Japan - May 2019

SPOTLIGHT
Savills Research

Japan Retail

Omotesando 1F rents surpass Ginza for now

Summary

- Tokyo's average 1F retail rents are trending upwards, with strong growth in Omotesando and Shibuya this period.
- Demand is sound nationwide, and rents, which are still 12% below 2008 highs, may still have room to grow.
- Inbound tourism supports retail demand growth, particularly in regional cities, while domestic consumers also demonstrate sound demand.
- Sales at drugstores and sports-related shops are firm, while some fast fashion brands appear to be struggling somewhat.
- Retailers who are embracing new technology such as e-commerce can still benefit from occupying physical space.
- A number of large transactions have already been reported in 2019, though the total is currently somewhat lower than at the same time last year. Diverse investor strategies should continue to provide transaction opportunities.

TOKYO SUBMARKET RENTS

According to a semi-annual survey by Japan Real Estate Institute (JREI) and BAC Urban Projects, most of Tokyo's retail submarkets saw rental growth in 2018. Non-1F rents saw steady year-on-year (YoY) growth of 5.7% at the end of 2018, while 1F rents grew more strongly, by 11.8% YoY. The prime retail hubs of Ginza and Omotesando still command the highest 1F rents, but, on average, Omotesando has taken the top spot from Ginza and Shibuya is catching up.

Ginza

Ginza 1F rents pared back by 15.9% half-year-on-half-year (HoH) in 2H/2018 to JPY56,700 per tsubo, giving back more than was gained in 1H/2018 and falling behind Omotesando 1F. The area tends to see far fewer listings than other submarkets, particularly in 1F, and average rents can be volatile as a result of the small sample size. Nonetheless, top rents in super-prime locations remain stable but with low availability. Non-1F rents, which are generally more stable indicators of the area's performance, increased by 2.5% HoH.

The market remains active, with sound demand resulting in available space being snatched up quickly. Muji will open its flagship global store in Ginza in the Yomiuri Namiki Dori Building, taking six floors of the 14,000 sq m complex. High-end luggage retailer Rimowa, owned by LVMH, has also opened a standalone store in Ginza in December 2018, replacing duty free store LAOX, while Bottega Veneta opened a six-storey 800 sq m store in Ginza in the same month, taking up space vacated by Dior. High-end jeweller Fred opened a store in December 2018 in place of former occupier Tenshodo. Red Valentino has opened another pop-up store, this time in Ginza, in the wake of last year's popular Omotesando location.

Omotesando

Omotesando 1F rents rose 1.7% HoH to JPY61,100 per tsubo, and YoY growth stands at a more impressive 24.9%. 1F rents in Omotesando surpassed those of Ginza this period, though whether this will persist is uncertain. Non-1F rents rose 7.0% HoH and 17.4% YoY, to JPY33,700 per tsubo. Omotesando generally has a similar cachet to Ginza, playing host to many luxury brands, but also includes Harajuku, an area renowned as the centre of Japan's pop culture. Popular with social media influencers and boasting a mix of niche pop-up stores, concept stores, and showrooms, Harajuku has a unique character that helps make the Omotesando market a hub for emerging fashion trends.

That being said, the Harajuku area appears to be branching out towards more mainstream sectors such as sportswear and outdoor activity shops. Tiffany has even opened a mixed-use café and retail store on the popular Cat Street. This trend could benefit the area through a more diverse customer mix, as well as luring in larger, more creditworthy brands. The Harajuku station redevelopment is expected to complete in 2020, and the Meiji Jingu Crossing development is expected to complete in 2022, both of which could breathe new life into the area. Indeed, the prospects for rental growth in Harajuku look promising.

While GAP closed one of its flagship stores in Harajuku, there have been many new openings in the area, with @cosme Tokyo taking that particular spot. Uniqlo will also open a "GU Style" store in Harajuku, where purchases must be made online and no stock is held on site. LUSH opened a store in Harajuku in November, which is trialling new digital retail technology. The new store is devoid of product descriptions and has no sinks for demonstrations, instead encouraging customers to use an app to navigate its wares. Starbucks opened one of its highest quality stores in Omotesando Hills in April, the first in the country to incorporate biophilic design, which is attracting a great deal of attention around the world for creating harmony between people and nature.

Shinjuku

In Shinjuku, 1F rents grew by 2.6% HoH and 0.8% YoY to JPY35,700. Non-1F rents in Shinjuku have been steadier over the long term, up 16.7% over the last three years, but are down slightly this period, by 1.5% HoH and 2.6% YoY. As with Ginza, the small sample size, rather than low demand, should be the cause of the recent decline. Indeed, there is such little availability that many brands who wish to open storefronts in Shinjuku are unable to do so. The East-West public passage, which will feature large-scale developments around the station, is expected to open in 2020 and could satisfy unaccommodated demand, perhaps driving rents higher in the process.

Shibuya

1F rents in Shibuya rose a whopping 21.1% HoH to JPY43,100, and have kept strong momentum over the longer term. Non-1F rents are also growing steadily. Shibuya benefits from its reputation as a haven for younger shoppers, making it a favoured location for fast-fashion retailers. Although such brands appear to have been struggling somewhat recently, fierce competition in the sector means vacancies tend to get filled quickly, shielding landlords from the sector's encumbrances to some extent. HOTMESS has occupied the NUBIAN pop-up store dedicated space in Shibuya since November 2018. Aside from fashion retail, soap maker AESOP opened a store in Shibuya in January 2019

Development of Shibuya Scramble Square is finally drawing to a close. When it completes in Autumn 2019, footfall and freedom of movement in the area should improve markedly. Further away from the station, Shibuya Parco, a landmark destination, is also set to reopen in Autumn 2019 after being closed for redevelopment. Aside from inducing new demand and increasing footfall, the presence of two landmarks might draw out competition between retailers and reinvigorate the area.

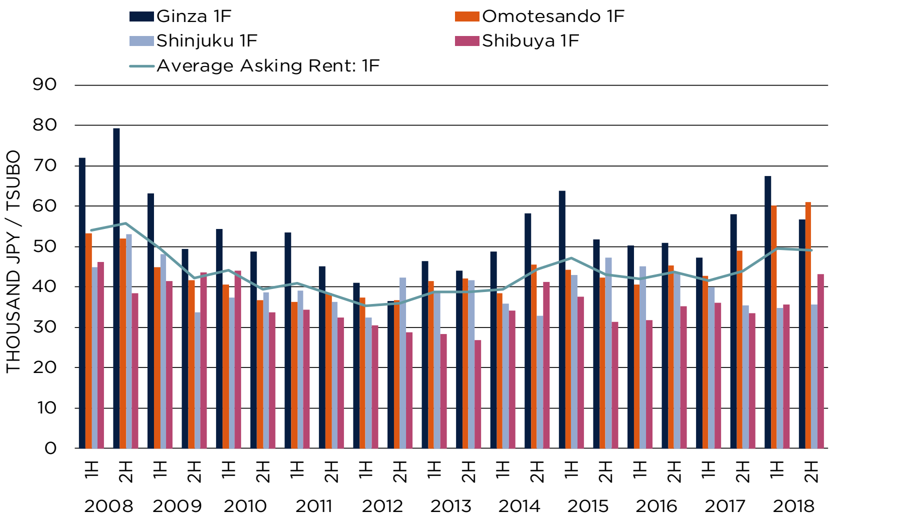
REGIONAL CITIES

Rents have been generally stable in key regional cities, exhibiting less volatility than Tokyo since 2009. On average, regional 1F rents increased by 5.0% HoH to JPY24,217 in 2H/2018, while non-1F rents, on the other hand, fell 6.6% HoH to JPY12,600.

Osaka appears to be in the most promising position of the regional cities, with strong draws for tourists and multiple infrastructure projects in the pipeline. Indeed, the latest Chika Koji land price announcement in 2019 found that

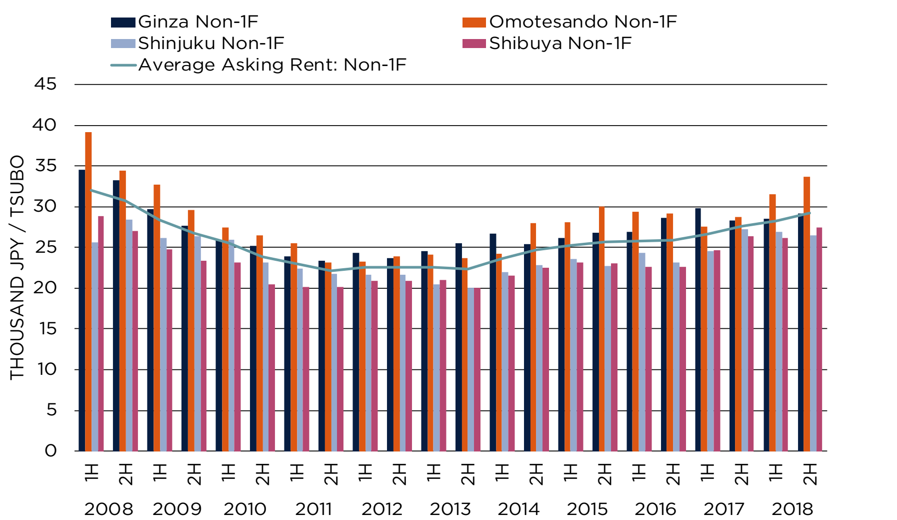
Retail assets remain attractive, particularly in prime locations, and large deals have already taken place in 2019. New restrictions on the resale of imported goods in China may have affected luxury sales somewhat, but domestic demand is still sound, particularly in popular shopping areas.

GRAPH 1: Tokyo 1F Rents, 2008 to 2018



Source JREI, BAC Urban Projects, Savills Research & Consultancy

GRAPH 2: Tokyo Non-1F Rents, 2008 to 2018



Source JREI, BAC Urban Projects, Savills Research & Consultancy

Kuromon market in Osaka, which is particularly popular with foreign tourists, saw the second highest rate of increase in commercial land prices nationwide. Other measures of land price growth also place Osaka at the upper end of the range.

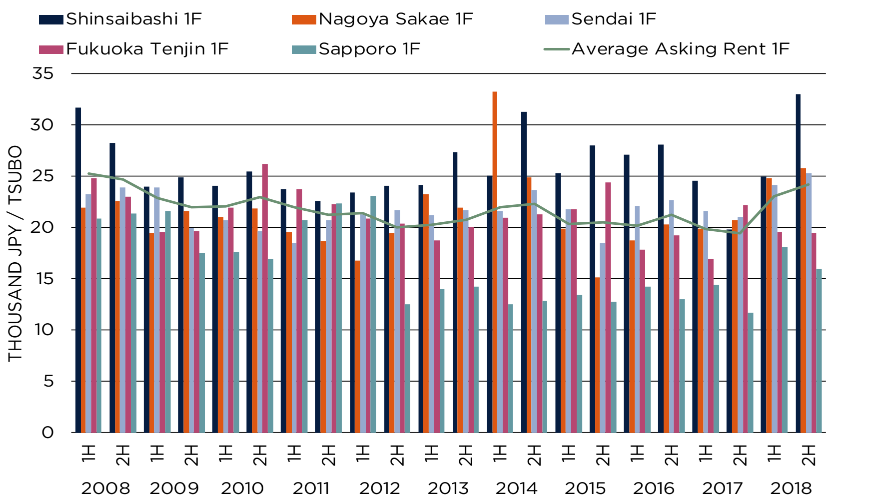
Osaka's Shinsaibashi 1F rents continue to see the strongest growth in Japan, up a whopping 32.0% HoH and 66.7% YoY. Osaka has seen a massive influx of tourists as the city lured low-cost carriers and promoted itself as a base to visit nearby Kyoto and Nara. Tourist numbers appear set to continue to grow: Osaka is preparing to open a 1 million sq m integrated resort in FY2024, expected to draw 2.2 million visitors by 2030 at an estimated economic impact of 760 billion yen per year.

1F rents in Nagoya's Sakae are steady, growing 4.0% HoH and 24.6%YoY. A number of mixed-use developments are underway in the area, such as the Chubu Nippon Building which should add fresh retail space when it completes in 2024. New supply could be taken as a vote of confidence in the viability of the area as a retail district.

1F rents in Sendai are growing at a similar pace to Nagoya, up 4.5% HoH and 19.9% YoY. In Sapporo, 1F rents were down 11.6% HoH, though they are still up 36.8% YoY after a strong increase in 1H/2018. 1F rents in Fukuoka Tenjin shrank by 0.5% HoH and 12.2% YoY. The outlook for regional shopping centres is looking rather weak, with some facing closure, though shopping malls in prime locations should hold up well.

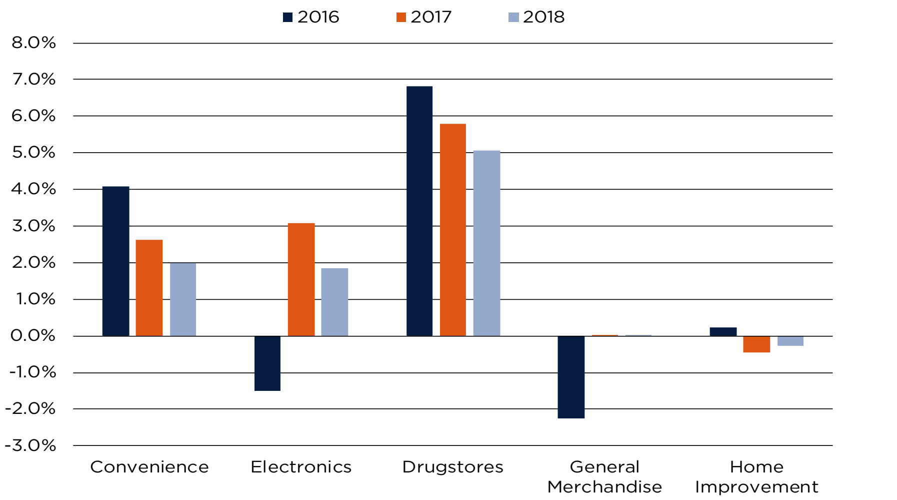
Tourism growth appears to have benefited regional cities more than Tokyo in relative terms: duty free and department store sales have been on an upward trend for years in conjunction with tourism growth. Although duty-free sales fell 7.7% YoY in January, perhaps as a result of China's new e-commerce and tax laws targeted at resellers of items purchased overseas, February and March data released by the Japan Department Stores Association showed a strong rebound and three of Japan's top department store operators reported brisk demand for luxury goods from tourists. As

GRAPH 3: 1F Rents In Retail Districts Of Regional Cities, 2008 to 2018



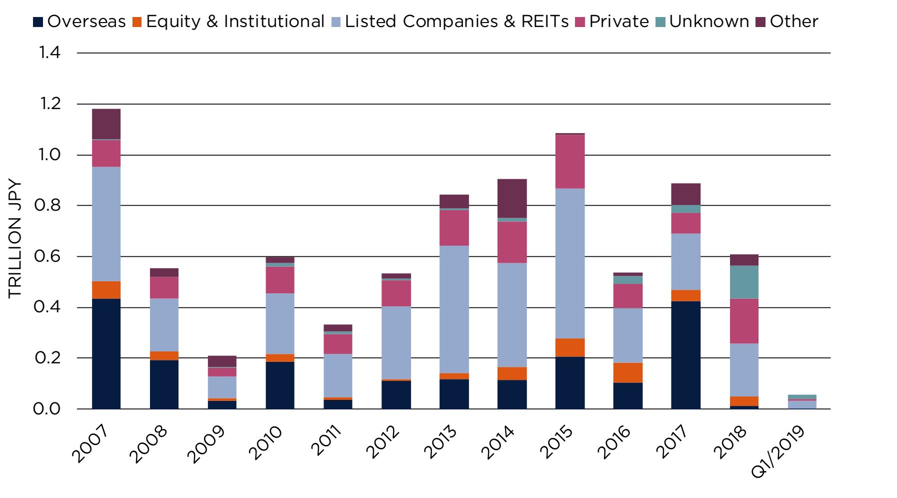
Source JREI, BAC Urban Projects, Savills Research & Consultancy

GRAPH 4: YoY Sales Growth By Sector, 2016 to 2018



Source Ministry of Economy, Trade and Industry, Savills Research & Consultancy

GRAPH 5: Retail Property Investment Volume By Buyer Type, 2007 to Q1/2019*



Source RCA, Savills Research & Consultancy
*Q1/2019 volume is preliminary and is likely to be revised upwards.

tourism continues to grow, despite the odd bout of volatility, overall tourist spending should also rise.

BRIGHT SPOTS IN THE RETAIL SECTOR

Overall, the retail landscape looks steady. Consumer confidence is firmer than it has been on average over the last decade, at 40.4 as of April. Consumer expectations of price rises are also high, with 87% of respondents in an April Ministry of Economy, Trade and Industry (METI) survey expecting prices to rise over the next year. Retail spending could increase in expectation of inflation. Retail sales are growing at a steady rate, and wages, particularly at the lower end, are rising, albeit at a meagre pace. Continued growth in inbound tourism spending should provide yet another tailwind for the sector. On the other hand, global uncertainty could weigh on aggregate spending: duty free sales and luxury goods are key indicators to monitor.

As for specific retail submarkets, Omotesando is faring very well, as demonstrated by strong rental growth this period. The area is a popular hub for pop-up stores, which have been taking up space vacated by fast fashion retailers. Shibuya expects the completion of multiple new developments this year, including the highly anticipated station-front redevelopment, Shibuya Scramble Square, which should further boost the area's popularity. The reopening of Shibuya Parco should also help increase footfall, as development works will no longer clog up popular shopping routes. In Fukuoka, where office demand is extremely strong, multiple retail floors at Aeon shoppers have been temporarily converted for office use, and in Nagoya, the upcoming Noritake Forest Project will mix office and retail space in the same property. Food and beverage retailers in these converted locations could benefit from a steady stream of office-worker demand.

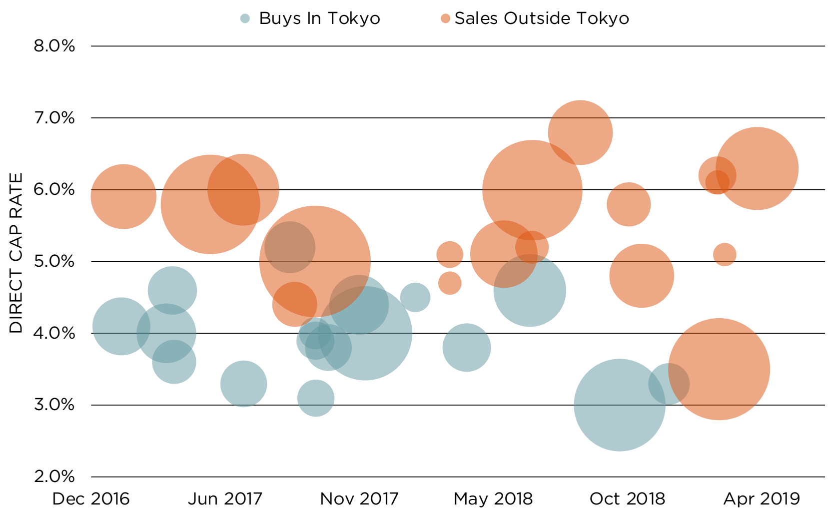
Drugstores have seen consistently solid sales growth over the last few years (Graph 4), their products proving particularly popular with the rapidly growing number of inbound tourists. Some consider that growth rates have peaked, however, so the outlook is more likely to be steady than optimistic. While all regions in Japan have seen positive YoY growth in drugstore sales, Tohoku and Chubu look particularly strong at 8% and 6.5%, respectively, as of March. Convenience stores have also been performing reasonably well, particularly in the Kansai and Chugoku regions, where YoY sales growth was up 5.7% and 4.6%, respectively, in February, and both up 2.3% in March. On the other hand, the industry faces severe labour shortages, which are eating into margins or in some cases forcing stores to cut opening hours. Although more employees could be attracted by the prospect of higher wages, as inflation is so low and competition so fierce, operators may struggle to raise prices and already razor-thin margins would suffer. Such labour shortages are severely affecting retail sectors, particularly labour

TABLE 1: Selected Retail Transactions, Announced Q4/2018 to Q1/2019

ANNOUNCED	PROPERTY	LOCATION	GFA (SQ M)	PRICE (JPY BIL)	DIRECT CAP RATE	BUYER
Nov 2018	LaSalle IM Portfolio Sale (4 assets)	Nationwide	430,000	98.1	NA	Undisclosed
Feb 2019	8953 Osaka Shinsaibashi Building	Chuo, Osaka	14,000	14.9	3.50%	Undisclosed
Oct 2018	G-Building Minamiaoyama 03	Minato, Tokyo	1,500	12.2	3.00%	Japan Retail Fund
Dec 2018	Luz Musashikosugi	Nakahara, Kanagawa	12,000	12.2	4.10%	United Urban REIT
Oct 2018	E-ma	Kita, Osaka	11,000	12.0	NA	Angelo Gordon

Source Press releases, RCA, Savills Research & Consultancy

GRAPH 6: Direct Cap Rates On Retail J-REIT Transactions*, 2017 to April 2019



Source J-REIT disclosures, Savills Research & Consultancy
*Bubble size reflects transaction value. Largest transaction is JPY18 billion.

intensive sectors such as convenience stores.

E-commerce has been branded as a threat to traditional bricks and mortar retailers, but those retailers who are able to adapt quickly could turn its popularity to their advantage. A 2019 METI survey found that a significant proportion of retailers had experienced greater physical sales after implementing e-commerce solutions. Many brands certainly see value in maintaining a physical presence: IKEA, for example, which is increasing its focus on e-commerce, will open a showroom in the Harajuku Station Front Project in 2020.

INVESTMENT TRENDS

The latest results of a semi-annual survey by JREI, reported in November 2018, revealed that expected cap rates for prime retail property in Ginza and Omotesando sat at 3.4% and 3.5%, respectively, while expected cap rates for suburban shopping centres in the Tokyo area and in regional areas were 5.4% and 6.1%, respectively. Across all of the above subsectors, cap rates were 10 basis points tighter than the previous period. Market cap rates for prime retail property currently sit at 2.9%, some 50 basis points lower than expected cap rates.

At the end of Q1/2019, year-to-date investment in retail property stood at a provisional JPY56 billion, a 46% decline from the same period in 2018, according to preliminary data from Real Capital Analytics (RCA). Osaka boasted the greatest share of the transaction volume, mainly through the sale of 8953 Osaka Shinsaibashi Building and AEON Minami Senri. In light of Osaka's tourist boom, strong land price and rent growth, it is unsurprising to see strong interest.

Investors are pursuing a variety of strategies in the retail space. Japan Retail Fund has long been shifting its strategic focus to core assets: it has recently sold assets in Osaka and Sendai and bought assets in central Tokyo. This well represents the general behaviour of retail investors. On the other hand, AEON REIT, which focuses on regional shopping centres, has outperformed other retail J-REITs since 2017, so there seems to be some investor enthusiasm for higher-yielding regional assets, as well. Cap rates in the regions are certainly higher, both from the perspective of JREI's expected cap rate survey and from reported J-REIT transactions (Graph 6). Investors appear to have opportunities to pick up higher-yielding assets or to dispose of prime assets at high prices.

OUTLOOK

Consumer confidence is lukewarm but stable, and firmer than it has tended to be over the last ten years, and expectations of price increases are somewhat high. Retail sales and tourist spending have grown steadily over the last few years, helping retailers increase their revenues at an encouraging rate. In tandem, rents have also grown steadily, and sound tenant demand suggests they could continue to grow for the time being. Average 1F rents still sit 12% below their 2008 highs. Investors should keep an eye on tenant profitability, however, as staffing costs are eating into margins somewhat, particularly for labour intensive sectors.

The impending consumption tax hike could impact retail sales, but the government is offering concessions which should soften the blow somewhat. Global uncertainty could also be an adverse influence given that tourist spending contributes in no small part to retail sales, particularly in regional cities. China's recent e-commerce and taxation laws appear to have had some effect on luxury product sales, for example, though there are signs this has already recovered somewhat. The unpredictability of Chinese policy requires constant monitoring.

The retail sector has already seen some large transactions in 2019. Market players are adopting varied strategies, some opting for core assets and others for higher-yielding assets. A mix of varied opinions is a major ingredient for a well-functioning market, so this could materialise into some transaction opportunities as investors reshuffle their portfolios. Given sound retail spending, steady rental growth, a stable economic environment and rapidly growing tourist visitation numbers, some retail assets remain attractive.

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