Japan - May 2020

SPOTLIGHT
Savills Research

Japan Retail

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The calm before the storm

Summary

- The upward trajectory of Tokyo's average 1F rental growth continued in 2H/2019, with Shinjuku in particular impressing.
- The retail sector has been hit hard by the onset of COVID-19 and footfall in usually busy commercial areas has unsurprisingly plummeted. As such, the future prospects of this vulnerable sector have taken a sudden turn for the worse.
- With global travel restrictions in place, inbound tourism has also been crimped. Though a blow to the government's ambitions, inbound tourism represents less than 1% of Japan's GDP and, therefore, should be more manageable compared to regional peers.
- Transaction volumes have fallen by over half compared to the prior year, and this looks unlikely to change any time soon. Most deals have understandably been put on the back burner, especially for overseas investors unable to complete their due diligence.
- Despite the short-term pain, the benefits from ongoing retail developments in Tokyo and beyond should be apparent over the longer term, with improved accessibility and modern facilities adding to the vibrancy of high street retail in Japan.
- The gap between the winners and losers in the retail sector is widening. Meanwhile, market players who had built up their technological capabilities before the outbreak are well placed to weather the pandemic and its aftermath.

TOKYO SUBMARKET RENTS

As reported in the semi-annual survey by the Japan Real Estate Institute (JREI) and BAC Urban Projects, rental growth in Tokyo's prime retail submarkets on the whole was impressive during 2H/2019. Average 1F rents increased by 4.9% half-year-on-half-year (HoH) and 14.9% year-on-year (YoY). As for Non-1F rents, growth in this sector has yet again exceeded its typically more volatile 1F peer, rising 8.8% HoH and 15.9% YoY. As such, for the first time, non-1F rents in all submarkets sit above JPY30,000 per tsubo per month. At the submarket level, 1F rents in Ginza remain streets ahead of rivalling districts, whilst the spread between average non-1F rents remains tight.

Ginza

It would appear that Omotesando's status as the most expensive submarket for 1F rents in 2H/2018 was indeed temporary, and normalisation has returned. 1F rents in Ginza have retained the top spot for the second consecutive half year after growth of 4.5% HoH and 38.6% YoY to JPY78,600 per tsubo[1]. As for non-1F rents, growth was equally impressive this period. Despite lagging behind Omotesando for over two years, the spread between these two submarkets has narrowed markedly as rents increased by 12.0% HoH and 21.2% YoY.

As the premier shopping district in Japan, Ginza, perhaps more than most, had benefitted from the boom in inbound tourism. Yet, this could now end up hurting the submarket disproportionately. As a harbinger of what was to follow, both footfall and sales in the submarket declined by around 20% YoY over the Lunar Celebrations. Nonetheless, the likelihood of rents suddenly dropping is low given very limited vacancy as well as the long-term contracts in place with many of the larger retail names with deep pockets.

Omotesando

With a diverse range of customers and demographics, Omotesando has recently seen a jump in the number of popup stores and showrooms to much success. Indeed, with e-commerce continuing to grow, these short-term leasing contracts could be an established trend going forward. Despite the popularity of the submarket, however, 1F rental growth faltered in 2019. Rents fell close to 14% YoY to JPY52,700 per tsubo. In contrast, non-1F rents fared much better, growing 11.2% HoH and 8.9% YoY, ensuring that it remains the most expensive submarket.

Shinjuku

Thanks to the importance of Shinjuku station, this submarket has the highest level of footfall in Japan, and unsurprisingly, sales figures also lead the way. As such, demand from a range of retailers for this submarket is high, adding to the stability of rents going forward. Maybe as a result, having lagged since 2H/2016, 1F rents in Shinjuku are now on par with Omotesando after an exceptional period of growth. Rents increased by 24.0% HoH and 47.6% YoY to JPY52,700 per tsubo – the greatest change out of all submarkets. Given the scarcity of prime locations, however, it is worth remembering the inherent volatility present. Meanwhile, non-1F rents in Shinjuku remain the cheapest out of all the submarkets, and this looks set to continue following muted half-yearly growth.

Given the resilience of the Shinjuku submarket, rents are expected to offer some more resistance under the cloud of COVID-19 when compared to the likes of Ginza. Over the longer term, noteworthy enhancements in accessibility, particularly surrounding to the station, should ensure that prime rents remain high.

Shibuya

Having been on a roll for three consecutive half years, 1F rents abruptly declined this period in Shibuya. After falling 7.5% HoH and 3.0% YoY – the only submarket to experience a drop over both periods – rents languish at the bottom of the pile. Non-1F rents, in contrast, have maintained momentum, somewhat driven by the previously bullish position of the office sector, growing 7.7% HoH and 17.5% YoY.

Despite the surprising drop in 1F-rents, the long-term prospects of Shibuya remain relatively bright. As in Shinjuku, the submarket benefits from a high level of footfall, especially in areas in close proximity to the station and recent developments such as the Urban Core Project have greatly improved accessibility. Otherwise, following in the footsteps of Shibuya Scramble Square and the most recently completed Parco, the Miyashita Park project – due to open its doors in June this year – will add to the vibrancy of the area, whilst also adding to the strong line-up of retail facilities currently available.

NEW DEVELOPMENTS AND EMERGING RETAIL MARKETS IN TOKYO

Despite the bearish prospects of the retail sector, the benefits from the numerous projects currently in progress in Tokyo should preserve the longer term potential of the respective submarkets. In the case of Harajuku for instance, the redevelopment of the surrounding areas, starting with the station – which commenced operation in March – will see a significant modernisation of the region. Likewise, the completion of With Harajuku in May will welcome global tenants such as Uniqlo and IKEA, which should help build on the submarket's already diverse consumer base. What's more, in 2022, the Jingumae 6-Chome District Project will see a 10F commercial complex with

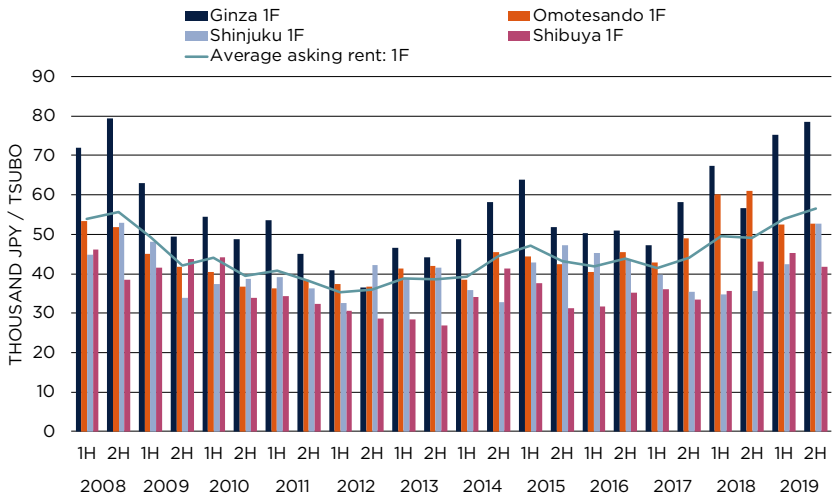
1 Throughout the report, "per tsubo" is shorthand for "per tsubo per month".

approximately 6,700 tsubo (22,000 sq m) of GFA brought to the table. Indeed, there appear to be some glimmers of hope amongst the current gloom.

Elsewhere, not wanting to be left out, Ikebukuro is also undergoing significant change. For instance, the completion of Hareza Ikebukuro in the summer of this year creates a cultural hub, providing cinemas, theatres and concert halls, helping to improve the area's potential. Accessibility is also predicted to be enhanced thanks to the construction of an overpass, on both the northern and southern sides of the station, which will eventually connect the retail districts to the east and west. Looking further ahead, the East Ikebukuro 1-Chome redevelopment project, slated for 2024, is expected to add over 30,000 tsubo (100,000 sq m) of GFA, comprised of retail and office facilities, further adding to the footfall and liveliness within the submarket.

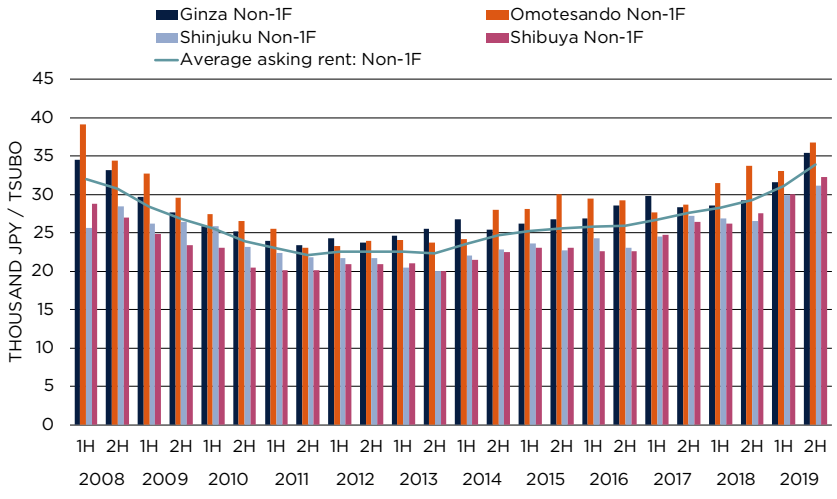
The COVID-19 outbreak has overshadowed the solid rental growth observed in 2H/2019 and, with no respite on the horizon, the prospects for the sector appear daunting. That said, some retailers are better placed than others to weather the ongoing pandemic, especially those able to leverage their technological capabilities.

GRAPH 1: Tokyo 1F Rents, 2008 to 2019



Source JREI, BAC Urban Projects, Savills Research & Consultancy

GRAPH 2: Tokyo Non-1F Rents, 2008 to 2019



Source JREI, BAC Urban Projects, Savills Research & Consultancy

Outside of Tokyo, other major regional cities, such as Osaka, Nagoya, and Fukuoka, have numerous redevelopment projects in the pipeline with the aim of enhancing retail districts and continuing to attract consumers.

REGIONAL CITIES

Average regional 1F rents are back to within 10% of their 2008 highs following a reversal in fortunes in 2H/2019. Growth returned to a respectable 4.2% HoH, pushing rents to JPY22,700 per tsubo. Over the year, however, rents declined by over 6%. Non-1F rental growth, in contrast, picked up where it left off last period. Rents increased by 2.9% HoH and 4.4% YoY to JPY13,150 per tsubo. In terms of specific submarkets, Sendai saw the strongest 1F rental growth over both the half-year and year.

1F rents in Osaka's Shinsaibashi maintained momentum in 2H/2019, though unfortunately in the wrong direction. Rents continued to fall, declining by 12.0% HoH and 26.7% YoY to JPY24,200 per tsubo, giving back much of the upswing seen during 2018. That said, 1F rental growth is inherently volatile given the small sample size. Looking at non-1F rents, growth in this sector was mixed. Rents now stand at JPY13,800 per tsubo following a fall of 1.4% HoH. Over the year, however, rental growth was a decent 4.5%.

The Shinsaibashi submarket has always been a hub of activity, with a significant level of footfall, including a large proportion of foreign visitors. Consequently, the make-up of the retail district had been going through a transition of late, with drug stores replacing fast-fashion retailers to take advantage of the surge in inbound tourism. Yet, for all the footfall, the over-reliance on inbound tourism could end up being the Achilles heel of the submarket under the current circumstances. For instance, Daimaru Shinsaibashi – given the crown for the highest duty-free revenues in the country – has seen transaction volumes largely dry up compared to a year prior. With the COVID-19

outbreak halting the previously high demand from drug stores, rents are unlikely to remain at the current levels, whilst those currently paying high rents may have no choice but to ask for temporary reductions.

In Nagoya's Sakae, 1F rents continued to fall and now lie at JPY20,600 per tsubo. The rate of decline did, however, slow meaningfully during the half-year to 0.5%. The same could not be said for annual rental growth which fell a further 20.2%. Meanwhile, non-1F rents saw rental growth of 2.7% HoH and 6.4% YoY, increasing to JPY15,000. With traditional department store heavyweights such as Takashimaya dominating areas surrounding the main station, fashion retailers are few and far between, found mainly in the Otsu-dori shopping district. That said, the lack of vacancy in this exclusive area has maintained the high level of rents, ensuring the continued premium over its peers.

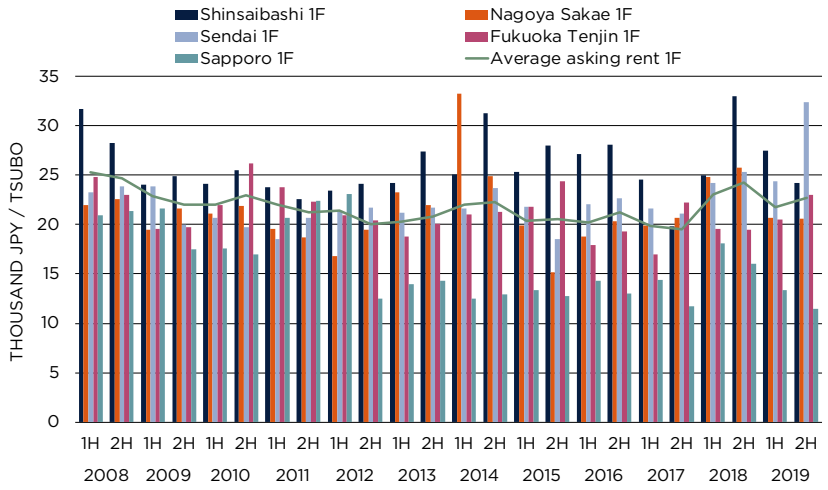
Looking forward, the landscape of the Sakae submarket is set to change significantly. Along with the numerous mixed-used developments due to be completed this year, 2021 will see the completion of the tentatively named Nagoya Mitsui Building North Tower, bringing up to 9,000 tusbo (30,000 sq m) of GFA online. Looking even further ahead, the redevelopment of the Oriental Building, which currently counts Mitsukoshi as the main tenant, is aiming to be completed in 2029. The new B4/34F multi-use facility is reported to be 180m tall, with a potential GFA of 39,000 tsubo (130,000 sq m).

In Sendai, as with the Sakae submarket, fashion retailers are slowly being pushed out of locations around the station, with F&B facilities taking their place. Having remained fairly flat lately, 1F rental growth in Sendai in 2H/2019 was remarkable. Rents now stand at JPY32,400 – by far the highest out of the main regional submarkets – on the back of a 32.8% HoH and 28.1% YoY increase.

The number of 1F listings remains low in Sapporo and therefore volatility is to be expected. Indeed, listed 1F rents fell 14.2% HoH and 28.1% YoY this period, continuing where the last period left off. Even so, actual rents are likely to exhibit more stability as turnover in the prime locations is limited. Inbound tourism has been a significant growth catalyst in this submarket, with department stores and pharmacies alike profiting. Nonetheless, the impact of COVID-19 has put an unforeseen end to this dynamic. Major department store sales declined by 45% in March, the hardest hit among major cities, and the outlook for this submarket is unclear.

As a top destination for overseas visitors, especially from South Korea, the Tenjin submarket was well-placed to ride the inbound tourism wave. Despite the relationship between Japan and South Korea souring, it would appear that it was able to prolong the upward momentum during 2H/2019. Specifically, 1F rents in Fukuoka Tenjin moved 12.2% HoH and 17.9% YoY higher to reach JPY23,000 per tsubo – the highest level in four years. Even so, given its exposure to inbound tourism, and with the disruptions to international travel expected to outlast the pandemic itself, this submarket is likely feeling the pain more than most. Dependent on how it gets through this current uncertainty, however, the longer term prospects of the submarket appear bright, with the Tenjin Big Bang Project expected to be the centrepiece of this recovery.

GRAPH 3: 1F Rents In Retail Districts Of Regional Cities, 2008 to 2019



Source JREI, BAC Urban Projects, Savills Research & Consultancy

GRAPH 4: Diffusion Index Of Current Economic Conditions For The Overall Market And Retail Sector, 2008 to Q1/2020

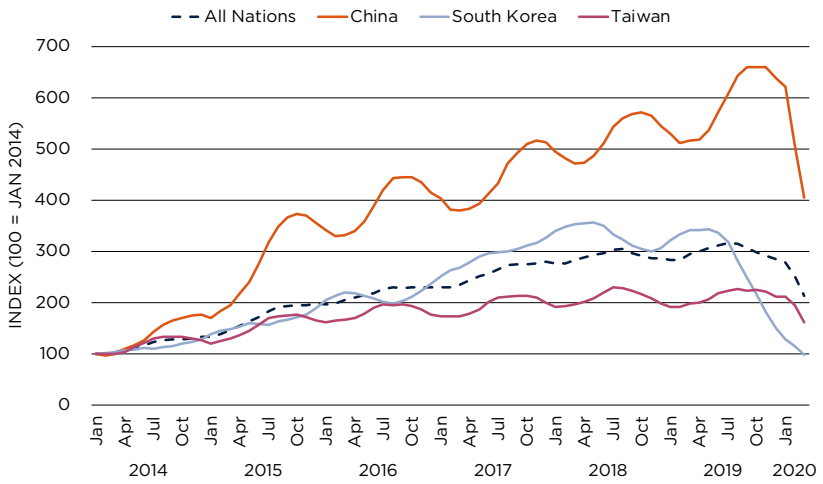
Source Cabinet Office, Savills Research & Consultancy

COVID-19 AND ITS IMPACT ON THE RETAIL SECTOR

Although Japan has yet to implement a strict lockdown as seen in the West, caution amongst residents has been high since February. Footfall, as a consequence, has unsurprisingly faded. What's more, this trend may continue for the time being, and might worsen if the government takes additional steps to restrict the spread of COVID-19. Indeed, this gloomy market sentiment can be clearly seen in the diffusion index for current economic conditions, with the reading touching lows not even seen in the midst of the financial crisis (Graph 4).

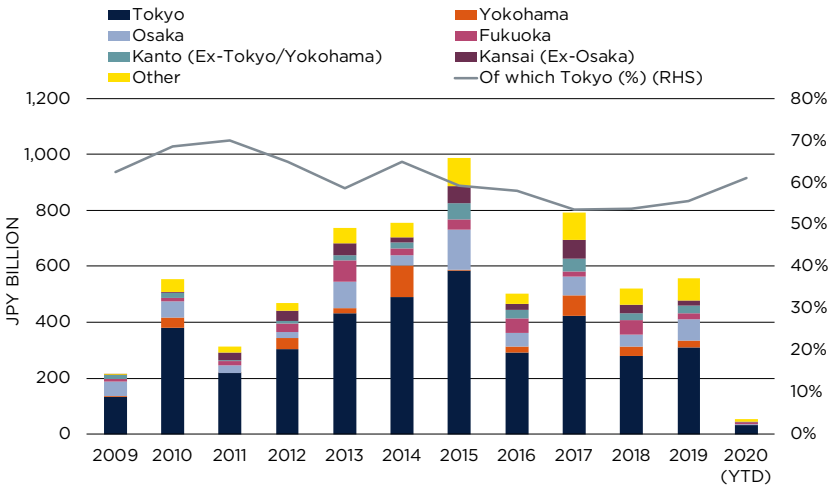
Self-isolation has unsurprisingly hit retail revenues, and financial forecasts have not fared any better. For instance Saizeriya, a low-cost Italian restaurant chain, saw an estimated 22% YoY decline in domestic sales during March – the largest decrease in a decade. Going forward, with 300 branches nationwide set to be closed, forecasted profit growth for the remainder of the fiscal year has gone from of a 20% increase to a 60% decline. Meanwhile, Bic Camera, a large electronics retailer popular with foreign visitors, has been dealt a double whammy. Not only were sales in March a fifth lower compared to the previous year, supply chains have also been significantly disrupted. Profits for the rest

GRAPH 5: Index Of Inbound Tourism On A Rolling Half-yearly Basis, 2014 to Q1/2020



Source JNTO, Savills Research & Consultancy

GRAPH 6: Retail property investment by region, 2009 to Q1/2020*



Source RCA, Savills Research & Consultancy

*Q1/2020 volume is preliminary and is likely to be revised upwards. In principle, RCA investment volumes do not include related-party transactions, such as those among a J-REIT and its sponsor.

TABLE 1: Selected Retail Transactions, Announced Q4/2019 to Q1/2020

ANNOUNCED	PROPERTY	LOCATION	GFA (SQ M)	PRICE (JPY BIL)	DIRECT CAP RATE	BUYER
Mar 2020	A-Place Shinbashi	Minato, Tokyo	8,500	21.0	3.6%	GK Asunaro (SPC of Tokyu Land)
Mar 2020	Tod's Omotesando Building	Shibuya, Tokyo	2,500	19.5	n/a	Omtesando Investment GK (SPC of Kering)
Oct 2019	Kalsa Hiratsuka	Hiratsuka City, Kanagawa	19,200	6.0	4.4%	Kenedix Retail REIT
Jan 2020	Tonarie Yamatotakada	Yamatotakada City, Nara	15,500	4.2	4.9%	Escon Japan REIT
Mar 2020	Osaki Bright Core (the eighth floor only)	Shinagawa, Tokyo	1,400	2.8	3.2%	Nippon Building Fund REIT

Source Press releases, RCA, Savills Research & Consultancy

of the fiscal year have accordingly been marked down by close to 90%. Meanwhile, prime retail sales are also under pressure. For now, however, owners in this subsector have a higher degree of protection as rents are fixed with creditable tenants, whilst the most sought after locations still have the advantage of high land values and strong demand. As such, the prime subsector is perceived to be defensive.

With international travel prohibited, to say that inbound tourism has suffered would be an understatement. To wit, the number of inbound tourists plummeted by close to 93% YoY in March. When looking closer at the three largest contributing countries in terms of visitor numbers, the drop off in Chinese tourists is staggering (Graph 5). Accounting for a large chunk of overall inbound expenditure, the decline in these visitors will clearly be a blow to the retail sector. Meanwhile, all the progress made in increasing the number of South Korean tourists has all but disappeared as the various issues since last year takes its toll. That being said, some submarkets are less reliant on inbound tourism compared to others, and therefore the impact of this dynamic will vary.

INVESTMENT TRENDS

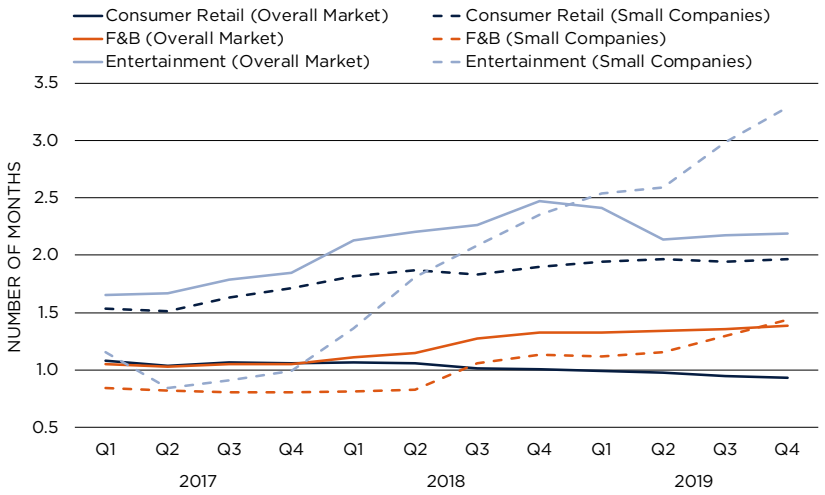
The latest results of a semi-annual survey by JREI, reported in October 2019, indicated that expected cap rates for prime retail property in Ginza and Omotesando remain steady at 3.4% and 3.5%, respectively, while expected cap rates for suburban shopping centres in the Tokyo area and in regional areas were 5.4% and 5.7%-6.5%, respectively. Actual market cap rates could be 50-100 basis points lower than these expected cap rates.

With most transactions, if any, completed prior to the full blown COVID-19 outbreak, it is not surprising that investment in retail property has declined in Q1/2020 compared to the same period last year (Graph 6). Specifically, total transaction value stood at a provisional JPY53 billion, a 58% YoY decline, according to preliminary data from Real Capital Analytics (RCA). Currently, with nearly all rumoured transactions suspended or postponed, this trend is unlikely to shift anytime soon and is not inconceivable to persist months after the pandemic has started to recede.

WINNERS AND LOSERS

As inbound tourism grinds to a halt, and with lockdown measures hindering footfall, the outlook is certainly bearish for the retail sector. Of particular concern are smaller companies, whose capital is between JPY10-20 million, especially in the F&B industry. Even before the impact of COVID-19 had taken hold in Japan, average cash reserves, equivalent to monthly revenue, of these businesses had been below their peers in the consumer retail and entertainment sectors (Graph 7). What's more, with only around a month's revenue held as cash as at the end of 2019, and with very high break-even points historically in the industry – at well over 90% – this sector certainly looks

GRAPH 7: Months Of Revenue Held As Cash By Industry Type And Company Size*, 2017 to 2019



Source Ministry of Finance, Savills Research & Consultancy
*Small companies are defined as those whose capital is between JPY10-20 million.

vulnerable.

That said, not all retailers are expected to suffer the same fate. Indeed, some retailers, including those necessary for daily essentials function as part of social infrastructure and, accordingly, sales have outstripped rivals such as department stores. Meanwhile, those who had improved their technological capabilities should be able to weather the ongoing storm. For instance, Nitori, a home-furnishing retailer akin to IKEA, has been able to leverage its pre-existing digital infrastructure to diversify business streams. More specifically, using advanced technology, the retailer has been able to provide around 150 small -and medium-sized companies a service that helps to improve their logistical capabilities. From using artificial intelligence to plan the most efficient route to reduce delivery times, to inventory management using blockchain technology, Nitori hopes that these services will add around a few JPY100 billion in annual sales by 2030, compared to approximately JPY20 billion currently.

Looking further ahead into the post-COVID-19 world, urban high street retail may function more as a showroom – a dynamic already seen in submarkets such as Omotesando – while suburban retail may be seen more as a logistics play. Meanwhile, following a prolonged period of working-from-home, some companies may decide to continue these practices for the longer term. As such, teleworking spaces, especially beyond the urban centres, should be in high demand, in turn creating new opportunities for retailers in these locations.

OUTLOOK

Despite rents in the retail sector marking a strong end to 2019, the positivity was swiftly overshadowed by what came next. Indeed, with the economy already under pressure following the consumption tax hike of October 2019, the COVID-19 crisis has created a perfect storm for Japan. The one-year postponement of the Tokyo Olympics has further dampened market sentiment for 2020, though it would seem more welcome than an outright cancellation.

With caution amongst citizens high, footfall has unsurprisingly continued to decline in commercial hubs normally abuzz with activity. This dynamic is expected to continue, or even worsen, depending on the severity of the government's next steps in order further limit business activity and the movement of people. Looking ahead, it not inconceivable that footfall takes longer to recover even after the outbreak subsides, as consumers slowly get to grips with the post-COVID-19 era. As such, the potentially seismic impact of the pandemic means that the future prospects of this sector are extremely unclear.

To make matters worse, the collapse in overseas visitors is another huge blow to the sector. Yet, Japan remains an emerging market for inbound tourism and therefore the adverse effects from the pandemic are somewhat more manageable, especially when compared to regional peers. Broadly speaking, inbound tourism accounts for less than 1% of its GDP, though some retailers and submarkets are more dependent on these visitors than others.

Nonetheless, the disparity amongst winners and losers in the retail sector has been stark and this trend is likely to become more pronounced. Those who implemented digital platforms early can continue to leverage these channels during the COVID-19 crisis and beyond, while those who are late to the digital game will continue to struggle. On a longer-term basis, this crisis will likely change shopping behaviour, with retailers now needing to respond to not only e-commerce but also to the post-COVID-19 customer.

In the meantime, however, multiple retail property managers have begun to receive rent reduction requests, especially from thinly capitalised subsectors such as food services. More requests should follow as operating activity is further constrained by social distancing guidelines and closed borders. As a result, we should see some consolidation in this fragile sector, which should be a positive development in the long-term. For now, however, skillful asset management matters more than ever.

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For more information about this report, please contact us

Savills Japan

Christian Mancini
CEO, Asia Pacific
(Ex. Greater China)
+81 3 6777 5150
cmancini@savills.co.jp

Savills Research

Tetsuya Kaneko
Director, Head of Research
& Consultancy, Japan
+81 3 6777 5192
tkaneko@savills.co.jp

Simon Smith
Senior Director
Asia Pacific
+852 2842 4573
ssmith@savills.com.hk