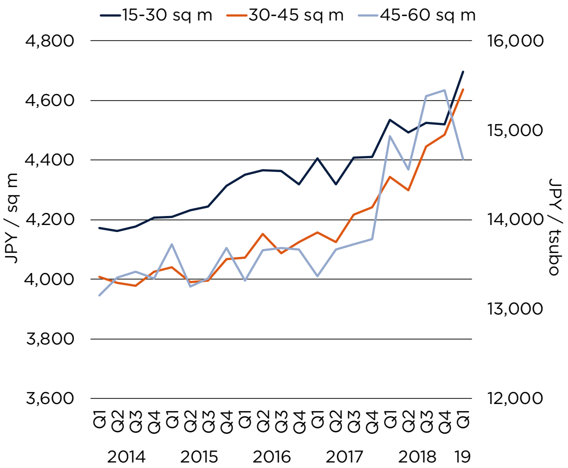
Source Savills Research & Consultancy

GRAPH 3: Mid-market Apartment Rents, Q1/2015 to Q1/2019



Source Savills Research & Consultancy

GRAPH 4: Rents By Unit Size, C5W, Q1/2014 to Q1/2019



Source Savills Research & Consultancy

MID-MARKET RENTAL TRENDS BY SURVEY AREA

Rents in both the C5W and the 23W have now grown for three consecutive quarters, as young professionals continue to migrate to Tokyo for job opportunities and add to the demand pool. The premium that C5W apartments command over the 23W average appears to have levelled off at 19%, though it has risen steadily from 15% in 2015. As there is a relative scarcity of development land in the C5W and demand is unlikely to decrease for centrally-located properties, the premium is unlikely to decline much from this level.

C5W rents rose 2.6% QoQ and 3.2% YoY to reach JPY4,674 per sq m in Q1/2019. Rental growth was generally strong across the component wards, though Shibuya and Minato lagged slightly, rising just 0.4% and 2.2% QoQ, respectively. YoY growth in these two wards is also below the average, with Shibuya up 1.9% and Minato down 0.3%. Chiyoda rose at the strongest pace, up 3.8% QoQ and 5.3% YoY, with Shinjuku not far behind at 3.5% QoQ and 5.7% YoY. Chuo was also up a respectable 3.0% QoQ and 3.9% YoY. Earlier this year, Chuo announced its intention to reduce floor area ratios for new developments, as current social infrastructure is creaking under the pressure of its rapidly growing population, itself encouraged by recent large condo developments. If supply weakens as a result, this could add a tailwind to rents.

Rental growth in the South was 0.7% QoQ and 1.2% YoY, with rents registering at JPY3,934 per sq m at the end of the quarter. While rents in Shinagawa surpassed those in Meguro for a brief period in 2018, they fell 0.6% this quarter, adding to reductions in previous quarters to register a drop of 2.4% YoY. Shinagawa rents now sit between those of Setagaya and Meguro, in line with the trend of the past several years, but seem to have the most upside potential in the South. For example, a new train station opening up just to the north of Shinagawa next year, despite being in a different ward, could increase its status as a commuter interchange even further and boost demand over the medium term.

Growth in the Inner North paused once more in Q1/2019 after a slow Q4/2018, registering the lowest quarterly growth at just 0.1%. Its two component wards moved in opposite directions this quarter, with Bunkyo, the more centrally located ward, rising 1.2% and Toshima, located further from the centre, falling 1.1%. Nonetheless, both still show healthy YoY growth of 7.5% and 3.6%, respectively, and YoY growth for the submarket, at 5.5%, even surpasses the C5W. The Inner North's close proximity and 15% discount to the C5W is likely providing a steady stream of demand.

The Outer North grew 2.1% QoQ and 5.1% YoY to JPY3,336 per sq m, registering the second fastest annual growth after the Inner North, though it is still the second cheapest submarket in terms of average rent per sq m. Some may view the submarket as attractive given its affordability and relative proximity to their home towns, as a decent proportion of migrants to Tokyo hail from adjacent prefectures to the north, namely Saitama and Ibaraki.

The Inner East was up 3.6% to JPY3,785 per sq m this quarter, even stronger than the C5W, and is steadily approaching the 23W average. Taito appears to have driven the majority of this growth, rising 6.3% QoQ and 8.1% YoY, as a raft of studio and one-bedroom listings were brought online at a significant premium to the average.

The Outer East rose 3.5% QoQ to JPY3,050 per sq m. Katsushika has seen phenomenal growth of almost 10.0% this quarter, mainly due to a small number of premium listings in the 15-30 sq m size band. Supply of new developments in the area is limited, lending significant weight to such outliers. However, considering it is one of the cheapest wards in Tokyo, such growth might not be as unrealistic as it seems, particularly if new developments can clear the market. Indeed, YoY growth is even stronger, reaching into the mid-teens, suggesting there may be some momentum.

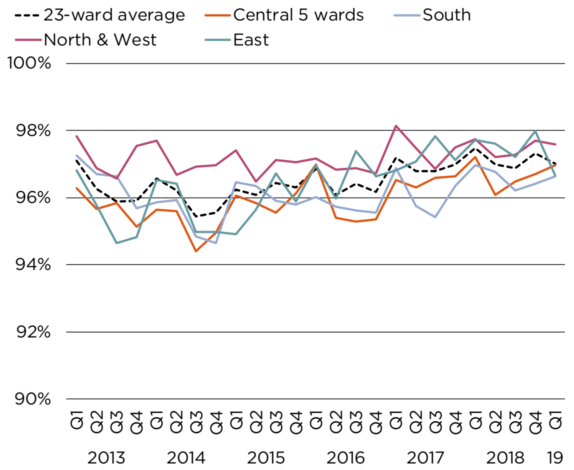
Rents in the West were up 1.1% QoQ and 4.8% YoY, to JPY3,532 per sq m. The primary source of growth is Nakano, where rents are up 2.2% QoQ and 6.8% YoY, which is unsurprising given it is adjacent to the C5W and the remaining wards spread relatively far out to the west. Suginami is also seeing decent growth at 2.7% QoQ and 3.9% YoY, though, perhaps reflecting strong demand from commuters who value access to the Chuo Line, one of Tokyo's most convenient commuter lines, which runs right through the centre of the ward.

RENTS BY UNIT SIZE

Tokyo's rental market is principally made up of compact single-occupier units, typically less than 45 sq m (13.6 tsubo) in size. Such units can often make up as much as 75% or more of the 23W area's rental listings. Unlike other major global cities such as London and New York, house or apartment sharing does not form a major segment of the rental market. As a result, there is a large, stable market for small- to mid-sized units.

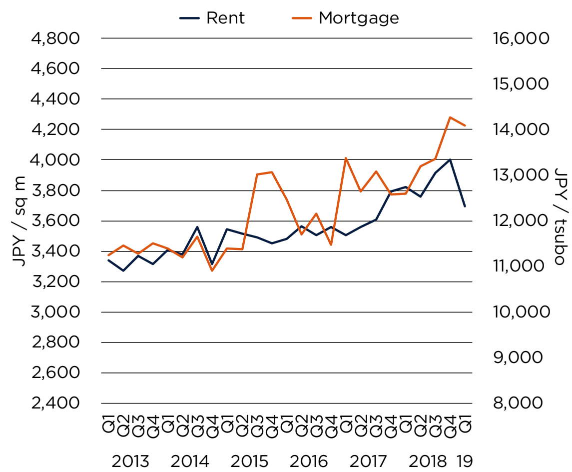
After sitting below the 45-60 sq m size band for two consecutive quarters, the 15-30 sq m size band has returned to the top spot, having risen 3.9% QoQ to JPY4,696 per sq m. The 30-45 sq m size-band has also regained second place after growing 3.4% QoQ to JPY4,637 per sq m. The 45-60 sq m size band, on the other hand, dropped by 5.0% QoQ this period. While this may have been a return to trend, with the last few quarters being anomalous, it might be noteworthy that the average age of large apartments in this quarter's sample was somewhat greater than in Q4/2018.

GRAPH 5: Average Occupancy For J-REIT Residential Assets, Q1/2013 to Q1/2019*



Source Savills Research & Consultancy based on publicly disclosed J-REIT property data (Advance Residence and Nippon Accommodation Fund)
*Q1/2019 estimate based on January & February data.

GRAPH 6: Monthly Rent vs Monthly Mortgage Payment In The 23W, Q1/2013 to Q1/2019



Source Japan Housing Finance Agency, Tokyo Kantei, Savills Research & Consultancy
* Mortgage payments assume a 70 sq m apartment in the 23W, financed at 90% LTV on the reference mortgage rate from the Japan Housing Finance Agency, over 25 years. The reference mortgage rate assumes fixed payments for the first 10 years, reverting to floating payments thereafter. Rent is the average of the 45-60 and 60-75 sq m size bands in the 23W.

Furthermore, there have tended to be many fewer samples available for larger apartments as compared to smaller apartments, making the average more prone to volatility. For example, the number of large size band listings in more expensive wards, such as Minato, has risen steadily over the last year following a lull in Q1/2018.

OCCUPANCY RATES

The average occupancy rate for J-REIT residential assets in the 23W in Q1/2019 was 97.0%, 0.3 percentage points (ppts) lower than in Q4/2018, and 0.5ppts lower YoY. C5W occupancy, on the other hand, rose for a third consecutive quarter, up by 0.3ppts QoQ to register at 96.7%. Occupancy is still down by 0.2ppts YoY, however, after dipping temporarily in Q2/2018.

Demand for institutional-quality residences remains robust across most submarkets, though the East submarket noticeably lagged this quarter. Small pockets of vacancy can adversely affect the average where the number of J-REIT holdings is limited, as in the East, making occupancy appear lower than it might be in reality. For example, the East submarket average dropped 1.3ppts QoQ on an unweighted basis as occupancy in Edogawa dropped to 90%. On a weighted-average basis, the drop in occupancy in the East would be nominal as the size of the apartment in question is just a small fraction of the total.

J-REIT occupancy is expected to remain strong over the long term as J-REITs target new, well-located properties which tend to receive the greatest demand. Dips in occupancy, such as that seen in Edogawa this quarter, are typically isolated and filled within a few short months. Steady economic growth, underpinned by a healthy corporate sector which continues to add jobs, should support demand for Tokyo residences, as should ongoing net migration to urban centres. The significant flexibility of renting as opposed to owning outright should also continue to attract young professionals who are not yet ready to settle down.

RENTING MAY BE A LOGICAL CHOICE

The average price-to-income multiple for a 70 sq m condo in the 23W, according to Tokyo Kantei, now sits above 13x. At this level, average households are understandably hesitant to buy, and indeed, first month contract rates on new condos have been below 70% for two years. While the cost of a mortgage has tended to be similar to that of renting, initial costs, many of which are calculated as a percentage of the purchase price, are high[2], making it difficult for young professionals to afford. Prospective buyers may be tempted to delay their purchases for the time being and remain in the rental market, thereby supporting rental demand.

Such high price-to-income multiples would normally raise concerns that prices should fall, suggesting the windfall to the rental market may be fleeting, but at least three factors provide comfort. First, condo developers have strong balance sheets, and therefore have no pressing need to discount their sales prices. Second, capital values have risen mainly as a result of the Bank of Japan's policy of low interest rates, which appears set to continue for the time being. Third, urban population growth and rising incomes provide sturdy support to purchase demand as much as they do to rental demand.

On the other hand, the second-hand market is becoming increasingly popular, and detached homes are also a popular alternative. In 2018, for example, there were more sales reported in the second-hand market than in the new-build market.

Although the average resident may choose to rent rather purchase at this time, wealthy individuals are interested in luxury condos, and there has been somewhat of an increase in the number of such developments in Tokyo. For more detail, please see our report "Tokyo Residental: Ultra Luxury (March 2019)".

OUTLOOK

Smaller apartments regained their premium over larger apartments this quarter. As net migration to the 23W is largely made up of young, single-person households, rents for smaller size band apartments should see continued growth. Even so, larger size bands should still be supported by dual-income households looking to rent rather than buy, and see their rents grow as well, albeit at a more moderate rate. Condo prices are at high levels and may steer potential owners towards the rental market, further supporting leasing demand. That being said, purchase demand could possibly shift to the second-hand market, sapping some of the potential windfall for the leasing market.

Global economic uncertainty, which was particularly apparent over the last few quarters, now appears a little less severe, though certainly still present. Tokyo's residential market is also relatively insulated from such uncertainty, with stable rent and occupancy movements.Institutional-quality assets, with a solid demand base, should manage to weather softening economic conditions.

Demand for residential assets in Tokyo is sound and increasing steadily, as net migration favours urban centres in general and Japan's capital in particular. Furthermore, companies are continuously adding new jobs as the economy steadily grows, while wages in some industries are showing signs of growth. As such, rents should continue to rise in the 23W, and perhaps more rapidly in the C5W, where supply is tighter and demand is stronger.

2 Actual fees can vary significantly, but are likely to include: 10% deposit, 3% real estate acquisition tax (to revert to 4% in March 2021), 0.4% real estate registration tax, pro-rata consumption tax (8% consumption tax not levied on land, which is assumed to make up the majority of total value in central Tokyo), as well as other miscellaneous fees such as mortgage arrangement fees, legal fees, and other registration fees. Notably, brokerage fees could be nominal on new condos, whereas they can be multiple percentage points for second-hand purchases.