Prices continue to rise amidst weakening contract rates

INTRODUCTION
Rising land prices and construction costs are driving up condo sales prices. While the contract rate\(^1\) in the Greater Tokyo area has continued to fall since dipping below 70% in 2016, and inventories are slowly increasing, a number of fundamental factors, including population growth in Tokyo and a stable economic climate, support demand. If the current environment persists, condo prices are likely to inch up, or at least stay flattish, over the next few years. However, some scandals involving apartment loans inflicted damage on some residential submarkets, revealing potential risk, albeit mainly for a certain subset of tenants.

DEMAND AND SUPPLY
The average contract rate for new condos in the Greater Tokyo area has remained below 70% – the level considered to represent “sound demand” – since 2016, dipping to 62.1% at the end of 2018. As a result of ever-rising condo prices, the price-income multiple pushed beyond 13x in 2017, a level that makes average households hesitant to buy homes in this cycle. These conditions have led to a robust rental market, especially for family-preferred apartments, as those who once purchased homes upon growing their households appear to be leasing instead.

However, construction volumes for the Greater Tokyo area as reported by the Real Estate Economic Institute (REEI) remain below the 10-year average of 42,100 and the forecast for 2019 is for supply to approximately match that of 2018, at 37,000 units (Graph 1). Developers who struggle to acquire land appear to be retaining more inventory on their balance sheets in an effort to maintain market balance. Additionally, Chuo, which has historically accounted for a significant portion of Tokyo’s condo supply, is facing a shortage of infrastructure to support explosive population growth and a recently announced reduction in effective floor-area-ratios. This change should limit supply in the area.

Concerns over a declining contract rate and increasing inventory could ease if supply remains below average. Demand has been consistently sound, supported by positive fundamentals including a growing Tokyo population and a strong employment market. Moreover, increases in the number of households living in multifamily residences over the past decades illustrate a gradual preference shift from detached homes towards conveniently located condos.

PRICE INCREASES CONTINUE
Condo prices have risen across the Greater Tokyo area. While high land prices and rising construction costs are driving this upward trend, a reduction in borrowing costs has also accelerated price increases (Graph 2). Prices currently sit above affordable levels for average households and could be slowing sales.

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\(^1\) The contract rate is generally defined as the percentage of offered units sold within the first month. This measure is closely monitored as it gauges the strength of demand. Given the significant sales effort before the beginning of actual sales, 70% is typically considered to be an inflection point.
At high development cost, cash-rich developers so far appear to have little motivation to discount prices to expedite sales and lack strong incentives to do so in the near future.

Nonetheless, there are signs of slowing price growth. According to REEI, the average price of a new unit in the 23W area was about JPY1.1 million per sq m in 2018 (Table 1), up 3.4% year-on-year (YoY), while the average price of a new unit in the Greater Tokyo area was about JPY863,000, virtually the same as in 2017. Price growth has noticeably slowed in both areas compared to 2017, where they recorded growth of 7.9% and 9.2%, respectively. With prices already high and little prospect of further decreases in interest rates, prices appear likely to continue to grow at a more measured pace over the near term.

According to Tokyo Kantei, second hand property comes at a significant discount of about 35% to new builds. With new condo prices so elevated, second hand property is becoming more popular (Graph 3). Data from Real Estate Information Network System (REINS) suggests that the discount is heaviest once the age of a building exceeds 25 years, and the number of transactions also significantly declines at this point (Graph 4).

POLARISED MARKET
In the past, a lack of land for development forced developers to build condos beyond the city centre and station-front areas. Those properties in peripheral markets do not sell well and are considered especially vulnerable during a downturn. The scandal related to Suruga Bank also revealed a potential risk that could harm certain markets, especially in suburban areas. The line between winners and losers is likely to further materialise.

OUTLOOK
Condo prices in the Greater Tokyo area continue to rise steadily, driven by rising costs as well as long-term fundamental factors including net migration and a strong employment market. While a significant reduction in borrowing costs and estate planning benefits have likely boosted the market in recent years, there is limited scope for further contributions from these factors.

Although high prices appear to be slowing sales, cautious supply from developers should ensure that housing stock remains fresh without triggering abrupt price declines. Considering that the market has not experienced a surge in sales prior to the consumption tax hike planned later this year, a reversal effect is likely to be limited. The government also plans countermeasures to alleviate the impact of tax increases.

Overall, the condo market in the Greater Tokyo area is expected to continue its moderate growth trend. As development cost remains high and developers have enough cash to play the waiting game, prices are unlikely to decrease in the near term. However, a weakening of economic conditions could deepen the polarisation of the market. Suruga Bank’s scandal is another concern that may affect the residential market as a whole, though for now the impact appears mostly limited to lower-quality apartments in suburban markets.