Japan - December 2019

SPOTLIGHT
Savills Research

2019 Review and 2020 Prospects

Moderate property upswing continues

INTRODUCTION

In the face of both global and domestic macro headwinds, the Japanese real estate market performed well in 2019. Enduring political and economic stability – bolstered by low interest rates and a competitive yield gap – continue to promote an attractive environment for real estate investment. The defensive nature of prime assets in Japan appears to be a key draw, especially in the late stage of a property cycle that is shadowed by global uncertainty.

As early as 2015, market participants began showing concern over large office supply scheduled to enter the Tokyo market, fearing an abrupt end to what would have been a short-lived upswing. However, these fears proved to be largely unfounded as, despite historically high supply levels in both 2016 and 2018, no major secondary vacancy has materialised thus far, and supply through 2020 has been mostly pre-leased. With the existing market experiencing air-tight conditions, there are no immediate concerns regarding the performance of hard assets.

Office property prices are approaching 2008 levels, though high valuations still appear justifiable in light of solid underlying fundamentals. Cap rates are much lower than the previous peak, but the government bond interest rate is 150 basis points (bps) lower and the yield spread is even healthier, at almost 300 bps. Prime office rents have grown steadily, yet still stand around 70-75% of the previous peak. This may leave room for further upside potential - with limited downside risk.

Japan's economic and political environment continues to appear sound, particularly when compared to that of global peers. To wit, despite significant demographic headwinds, Japan's economy has been steadily growing since 2012, with real GDP growth per capita[1] from 2012 to 2017 increasing 2.3% per annum, the highest among the G7, based on IMF and BOJ data. Further, Japan has essentially achieved full employment, and youth unemployment is the lowest among major economies. Domestic corporations and households are cash rich, supporting a low interest rate and giving comfort to investors. Japan has enjoyed political stability for the same reasons.

The solid financial performance of Japan Inc. is underpinning robust demand for office space. Indeed, the profitability of domestic corporations has significantly improved since the advent of Abenomics. For instance, the recurring profit margin of large companies[2] increased from 3.3% to 8.2% through the decade as of fiscal 2018. This robust performance has been attained in spite of a labour shortage, prompting Japan Inc. to deploy its winnings to secure prime office locations as a means of attracting and retaining workforce.

A degree of upside may still be had, albeit with limitations. Even amidst a declining population, Japan's workforce has grown since 2012, primarily because of higher labour participation among women and the elderly. A further increase is possible, but participation rates among the aforementioned groups are now at high levels. Corporations have paid higher rents as strategic investments for recruitment, but some have become more cost-conscious in light of macro conditions, considering relocation to more affordable areas. Indeed, the financial capacity of tenants is being tested.

1 PPP, working-age population based
2 Firms with capital of over JPY1 billion

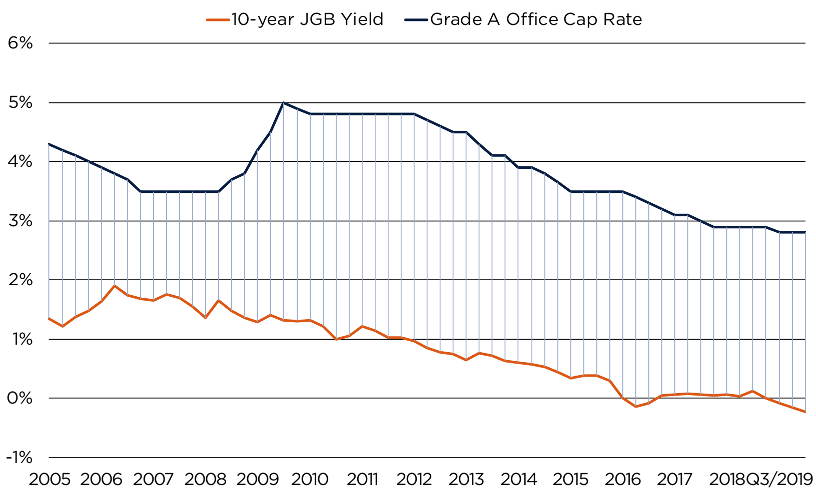
Japan Inc. has not been immune to the ongoing trade conflict among the U.S. and China. While still at historically high levels, overall profits have fallen over the last four quarters as demand slows on a global scale. More encouragingly, the capital markets have reignited once again. However, it is too early to determine whether the global economy will return to a growth track. On the domestic front, the impact of the consumption tax hike implemented in October has yet to be fully understood.

Despite these macro concerns, an expanding pool of overseas capital is pursuing investment opportunities in Japan. With interest rates at effectively zero on traditional fixed-income vehicles, pension funds are particularly desperate to increase allocation to core real estate. There are multiple catalysts for long-term growth in Tokyo and other major cities beyond the 2020 Olympics. Incoming integrated resorts, the World Expo in 2025, mag-lev trains, and mega mixed-use development projects are all positive for the macro economy and real estate markets.

Property is not the only asset class to draw overseas interest, however. With ongoing reforms in domestic corporate governance, inward foreign direct investment stock has doubled over the last five years to JPY30 trillion. The fact that Japan continues to display steady economic growth and political consistency is an additional boon for inbound investors.

To be sure, macro headwinds are rising; however, Japan Inc. is well positioned to weather a correction. To wit, Japanese corporations have JPY500 trillion (US$5 trillion) in cash and 60% of listed companies are effectively debt free. The property upswing is already well extended, but bullish momentum may persist for the time being. Given the financial position of domestic

GRAPH 1: Tokyo Grade A Office Net Yield, 2005 to Q3/2019



Source Ministry of Finance, Savills Research & Consultancy corporations and households, the Japanese property sector should be in for a much milder chill when winter comes.

INVESTMENT TRENDS

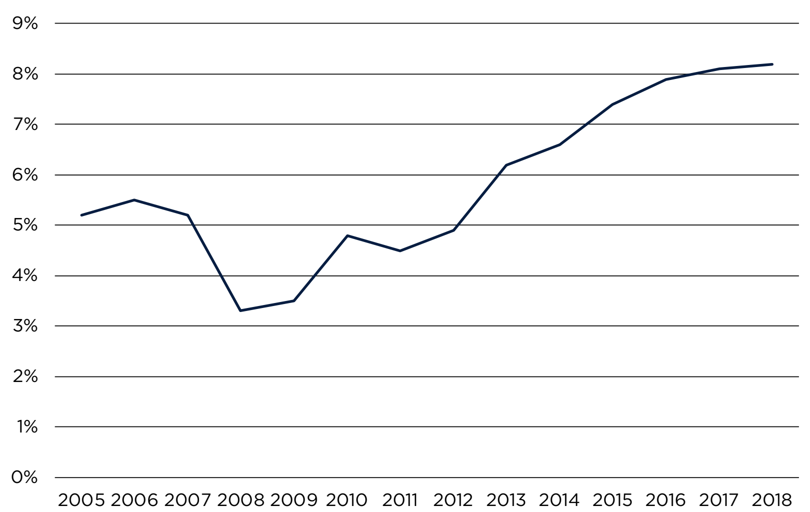
Cap rate tightening continued in 2019, though changes were noticeable in some sectors more than others. Prime Tokyo office cap rates continued their downward trajectory, compressing to around 2.7%, while premiums of regional office markets have started to fall as investors search for value. Against a backdrop of elevated valuations and limited opportunities, however, transaction volumes have declined.

According to RCA, as of Q3/2019, total investment in Japanese real estate equated to around JPY3.0 trillion year-to-date (YTD) – broadly in line with the same period last year. Once again, the majority of flows went into the office sector, whilst Tokyo was the most in-vogue market. Additionally, cross-border investment rebounded from its decline in 2018, increasing by 12% a year later. This figure is expected to further increase on the back of sizable transactions such as Allianz's JPY129 billion deal for Blackstone's residential portfolio, as well as the latter's JPY100 billion acquisition of Mapletree's logistics portfolio. Still, despite the robust demand, affordable deals are limited.

The theme of global uncertainty looks set to continue into 2020. Yet, amid the disorder, the economic and political stability of Japan stands out. In fact, this sentiment was recently echoed in an annual investor survey by the Urban Land Institute, where Tokyo was ranked second for real estate investment prospects in the Asia Pacific region, behind only Singapore. Macro headwinds notwithstanding, the Japanese real estate market, therefore, remains appealing. Fundamentals are sound, and the availability of attractive financing continues to lure investors. Furthermore, the BOJ's stealth tapering of JGB purchases should allow for more leeway if further monetary stimulus becomes necessary. That said, rental growth has started to slow, showing signs that this extended cycle may finally come to an end. Yet, provided the world economy does not take an abrupt turn, the rise in capital chasing stable real estate assets should lead to marginal cap rate compression in 2020.

Amidst global macro headwinds, Japanese real estate continues to exceed overall expectations. 2020 prospects are positive, though more clouds are gathering on the horizon.

GRAPH 2: Recurring Profit Margin Of Japanese Corporations, 2005 to 2018

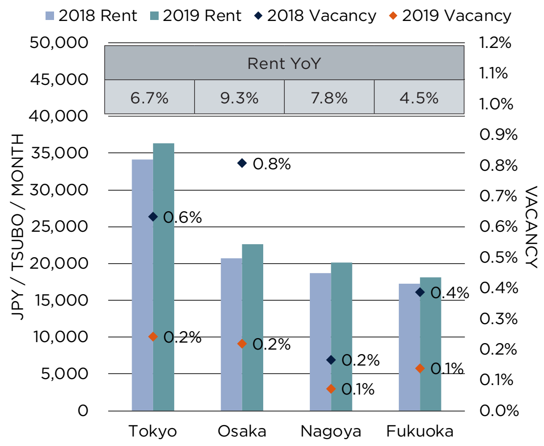


Source Ministry of Finance, Savills Research & Consultancy

GRAPH 3: Investment Volumes And Cross-border Share, 2007 to Q3/2019

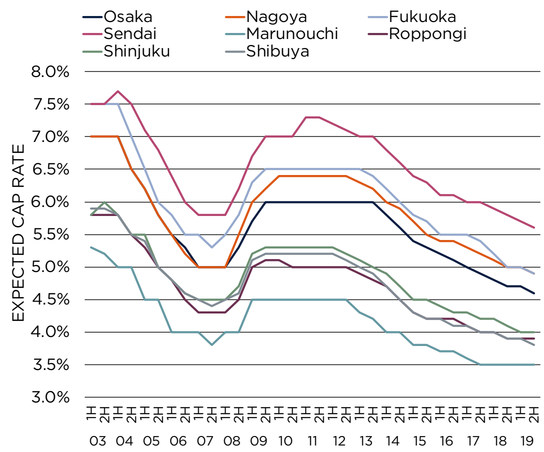
Source RCA, Savills Research & Consultancy

GRAPH 4: High-grade Office YoY Rental Growth And Vacancy Rates, Q3/2019



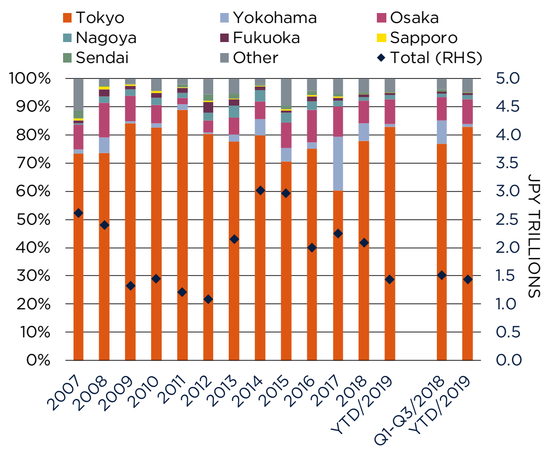
Source Savills Research & Consultancy

GRAPH 5: JREI Expected Prime Office Cap Rates By City, 2003 to 2019



Source JREI, Savills Research & Consultancy

GRAPH 6: Office Investment Volumes By Region, 2007 to Q3/2019



Source RCA, Savills Research & Consultancy

OFFICE

Investment Trends

In a sign of market optimism against a backdrop of tight market conditions, in-house Tokyo office cap rates have compressed by 20bps to 2.7% in 2019. According to the October 2019 survey conducted by Japan Real Estate Institute (JREI)[1], expected cap rate premiums in Osaka, Nagoya, and Fukuoka stand at roughly 80bps, 110bps, and 110bps, respectively, a tightening of around 10bps on last year, as demand for regional assets continues to grow.

As of Q3/2019, YTD investment into the office market in Japan was approximately JPY1.4 trillion, around 5% less than the same period last year. It appears the market has, to some extent, stabilised as investors err on the side of caution. Needless to say, Tokyo is the main destination of investment funds in this sector (Graph 6), accounting for over 80% of transaction volumes.

Review and Prospects

Tokyo is currently going through a significant expansion of office stock, most of which is expected to be completed come 2020. Thereafter, the number of projects is expected to fade until 2023. Despite this short-term surge in supply, low vacancy rates, in concert with solid pre-leasing, has resulted in rent growth quickening in 2019. In fact, the capital was the sole region to experience an increase in the rate of growth year-on-year (YoY), and now outpaces Fukuoka. Given the tight market conditions explained above, as well as the lack of suitable alternatives, rents are expected to continue rising, albeit the pace of growth may slow somewhat as the financial capabilities of tenants are tested. Grade B, on the other hand, with its limited supply, is expected to keep benefiting from the relative affordability compared to Grade A.

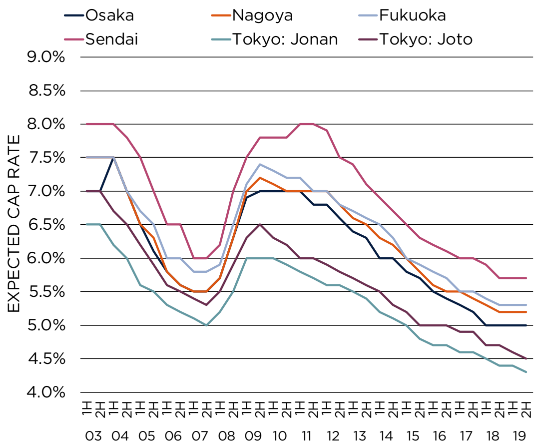
In the regional markets, performance of high-grade offices continues to be robust. Rents climbed over 7% YoY on average, underpinned by air-tight vacancy across all three markets. Looking forward, rental growth should, despite the pace slowing, maintain its upward trajectory as demand prevails in the absence of meaningful supply expansion.

Having started the year full of optimism, 2019 has turned out to be a year to forget for WeWork. In the aftermath of the co-working start-up's botched IPO, concern has replaced optimism. Unlike in its Western counterparts such as New York and London, however, Tokyo's exposure to WeWork is limited, with approximately 1% of the overall Grade A floor-space in the central five wards (C5W) leased by the firm. In addition, the start-up benefits from its owner and affiliates, namely SoftBank Group, also being its largest tenant in Japan. Nonetheless, in light of their previously ambitious expansion plans, approximately 3% of new supply for the last two years was absorbed by WeWork. Therefore, we should expect a noticeable pull-back in demand going forward, though the overall impact should be limited.

A harbinger of change has emerged with rents reaching levels not seen for a decade despite rental growth slowing. As a result, there have been some cases whereby tenants have relocated from pricey prime areas to more affordable locations. This is not unexpected, however, given the current stage of the property cycle. Nonetheless, economic fundamentals such as employment and corporate profits remain supportive of the present levels of rent. Therefore, unless an economic downturn were to occur, rents should remain on an upward path - especially in regional cities - albeit not as strongly as before.

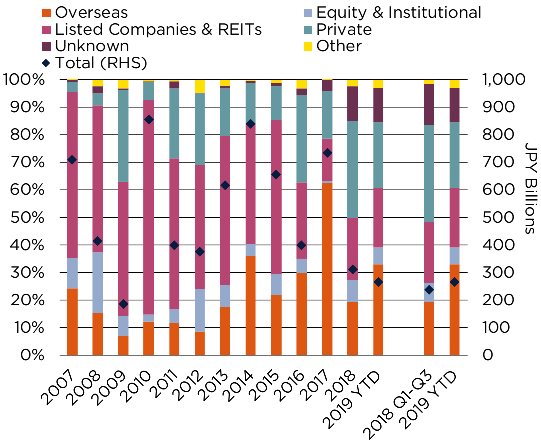
1 Expected cap rates reported by JREI tend to be looser than market cap rates.

GRAPH 7: JREI Expected Residential Cap Rates By City, 2003 to 2019



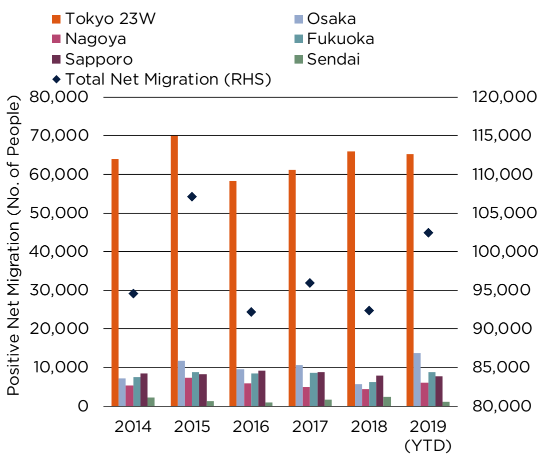
Source JREI, Savills Research & Consultancy

GRAPH 8: Residential Investment Volumes, 2007 to Q3/2019



Source RCA, Savills Research & Consultancy

GRAPH 9: Total Net Migration, 2014 to Q3/2019



Source Statistics Bureau of Japan, Savills Research & Consultancy

RESIDENTIAL

Investment Trends

In-house cap rates for mid-market residential property in the 23 wards have compressed by 20bps to 3.4% from a year ago. According to JREI, expected cap rates for residential property in Jonan and Joto have fallen to 4.3% and 4.5%, respectively, following a 10bps contraction in the former and a 20bps tightening in the latter.

As of Q3/2019, YTD investment in residential property has increased by over 10% compared to the same period last year. A noteworthy contributor to this has been the near doubling of overseas investment, which now stands at a third of total investment (Graph 8). In Q4/2019, this figure is expected to markedly increase following the completion of the JPY130 billion deal between Allianz and Blackstone for the latter's Japanese residential portfolio in October 2019. Additionally, according to Reuters, Chinese Insurance Group, Anbang, is looking to dispose of its property portfolio – the majority of which is invested in residential assets – worth an estimated JPY250 billion. The scale of these deals, despite the elevated valuations, continues to evidence investors' attraction to residential assets in this late property cycle, given its defensive nature.

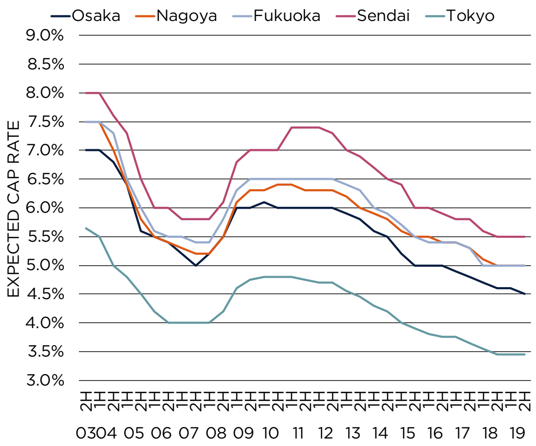
Review and Prospects

Despite the ongoing demographic challenges facing Japan, Tokyo bucks the trend. The economic hub, given its prospects for employment, has continued to experience positive net migration (Graph 9). In fact, Tokyo accounted for more than half of all migration into the major cities this year. This theme is anticipated to continue over the longer term with the population in the C5W, for instance, expected to expand by up to 20% on average between 2015 and 2045. The other driver of rent growth, namely residential market supply, remains tight in the capital, as evidenced by occupancy rates in both the 23W and the C5W hitting record highs this year. As a result, mid-market rent growth has been robust across the board, with the rate of growth in the 23W recently increasing.

Within the residential market, the luxury segment continues to perform strongly. Demand for these properties has continued to strengthen despite the ongoing global economic uncertainty, while supply has been slow to catch up. It appears, however, that developers have started to remedy this. Developments such as the Toranomon-Azabudai Project, for example, which is slated for completion in 2023, will see up to 1,400 new rooms, including serviced apartments.

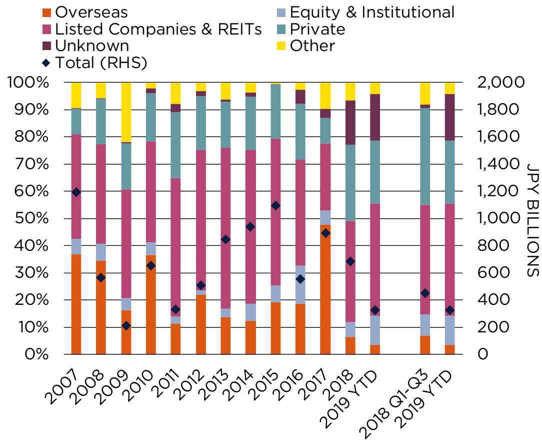
It seems, therefore, that the fundamental forces driving Tokyo's residential market are working in tandem, continuing to support solid rent growth. That being said, with the rise in rents outstripping wage growth, some segments of the market are beginning to look relatively pricey as occupier budgets are stretched. The slowing of rent growth witnessed in the C5W being case in point. Furthermore, there is the risk of developers, on the back of rising costs, opting to lease condominiums, adding to the supply of rental units. Even so, unless a significant economic downturn were to occur, the absence of meaningful mid-market supply expansion, combined with the lack of suitable alternatives in Tokyo, should see average rents continue their upward momentum, albeit at a more moderate pace going forward.

GRAPH 10: JREI Expected Retail Cap Rates By City, 2H/2003 to 2019



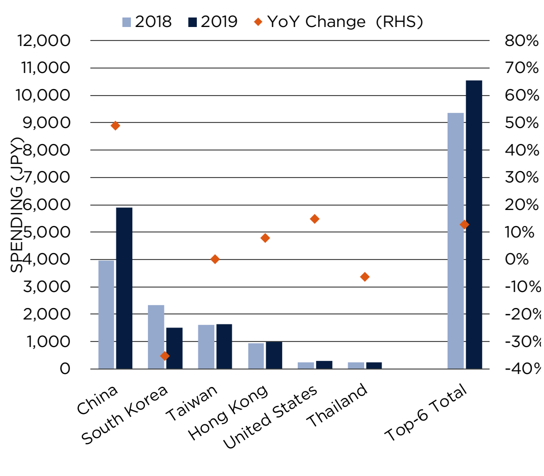
Source JREI, Savills Research & Consultancy

GRAPH 11: Retail Investment Volumes, 2007 to Q3/2019



Source RCA, Savills Research & Consultancy

GRAPH 12: Weighted Average Of Retail Spending Per Person of the Top Six Visitor Nations, 2018 to September 2019



Source JNTO, Savills Research & Consultancy

RETAIL

Investment Trends

Based on our in-house survey, cap rates for high-street retail in Tokyo have compressed 20bps to 2.7% over the year. Expected cap rates for prime retail property in Ginza and Omotesando, according to JREI, have held steady at 3.4% and 3.5%, respectively, while rates in Osaka slightly tightened to 4.5%.

Investment volumes in the retail market have continued to decline, with total investment during the first three quarters of 2019 around 28% lower than the same period last year. That said, Osaka attracted a significant increase in flows, with the reported JPY21 billion acquisition of Croesus Shinsaibashi by Sumitomo Corporation representing a large chunk of total investments, implying confidence in the continued growth of inbound tourism.

Review and Prospects

In Japan, high-street retail remains popular and the importance of the shopping experience itself rings true. As such, retail assets on the first floor continue to reign supreme, and the divergence in rents between non-1F stores has been widening since 1H/2017. In fact, rents at these prime locations have reached levels not seen since 2008, with places such as Ginza commanding north of JPY75,000 per tsubo. The divergence is also apparent when comparing Tokyo and its regional peer, Osaka. The capital has benefitted from being the country's economic hub, with annualised rent growth of 1F and non-1F stores in the city outpacing its regional rival by 6% and 4% per year, respectively.

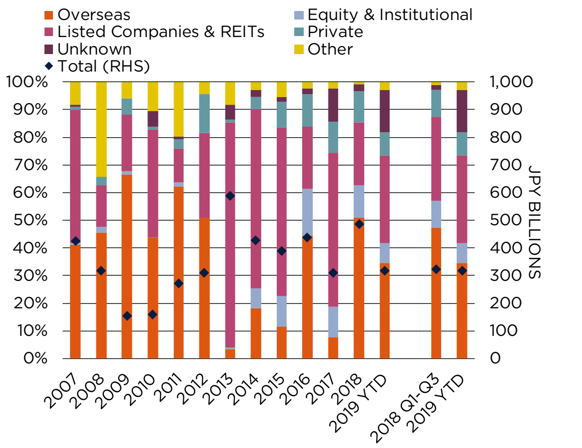
Given the huge boost to the retail sector that inbound tourism provides, the fallout from the dispute between Japan and South Korea was an unwelcome headache. That said, the weighted average of spending by the top six countries of origin, which make up close to 80% of total visitors, has grown YoY despite the large drop in Korean tourists. In fact, Chinese tourists significantly outspent their Korean counterparts, more than offsetting any losses, and this trend may grow in importance going forward.

Retailers experienced a 9.2% YoY pick-up in sales in September prior to the consumption tax hike. According to retail sales data released recently, sales in October, however, declined by 7.1% YoY – significantly worse than expected – despite the Government's counter-measures. Though these figures were further dragged down by extreme weather conditions, the marked change in consumer habits following the tax hike cannot be ignored. The worse hit sectors were big-ticket items such as cars (-17.0%) and machinery (-15.0%), whilst F&B appears to have been left relatively unscathed (-2.2%), perhaps offset by the Rugby World Cup.

Although the impact of the tax hike still needs to be fully understood, the effects witnessed thus far are neither promising nor particularly dire. Nonetheless, investment appetite in retail assets remains strong – the recent takeover of Tiffany by LVMH being case in point. Closer to home, PGIM Real Estate has reportedly disposed of the Abercrombie & Fitch Company's flagship store in Ginza for up to JPY400 million per tsubo of land.

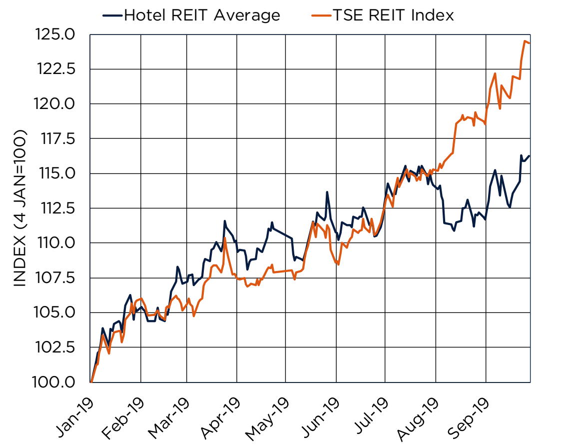
Despite facing difficulties on multiple fronts this year, the retail sector in Japan remains resilient. This is especially true for 1F stores. As such, the shift towards the consumer experience means some retail facilities are ready to satisfy consumer needs. Regardless, there are headwinds aplenty: the consumption tax hike and the continued growth of e-commerce being two key risks. That said, the continued growth of inbound tourism, has the potential to overcome these obstacles for the time being.

GRAPH 13: Hotel Investment Volumes, 2007 to Q3/2019



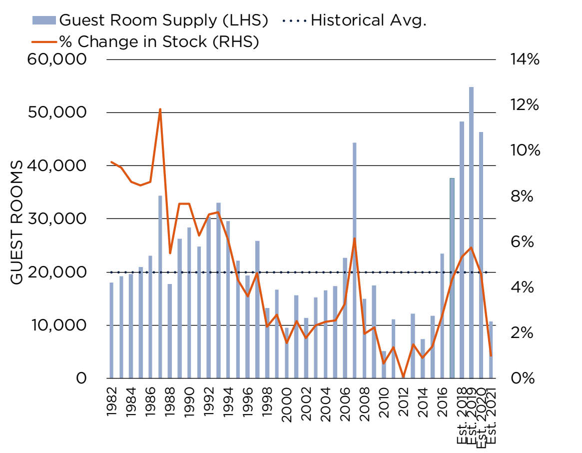
Source RCA, Savills Research & Consultancy

GRAPH 14: Average Hotel REIT Performance, 2019YTD*



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy
*Market data between Q1-Q3/2019.

GRAPH 15: Hotel Guest Room Supply, 1982 to 2021



Source Hoteres, news articles, the Ministry of Health, Labour and Welfare, Savills Research & Consultancy

HOTEL

Investment Trends

According to JREI, as of October, expected cap rates for limited-service hotels in Tokyo have compressed by 10bps to 4.4%. This was also the case in the regional markets. Actual cap rates tend to be 50-100bps lower than these expected rates.

As of Q3/2019, investment volumes into the hotel market increased by around 20% relative to the same period last year. Investment appetite from overseas investors appears to have returned somewhat, with volumes YTD exceeding investment during the whole of 2016 and 2018.

Review and Prospects

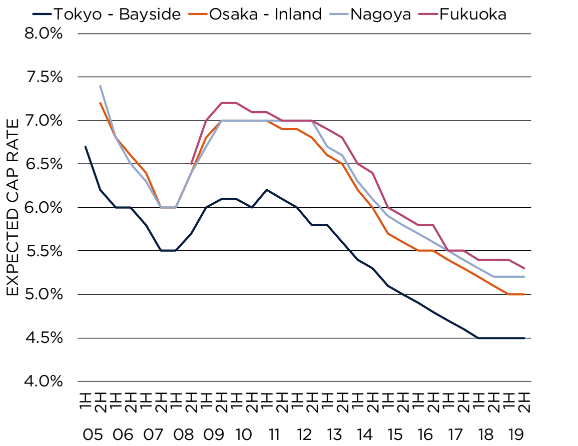
With the expansion of the global economy in general, and the Asian economy in particular, inbound tourism to Japan has increased substantially. As of September, the number of visitors stood around 25 million YTD – a 4% increase compared to the same period last year. The pace of growth, however, appears to be slowing.

Systematic risks abound in the hotel market, with this year being no different. Having already experienced Typhoon Faxai at the start of September, October saw Typhoon Hagibis devastate the Kanto region, with thousands of flights and hotel reservations subsequently cancelled. Additionally, the dispute with Korea, which commenced in Q3/2019, has impacted the number of Korean visitors to Japan – who accounted for around 25% of all inbound tourists in 2018. According to the Japanese National Tourism Organisation (JNTO), the number of Korean visitors declined by 36% YoY in Q3/2019. The impact, however, is most felt in Fukuoka, given 40% of all visitors to Fukuoka airport come from South Korea. For Osaka Airport, this figure is around 15%.

The combination of these systematic risks, along with concerns of large supply in the market, has somewhat weighed on the recent performance of most budget hotels. For example, Ichigo Hotel REIT reported that occupancy levels had fallen to 83.4% in September 2019, while average revenues per available room declined by 10% YoY in Q3. In comparison, between January and June, the average YoY decline was 1.5%. As a result, the average performance of the five main hotel REITs, having moved in lockstep with the broader REIT index for most of the year, has recently diverged, with the spread widening towards the end of Q3 as market sentiment weakened (Graph 14). Even as budget hotels struggle, however, the luxury hotel market, which remains short-supplied, continues to perform well.

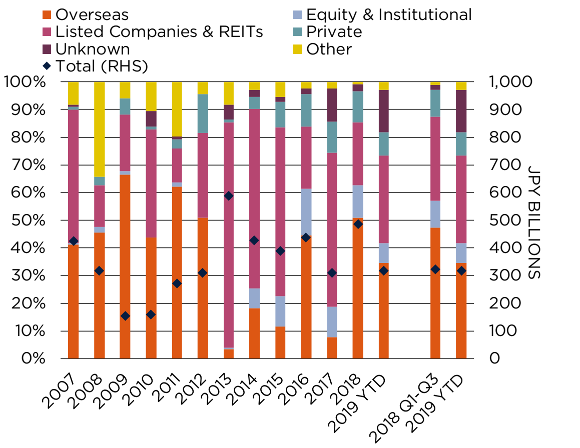
With employment near full capacity, cost pressures from higher wages are starting to weigh on the sector. This is especially true for thinly capitalised, inexperienced operators who entered the market in 2014 and 2015. We could, therefore, see these struggling businesses plan an exit from the industry, giving long-term investors the chance to make an opportunistic play in the sector. Regardless, inbound tourism continues to act as a major tailwind, with the increasing spending power of tourists, especially from the West and China, revitalising the hospitality sector. Furthermore, the success of the recently concluded Rugby World Cup demonstrates Japan's potential as an attractive destination for a wider range of visitors. The upcoming Olympics, as well as planned Integrated Resorts and the 2025 Expo, should build on this theme.

GRAPH 16: JREI Expected Logistics Cap Rates By City, 2005 to 2019



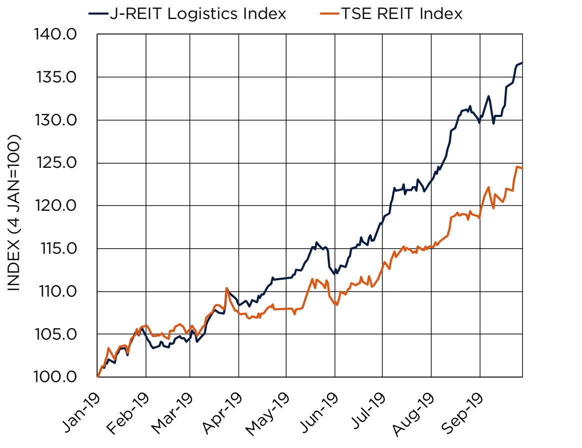
Source JREI, Savills Research & Consultancy

GRAPH 17: Logistics Investment Volumes, 2007 to Q3/2019



Source RCA, Savills Research & Consultancy

GRAPH 18: Average Logistics REIT Performance, 2019YTD*



Source J-REIT Disclosures, Japanese Exchange Group, Savills Research & Consultancy
*Market data between Q1-Q3/2019

LOGISTICS

Investment Trends

According to JREI's October 2019 survey, expected cap rates remained somewhat steady in most markets over the year. The Tokyo bayside area held firm at 4.5%, while Osaka saw a 10bps narrowing to 5.0%. Actual transaction cap rates, however, may be about 100 bps tighter.

As of Q3/2019, YTD investment in industrial property amounted to JPY317 billion, broadly in line with the same period in 2018. Yet, overseas investment flows have declined by around 30% as demand softened during 1H/2019. That said, investment appears to have picked up in 2H/2019 as evidenced by the JPY100 billion deal in July 2019 between Blackstone and Mapletree for the latter's industrial portfolio.

Review and Prospects

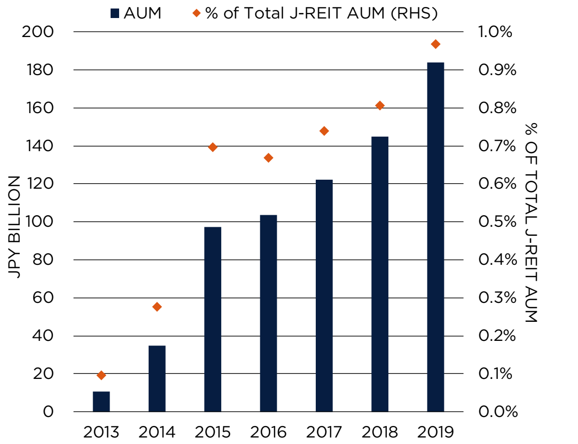
Tokyo witnessed unprecedented levels of new supply in 2018, and this has continued into 2019, leading to market conditions softening in 1H/2019. Even so, the market remains tight and vacancy rates continue to be low, following stronger-than-expected demand, as also observed in the office sector. This, however, has not been reflected in average rents. Supply has mainly consisted of the more affordable inland facilities, compared to prime assets in the Bay Area where rental growth is strong, but availability is limited. Following a glut in 2017, supply appears to have moderated in Osaka. Indeed, vacancy rates have responded to the robust levels of demand, contracting by over 7.0 percentage-points (ppts) YoY. Unlike its regional competitor, however, rents have responded accordingly, increasing by around 7.0% YoY.

Having witnessed the introduction of two new logistics J-REITs last year, December 2019 welcomed another new player to an already crowded market, namely the SOSiLA Logistics REIT. Although there have been many false starts in the J-REIT IPO market in recent years, SOSiLA REIT's launch appears to be a success thus far. In addition, the sponsor, Sumitomo Corporation, has plans to develop two new sites located in Osaka and Kanagawa. Slated for completion in 2021 and 2022, respectively, these facilities are reported to have a combined GFA of around 200,000 sq m. SOSiLA is not alone on the development front, however. For instance, GLP Japan has announced plans to commence construction of the GLP Alfalink Sagamihara facility with a GFA of 650,000 sq m – the largest in Japan – in February 2020, at a cost of JPY140 billion. Indeed, the growth in supply appears to have legs for the foreseeable future.

As the logistics sector garners more attention, increased demand for the sector has also been observed in the stock market. For instance, returns of listed logistics J-REITs have significantly outperformed the broader REIT index (Graph 18). To wit, average growth YTD of the Logistics J-REIT index has outpaced its comparator by over 12%, taking the title of best performing sector this year. Indeed, supported by the global low-interest environment, J-REITs exceeded market expectations in 2019. This robust performance in the capital markets should bolster hard-asset purchasing power moving forward, with logistics J-REITs in a particularly advantageous position.

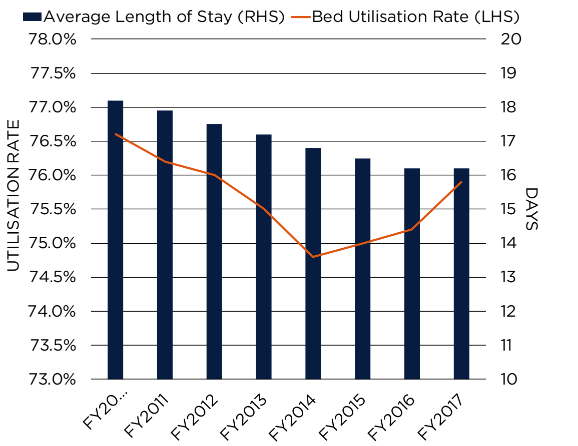
Despite the expected influx of supply, rents should remain fairly stable given the significant demand anticipated, as evidenced in the preleasing market. In fact, the long-term prospects of the market appear strong, especially when considering the relatively low levels of e-commerce penetration observed in Japan. That said, cost pressures arising from labour shortages could impact the sector, though technological innovations to improve efficiency should alleviate the pain somewhat.

GRAPH 19: J-REIT Healthcare AUM By Acquisition Value, 2013 to 2019*



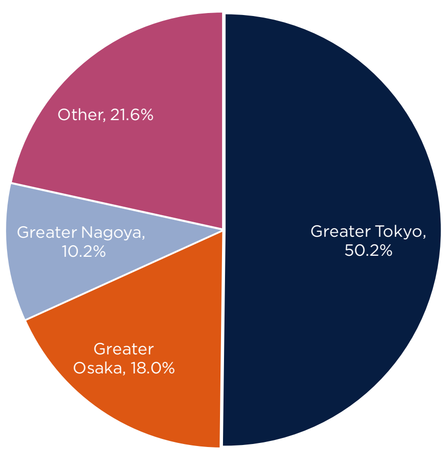
Source ARES J-REIT Databook, Savills Research & Consultancy
*2013 – 2018 values are as of 31 December for the respective years. 2019 values are as of 31 October.

GRAPH 20: Acute Care Length Of Stay And Bed Utilisation Rate, FY2010 to FY2017*



Source Ministry of Health, Labour, and Welfare via the Welfare and Medical Service Agency
*Fiscal years from 1 April to 31 March.

GRAPH 21: Regional Allocation Of Data Centres, 2019



Source Japan Data Centre Council, Savills Research & Consultancy

ALTERNATIVE ASSETS

Investors searching for higher yields continue to be drawn to alternative asset types in Japan. Assets in sectors such as healthcare, data centres, and student housing continue to gain traction, as opportunities become increasingly sparse in traditional sectors. Investor interest is steadily picking up as some large players enter the arena and new opportunities emerge. Even so, these sectors are still nascent and opportunities at institutional investment scale remain extremely limited.

Healthcare

With ironclad demand fundamentals driven by Japan's rapidly aging society, the healthcare sector is attracting increasing attention from foreign investors.

Although investment volumes picked up in 2019, the sector still accounts for a miniscule portion of real estate investment. Indeed, healthcare assets still account for only 1.0% of J-REIT AUM by acquisition volume, though this is around 0.2 ppts higher than at the end of last year. As the medical and nursing care industries remain fragmented, achieving appropriate investment scale can be challenging, limiting opportunities for institutional investors. Larger mixed-use complexes are therefore a popular target in the sector.

In February 2019, the Healthcare and Medical Investment Corporation acquired the Ship Senri Building, a mixed medical services facility offering 400 hospital beds and 181 private residential units, for JPY12.9 billion – the largest single healthcare asset ever transacted by a J-REIT. Other common mixes include fee-based nursing homes with outpatient medical clinics, nursery schools, pharmacies, or supermarkets occupying the lower floors.

Some investors have turned to consolidation in order to achieve scale. Japan Senior Living merged with Kenedix Residential REIT in March 2018, transferring its 15-asset portfolio to the rebranded Kenedix Residential Next. In November 2019, Nippon Healthcare Investment Corporation and Japan Rental Housing Inc. announced a merger to form Daiwa Securities Living Investment Corporation. These mergers allow healthcare REITs to achieve scale immediately, while residential REITs can more easily and efficiently add accretive assets to their portfolios.

Even if acquisition opportunities emerge in the sector, however, concerns regarding the sustainability of the hospital business model are weighing on investment prospects somewhat. Improvements in efficiency will be key to easing such concerns.

One area that has seen improvement is the number of days spent per patient in acute care, which has declined from 18 days in 2010 to 16.2 days as of 2017, even while bed utilisation rates have picked up since 2014 (Graph 20). Higher patient turnover leads to higher profitability, as revenue per patient tends to decline the longer a patient spends in the hospital following surgical or other acute care procedures.

As this figure is still well above the OECD average of around 6.8 days per patient in acute care, there remains significant room for improvement. Moving forward, hospitals will ideally serve to provide emergency and specialised acute care, while long-term care facilities can accommodate those with chronic conditions that require less-intensive monitoring. Government insurance pay-outs are also adapting in order to facilitate this transition. This synergy is also why facilities that integrate nursing care and hospital functions tend to be more attractive to investors and patients alike.

To be sure, the healthcare real estate market is still finding its legs. However, demand for nursing care and medical services only stands to grow for at least the next two decades. As such, though somewhat risky, early entrants may have the potential to gain a valuable foothold before the market heats up.

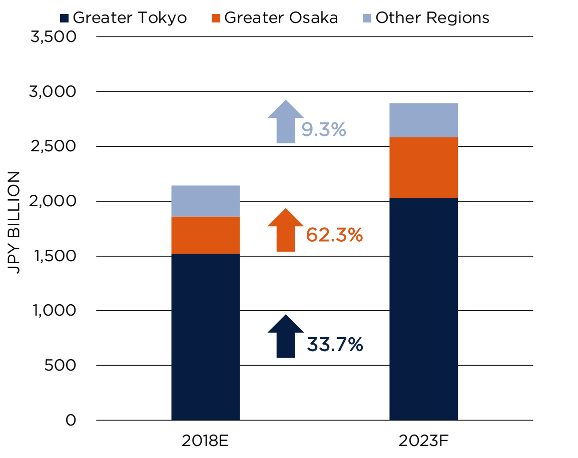
Please see our November 2018 "Japan Healthcare" report for a more in-depth analysis of the market.

Data centres

Japan's data centre market has historically been dominated by domestic telecom and network solutions providers, such as NTT, Fujistsu, Hitachi, and NEC. However, driven by the expansion of global cloud services into the country, major international players such as Digital Realty, Equinix and Colt DCS are actively deploying sizeable facilities in major metropolitan areas.

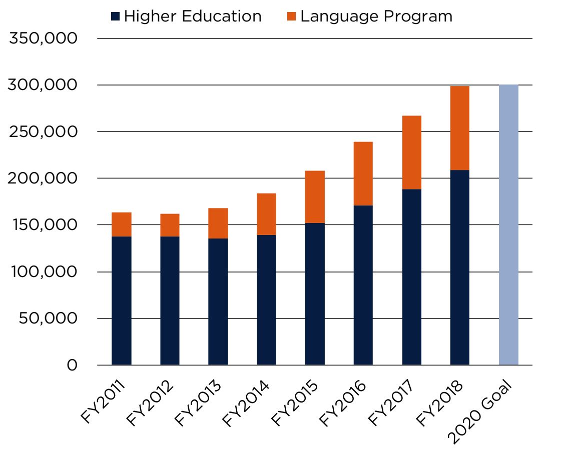
In Greater Tokyo, Inzai City has emerged as a hub for large-scale data centres. Colt DCS, for instance, has a campus with two facilities in the area and is planning to complete the third, and its largest facility in Japan, by the end of

GRAPH 22: Forecast Data Centre Services Market Value By Region, 2018 vs. 2023



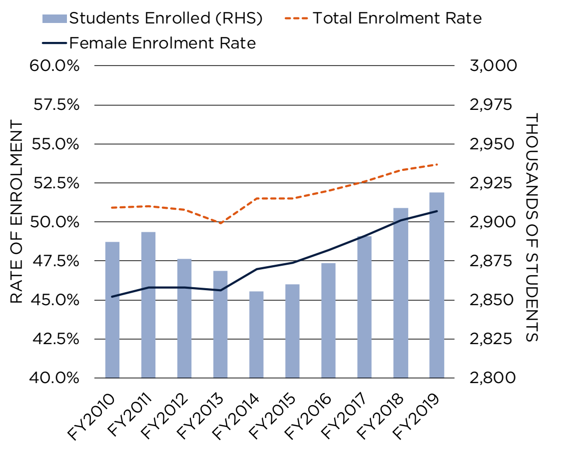
Source Fuji Chimera Research Institute, Savills Research & Consultancy

GRAPH 23: Number of International Students in Japan, FY2011 – FY2018 & FY2020 goal



Source Japan Student Services Organisation, Savills Research & Consultancy

GRAPH 24: Domestic Undergraduate Enrolment, FY2010 to FY2019



Source Ministry of Education, Culture, Sports, Science and Technology, Savills Research & Consultancy

2020. In fact, the firm reportedly sold out the capacity in its Inzai 2 facility within nine months of its completion in May 2018 and expects even stronger demand for its upcoming project, which has nearly double the capacity.

The expansion of the data centre market is not limited to Tokyo, however. According to the Fuji Chimera Research Institute, the data centre services market is expected to expand by 35% from 2018 to 2023, with the largest rate of growth occurring in the Greater Osaka region (Graph 22).

Following a deployment in Tokyo in 2016, Google successfully launched its second Japanese cloud region in Osaka in May 2019. Other global cloud service providers, such as Microsoft, have already established cloud regions in Osaka and other players appear set to expand there as well.

While Japan is geographically dense and, therefore, two cloud regions may lead to some redundancy, business continuity planning considerations have encouraged service providers to disperse their capacity in order to support disaster recovery. Osaka in particular is serving as a popular backup destination for Tokyo-based companies.

On the other hand, co-location data centres must be located in close proximity to their clients, as technicians need to be able to access locations quickly in the event of emergency maintenance or breaches of their servers. Also, though locations further from the city centre offer more space at lower cost, they generally require longer lead times to connect the appropriate energy and fibre-optic infrastructure. This has reportedly made it difficult for cloud operators to secure the land needed to develop their own facilities.

Regardless of the hurdles, with cloud operators expanding aggressively and the advent of 5G technology on the horizon, the sector is becoming a major target for real estate investment across the Asia-Pacific region. As the world's third largest economy, with relative political stability and data security, Japan will continue to be an attractive deployment zone for major cloud service providers, while domestic telecom's commitment to a swift rollout of 5G services will require more capacity to handle the resulting boom in data.

Student Housing

Despite the fact that Japan's population is aging, positive trends among the country's student population are encouraging developers and investors to embrace the student accommodations sector.

The number of international students in Japan has grown at an average annual rate of 10.8% since 2013, with the total as of FY2018 sitting just below the government's 2020 goal of 300,000 students (Graph 23). This influx of students has continued to drive demand for private accommodation in locations in close proximity to universities.

Although the number of international students should continue to grow over the long term, growth may slow somewhat in the near term as a result of the government's recent decision to impose tougher rules, specifically regarding the enrolment of foreign nationals after a Tokyo-based university lost track of 1,500 international students who overstayed their visas.

International students are not the only driver of student housing demand, however, as domestic enrolment in higher education is picking up in spite of demographic headwinds. Indeed, even while the 18 to 22 year old population has declined, both enrolment rates and the total number of enrolled students have reached historic highs, mainly driven by a strong increase in female enrolment (Graph 24).

Domestic developers have caught sight of these demand trends, with big names such as Mitsui, Tokyu, and Itochu announcing entries over the past three years. As with the healthcare sector, however, the market is still small and there are few entry points for larger investors. More opportunities should emerge as student demand grows, operators consolidate, and developers reinvigorate the subsector.

OPPORTUNITIES

A growing amount of capital is chasing global real estate, and the Japanese market has recently been drawing more interest, appearing as a fairly stable bet in a world mired in uncertainty. Hard assets became even more attractive as central banks made a dovish turn across the globe, indicating a continuation of the low interest environment and bolstering J-REIT unit prices to high levels. Leveraging these prices, J-REIT transaction volumes are likely to increase in 2020. The low-interest environment has also squeezed the returns of major pension funds, which must now allocate more capital to real estate in order to generate the yields necessary to meet obligations to pensioners. Against this backdrop, the below represent some of our views on investment strategies for Japanese real estate.

Core and Core-plus

At this late stage of the property cycle, Core and Core-plus have probably been the most popular investment targets and competition for such assets is therefore the fiercest. As a result, prospective investors face high ticket prices and are struggling to find affordable opportunities in an already-narrow field. Defensive in nature, multi-family residential assets remain very popular. Grade A/B offices in Tokyo, as well as major regional offices, continue to attract attention. Rents are steadily growing, but cap rates are highly compressed. Yet, the yield spread looks somewhat healthy and justifiable, due to lower interest rates.

Value add

Logistics facility performance softened temporarily through 1H/2019, with a historically high level of supply in both Tokyo and Osaka. Even so, driven by rapid growth in e-commerce and 3PL services, demand for new facilities turned out to be much stronger than originally expected, prompting major investors to target the sector in the second half of the year. With e-commerce penetration still lower than among global peers, the sector should continue to grow and fuel demand for advanced logistics facilities, which still account for only a small percentage of the industrial market.

Opportunistic

Inbound tourism to Japan has exploded over the past several years, drawing significant investor attention to the hospitality sector. Backed by this compelling demand story, sellers have been unsurprisingly bullish. However, an exceptionally large amount of supply coming online recently has led to some saturation. This has been compounded this year by Japan's dispute with South Korea, which has led to a precipitous drop in visitors from the peninsula. Despite the above, the long-term outlook for inbound visitation is positive.

On the operating side, a shortage of labour has led to rising costs, and there have been many new, inexperienced firms with low credit entering the market since 2014. Considering that the market is softening temporarily and that there is potential to improve hotel performance with operational acumen, 2020 might be an excellent entry opportunity, as underperforming hotels could be snapped up at a relative bargain. Also, subject to the outcome of the Unizo takeover, portfolio acquisitions through platform acquisitions and corporate transactions may become more common.

RISKS

On a long-term basis, Japan faces substantial challenges such as a declining population and excessive government debt. On the other hand, the country's stability stands out, especially amongst the backdrop of global turmoil. Indeed, with a stable government and consistent economic policy, Japan continues to avoid major social disruption. The central bank's stealth tapering is extending the life of loose monetary policy. We do not see any imminent domestic risks. Rather, global uncertainty may affect the Japanese market and abruptly alter its direction. Regarding the consumption tax hike enacted in October, though it is too early to tell, the overall impact seems somewhat manageable. That said, it could, at the very least, dampen market sentiment in 2020.

Overseas risks

The global economic and political climate is becoming more uncertain. Though Japan is relatively insulated from current global issues, the U.S.-China trade dispute is disrupting supply chains and slowing the world economy. Corporate activity has slowed across the globe as a result and financial forecasts have been revised downward. Japan has been no exception in 2019. To be sure, Japan Inc.'s performance is still at a historically high level, but revenues and profits have decreased for the last four quarters. As the current upswing is very well extended, lingering turmoil could lead to a sudden reversion in property markets. Finally, geopolitical risks continue to loom larger in East Asia. Unrest in Hong Kong is just the tip of the iceberg: if tensions in East Asia should reach a breaking point, however unlikely, the outcome would reverberate across the region - Japan included.

Interest rates

The prospect of higher interest rates appears less and less likely. The U.S. has a relatively high interest rate among developed economies, but still maintains rates at a historically low level, with additional hikes unlikely in the near term. Some European countries are seeing interest rates even lower than those of Japan. In this environment, Japan's interest rate should remain low, especially as 1) Japan Inc. has a stash of JPY500 trillion cash on hand, 2) 60% of listed companies in Japan are effectively debt-free, and 3) Household debt is moderate, at or below 60% of GDP. All of the above lead to weak cash demand in Japan. As such, we expect only mild, if any, increases in interest rates in the near future. Of course, Japanese interest rates are not independent from global rates, and shifts in the global rate environment may adversely affect the domestic market.

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